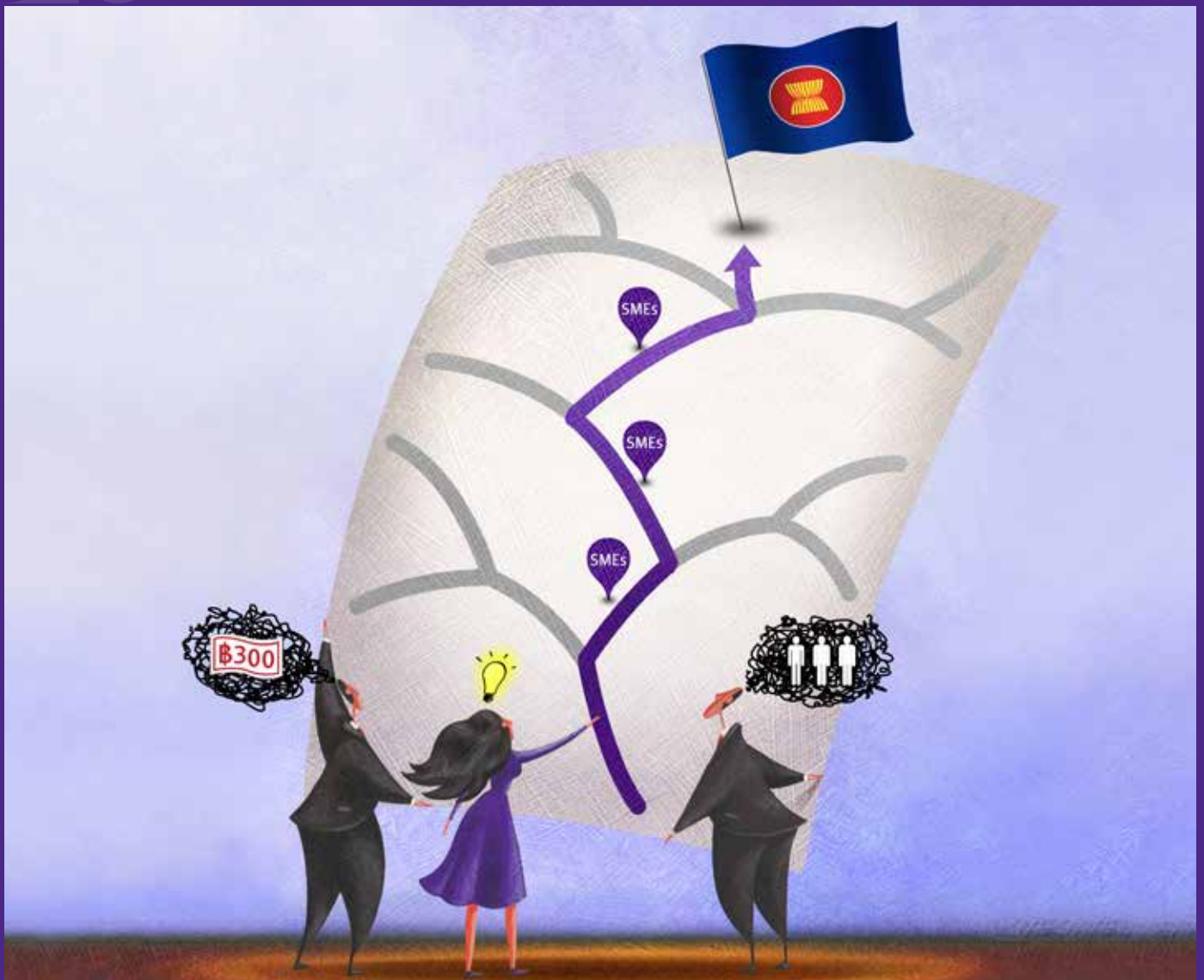




# Insight

On the road to the AEC...  
how can SMEs adapt and thrive?



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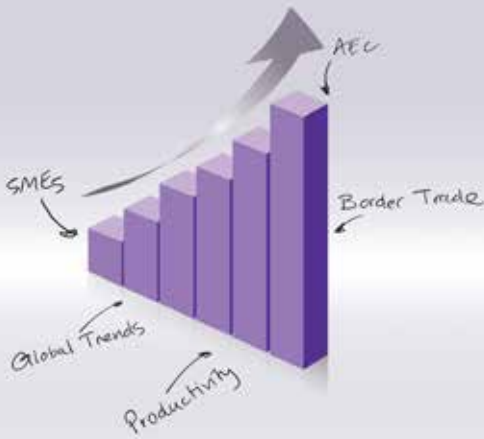
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# On the road to the AEC: how can SMEs adapt and thrive?



**Thailand's small and medium-size enterprises (SMEs) today face domestic and international conditions that are changing rapidly. Now more than ever, it is worth considering whether these SMEs are prepared to handle the challenges, and just how they might seek benefits from any opportunities that would arise.**

**SMEs face increasing challenges.** The rise of the minimum wage to 300 baht per day is a domestic factor that will directly affect operating costs, especially for SMEs in the services sector and in labor-intensive industries. Another challenge is rising shortages of labor, as more and more workers turn to self-employed jobs, and as high turnover rates result from skilled workers moving into larger industries. Thailand's integration into the ASEAN Economic Community (AEC) will also have both positive and negative impacts on SMEs. There will be more opportunities for trade and investment, but at the same time, pressures will increase.

**An analysis of the effects of the rise in the minimum wage shows that there will be both direct effects from increased**

**labor costs and indirect effects from costs passed through via other businesses in the supply chain.** Direct effects will inevitably hurt companies that rely heavily on unskilled labor and those that have labor costs as their main cost, such as these in the agricultural, services, and construction sectors. Businesses with long, complicated supply chains will be affected more from indirect costs. These businesses, such as food and beverage and vehicles and vehicle parts, will see higher costs for goods and services on the form of rising price of raw materials and logistics pushing through the supply chain. As a result, profits of these businesses will be affected by both direct and indirect effects of the raise in the minimum wage to 300 Baht. We expect that overall costs may increase up to 8% if companies are able to pass through 100% of costs. However, if the ability to pass through costs is less than 100%, the effect on costs may be reduced to 3%, but companies will still see a 4% reduction in their profits due to the burden of costs that cannot be passed through.

**Aside from the rise in the minimum wage, labor shortages also present a challenge to SMEs.** As the Thai labor force is expected to begin decreasing after 10 to 15 years from now, a scarcity of workers will become a large problem, especially in the manufacturing sector, where the effects can already be seen. Many Thai workers have turned to self-employed jobs. And there is a significant skill mismatch issue, involving an insufficient supply of the skills and experience that businesses need from workers. This means that workers will be harder to find and SMEs will have to pay more attention to increasing labor productivity







**SMEs that suffer direct and indirect effects from the minimum wage hike should act promptly to increase labor productivity.** They can do so by such methods as using technology to reduce reliance on labor. These companies should also increase value-added to their products and services, while training workers and upgrading skills to enhance labor efficiency.

**SCB EIC has surveyed the opinions of SMEs regarding business prospects and their readiness to handle both domestic and external factors.** Overall, SMEs are optimistic about the next one to two years, despite the challenges, especially the rise in the minimum wage. SMEs assess that the higher minimum wage will raise manufacturing costs by an average of 12%, which is higher than overall industries impact estimated by EIC. The service sector expects to be affected the most, because it relies on high levels of labor and is less able to pass through costs to consumers. SMEs also face the issue of labor shortages, especially among companies that require skilled labor, because they are unable to meet this need with foreign unskilled workers. However, most SMEs have started to implement new technologies to reduce long-term costs.

**Regarding the AEC, most SMEs have little understanding or knowledge about it, and believe that liberalizations will have either a positive impact or none on their business.** Businesses in the agricultural and manufacturing sectors foresee opportunities for exporting into ASEAN, while retail and services businesses see prospects to build new

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business alliances. On the other hand, Thai SMEs are also concerned about an increase in competition from within ASEAN. Most SMEs have prepared for this pressure by finding cheaper raw materials in ASEAN and improving their internal structures.

**Beyond getting ready for new challenges, Thai SMEs need to look into opportunities to expand trade and investment in many different forms, such as through border trade, by operating businesses in response to global trends, and expanding investment into neighboring countries.**

**Border trade is an opportunity that SMEs should not overlook.** Trade routes with neighboring countries still offer plenty of potential for growth, especially for various consumer products and construction goods. Demand in both categories has been growing a lot recently. Cross-border trade is another interesting channel for SMEs, especially the opportunity to trade with an economic superpower like China, which has a large consumer market with ever higher purchasing power. If overland transportation to China improves and becomes more convenient in the future, opportunities for trade will increase. Moreover, the establishment of Special Economic Zones over the border in neighboring countries will also add additional channel for trade and investment for SMEs that can supply raw materials, products and services to accommodate growth in these zones or construct amenities in them.

**Global trends generate a variety of opportunities for Thailand's SMEs.** For example, innovations in communications technology, such as social networks, are marketing tools that can

empower SMEs to become more competitive. For example, these innovations present new opportunities to respond to fast-growing demand in emerging markets. There is also rising demand in niche markets, such as among environmentally conscious consumers, which generates growth potential for “green” businesses. Opportunities even result from the changing demographics of aging societies. These are all quite major opportunities for SMEs.

**Thai SMEs should also utilize opportunities from liberalizations under the AEC to expand trade and investment into neighboring countries with lower manufacturing costs, which can help competitiveness.** The best trade and investment opportunities for Thai SMEs are in Cambodia, Laos, Myanmar and Vietnam, known as the CLMV countries. **Industries that present opportunities for market penetration include trading,** especially consumer goods and goods related to housing and construction materials, as well as construction services, vehicle repairs, **travel services and businesses which create linkages with export manufacturers.** In considering investment destinations, companies should study which competitive advantages they can best build upon, in order to choose the appropriate country and find the right business alliances. SMEs should target business investments to best suit the business sectors that the destination country is officially supporting. If companies invest in businesses that enjoy the support of the target country's government, barriers will be reduced and investment returns will be higher.

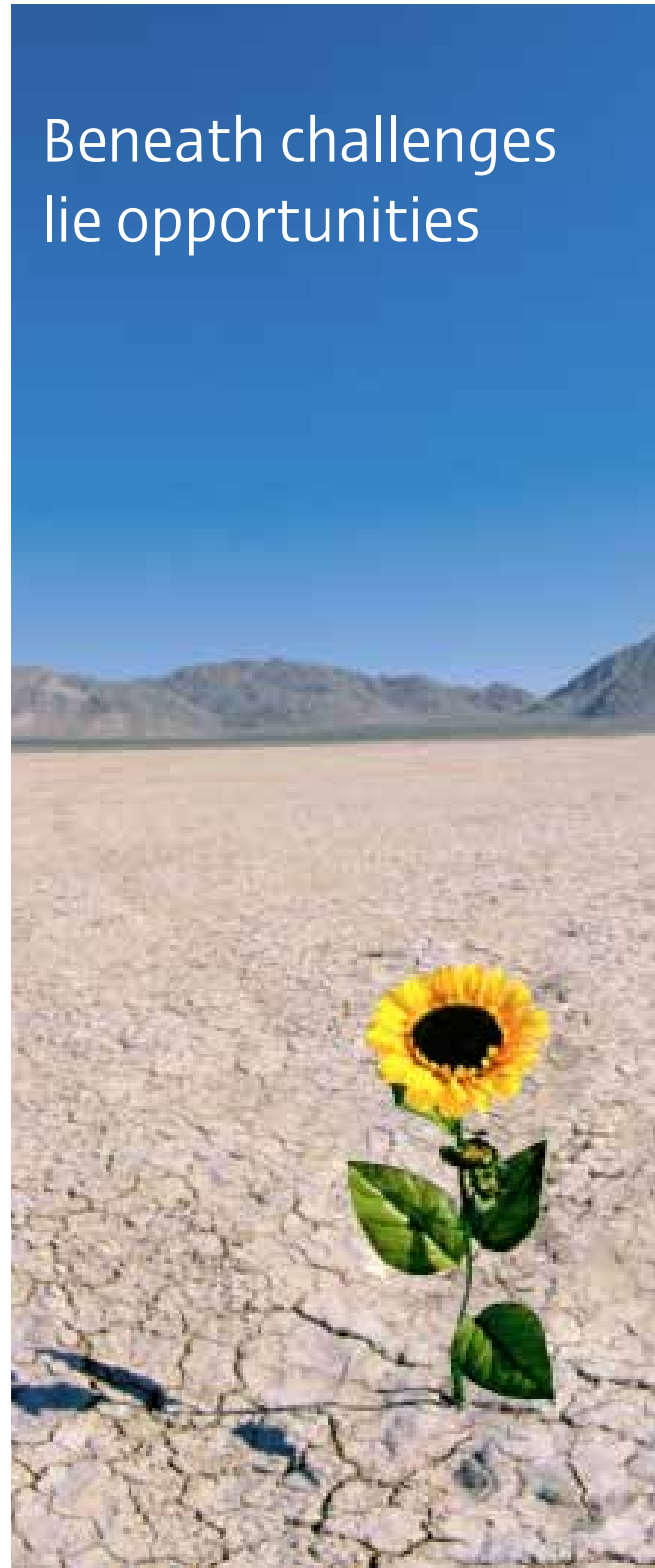
**It is now time for Thai SMEs to transform negative impacts from such factors as rising labor costs into motivators to develop to the next level.** In reality, Thai SMEs have many channels through which to expand, such as via border trade, capturing

new markets and adapting to changes in consumer behaviors, as well as seeking opportunities from AEC liberalizations. Because of increasing competition in regional and global markets, consumers can more easily purchase goods from many different suppliers. Prices of goods will therefore likely decrease, unless entrepreneurs increase the value of their products to support higher prices. So now is the time for SMEs to leave their comfort zone in traditional domestic markets to find new channels to increase earnings and counter profit erosion from rising domestic costs.

*In producing this report, we received great cooperation from the Federation of Thai Industries, in co-hosting seminars and focus groups to enable the exchange of opinions, and in conducting surveys with SMEs throughout Thailand. Such activities provided an understanding of SMEs capabilities and their readiness for future competition. In addition, research on border trade were generated in part from case studies provided by participants in the 12th SCB Young Entrepreneur Programs.*

*SCB EIC would like to take this opportunity to thank these parties for their cooperation.*

## Beneath challenges lie opportunities



# 1 Key factors that affect SMEs

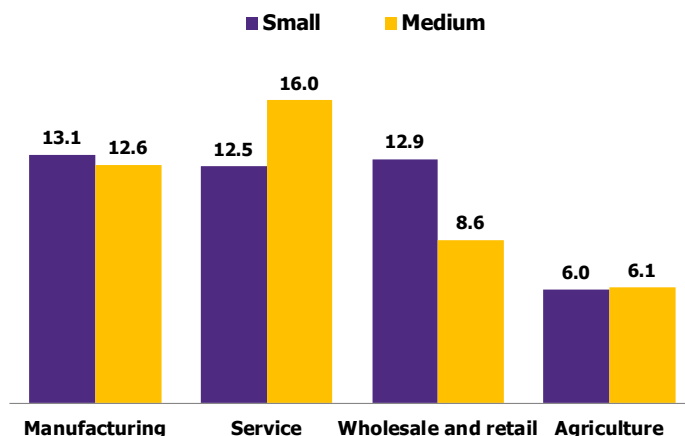
The business environment has both significant direct and indirect impacts on every company’s operations and success. All organizations, including SMEs therefore need to adapt quickly to changes in the business environment in order to gain competitive advantage; to reduce obstacles that may result from these changes; and to help shape change-related policies and strategies.

The Thai government’s recent policy to raise the minimum wage to 300 Baht per day is a domestic external factor that will affect all SMEs by raising their operating costs. This will, especially, affect SMEs in labor-intensive industries, such as furniture, garments, textiles, jewelry and leather, and even companies in the service industry that require large inputs of labor such as hotels, restaurants, construction contractors and transport operators. Analysis shows that the wage rise will have a larger impact on small businesses than on medium-size ones, because small companies will have a harder time adapting. In services industries, which mostly involves hotel, real estate and construction businesses, medium-size companies will be more affected. This may be because these companies have a higher share of employment costs related to providing a high quality of service.

**1** The rise of the minimum wage to 300 Baht per day will have the most impact on service sector, due to their higher reliance on labor.

The impact of 300 baht minimum wage policy on production cost of SMEs entrepreneurs

Unit: % to overall production cost



Source: SCB EIC analysis based on data from nationwide SMEs survey



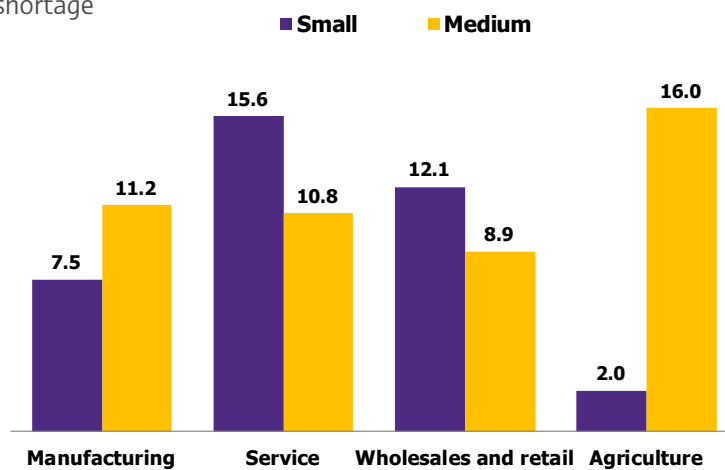


Another factor to consider is that many workers in Thailand are moving towards self-employed jobs, in order to gain more freedom in their jobs, get higher earnings than working as employees, and enjoy greater choice of work. The result is an overall shortage of labor and high turnover rates in the industry. Skilled workers with high expertise tend to favor working for large businesses with higher pay and better career opportunities. SMEs therefore face increased costs and reduced efficiency due to the departure of workers and having to train replacements in order to function up to required standards. According to surveys of SME entrepreneur nationwide show that medium-size firms in the agricultural sector face a more severe shortage of labor than other types of businesses. This is due to a change in attitude among that industry’s traditional labor pool, whereby potential workers increasingly desire employment in more comfortable, less physically demanding sectors.

## 2 The services sector will face the worst shortages of labor on average

The magnitude of labor shortage problem (classified by sector)

Unit: % of labor shortage



Source: SCB EIC analysis based on data from nationwide SMEs survey

Factors will also affect Thai SMEs. The main factor is the liberalization of trade and investment as well as various impacts of the ASEAN Economic Community (AEC), which will inevitably have both positive and negative influences on SMEs. Despite opening more opportunities for trade and investment within ASEAN, the AEC will also mean fiercer competition. More large enterprises and more imported products will enter the Thai market and steal market share from local SMEs. Thai companies will therefore have to adjust to cope with higher competition, which will become more extreme in fewer than three years from now.

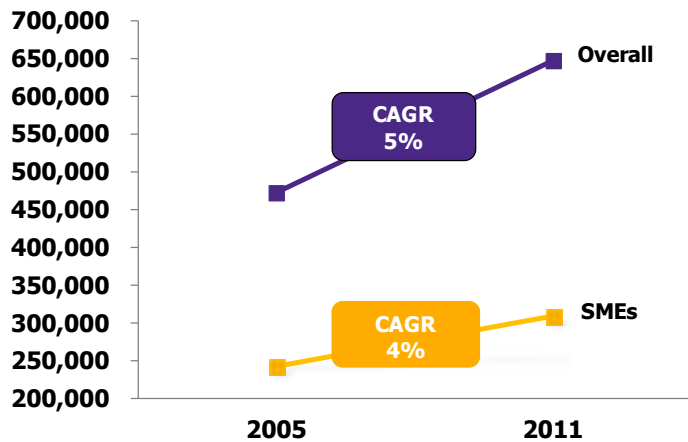
**At the same time, the strictness of Non-Tariff Barriers (NTBs), especially those concerning the environment and hygiene, seems to keep growing in importance.** This includes retro-inspection policies, whereby all product parts must be traceable back to the original manufacturer and supplier of raw materials. This particularly applies to goods in the agricultural sector. We expect that most SMEs will be affected significantly, because many of their manufacturing processes are not up to international standard and their raw materials' origins often cannot be traced. Ultimately these SMEs may find themselves cut off from the global supply chain of big companies. Already, large exporting countries like China, South Korea and many others in Asia have enacted policies to handle stricter environmental and hygienic regulations among their trade partners.

**Aside from domestic and international challenges, SMEs also face technological limitations and lesser ability to innovate compared to large companies.** Most SMEs rely on manufacturing techniques that are unsophisticated, while most operators and workers also lack adequate knowledge and skills needed to implement new technologies. SMEs therefore have lower manufacturing efficiency compared to large ones. They also lack the product development and innovation needed to match international standards. The implication is that the business opportunities for SMEs will depend on their ability to adopt new technologies and innovations on the one hand, and on the other hand, to differentiate their products based on their expertise in craftsmanship, which is a remarkable competitive advantage of many SMEs in Thailand.

### 3 Labor productivity among Thailand's manufacturing sector SMEs has a lower growth rate compared to Thai industry as a whole.

Labor productivity in manufacturing sector

Unit: Baht per labor



Source: SCB EIC analysis

In the face of changes and new challenges, SME operators should seek opportunities by analyzing and evaluating their current capabilities to see how they should best respond. They should also seek to discover opportunities from changes in the business environment, whether in global trends, in new markets resulting from border trade and changes under the AEC, or in ASEAN's increasing prospects for foreign direct investment.

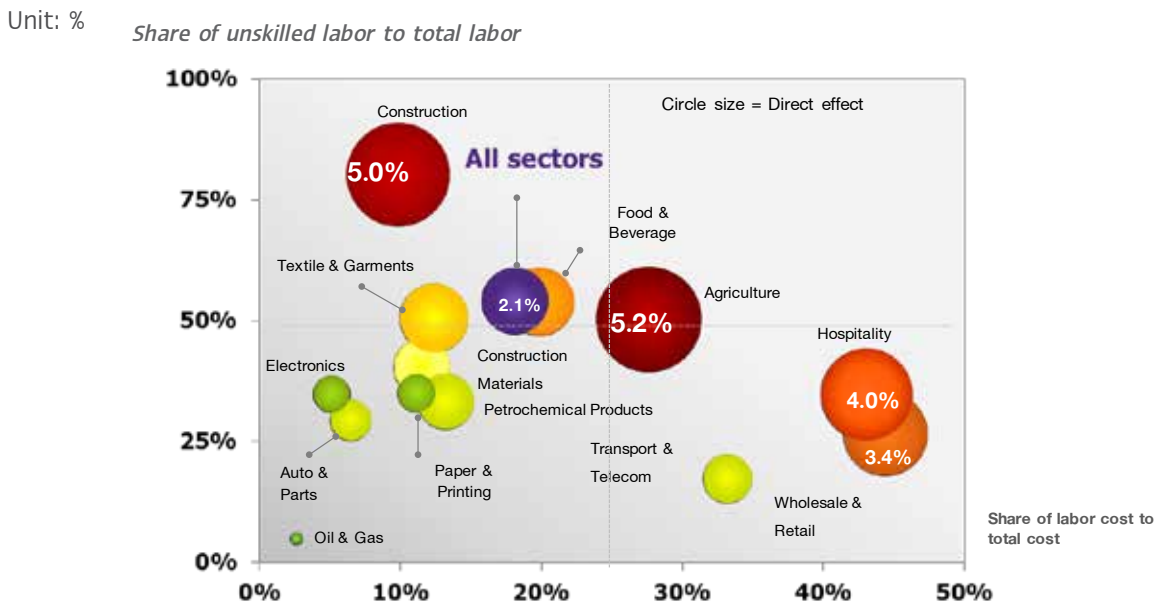
# 2 Analyzing the minimum wage hike and cost pass-through

The policy to raise the minimum wage to 300 Baht per day is a factor that will affect both SMEs and larger businesses. Not only will the rise have a direct effect on a company's costs, it will also have an indirect effect from higher costs passed through the supply chain. All SMEs and big businesses will therefore inevitably be affected by the wage increase. Each sector will be impacted by a different magnitude, depending on the sector's proportion of unskilled labor, ratio of labor costs to all costs, and ability to pass costs through the supply chain.

The wage hike will directly affect production costs by 2% on average across all industries. Sectors having a high proportion of unskilled labor or having labor costs as the main cost, such as the agricultural sector, the services sector – particularly construction and hospitality – and wholesale & retail, will be first to suffer from a direct loss in profit. SCB EIC's analysis suggests that agriculture will be most directly affected, because over half of its labor is unskilled and labor costs make up nearly 30% of all production costs. Construction is the second most directly affected; while labor costs make up only 10% of production costs in this sector, unskilled labor accounts for 80% of all construction labor. Conversely, hospitality and wholesale & retail have only 30% unskilled labor, but labor costs make up 40% of all costs in these two sectors, leaving them significantly affected by the wage hike.

## 4 The direct effect of the minimum wage hike will be highest in sectors having a large proportion of unskilled labor or in sectors having a large proportion of labor costs as part of total production costs.

Direct effect of minimum wage increase (both rounds) by sector



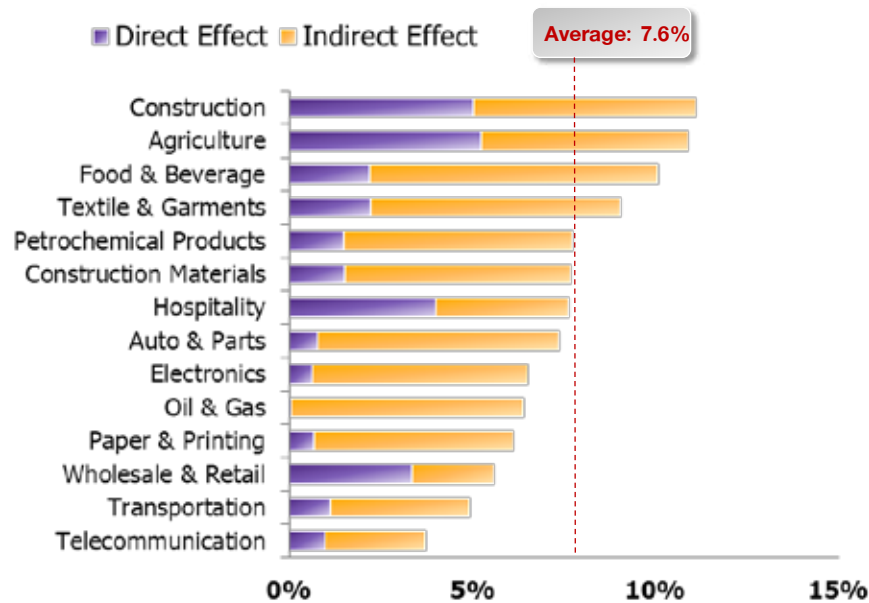
Source: SCB EIC analysis based on data from 1Q/2010 Labor Force Survey and NSO's 2005 Input-Output Table

When indirect effects are taken into consideration, businesses having long, complex supply chains will be indirectly affected, even though they may suffer less direct effects. The impact on them comes from costs being passed through by related businesses. In the long run, because businesses can adjust to higher costs by passing them through the supply chain, the minimum wage hike creates indirect effect from rising costs of raw materials and transportation. In the case where suppliers are able to pass 100% of their increased costs as a result of the minimum wage hike, the food & beverage sector will be the most impacted because it has a long and complicated supply chain. Also affected more indirectly than directly are sectors related to oil & gas, auto & parts, textile & garments, and electronics. The overall direct and indirect effects of the rise in the minimum wage will increase production costs in the system by an average of 8% in the case where businesses are able to pass 100% of their costs through the supply chain.

**5** If 100% of costs are passed through in all sectors, production costs will increase by 8% in the long run, due to the indirect effects of pass-through costs in the supply chain.

Direct and indirect effects of minimum wage increase (both rounds)  
In the case of 100% cost pass-through rate

Unit: %



Source: SCB EIC analysis based on data from 1Q/2010 Labor Force Survey and NSO's 2005 Input-Output Table

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**The reality, however, is that the ability to pass through costs varies from sector to sector, and it is unlikely that companies will be able to pass through 100% of costs from the wage rise.** By using the impact of the weakening of Baht on the cost of importing raw materials, research by the Bank of Thailand on inflation dynamics shows that the passing-through of costs from producers to consumers in the long run is only 25-35% on average. Moreover, we believe that different sectors have different abilities to pass through costs, depending on the bargaining power of individual business, especially when there is high domestic and international competition. Another factor that can determine the pass-through rate is how much the demand for related products or services is likely to grow. With these two factors in mind, we have categorized sectors into five groups according to ability to pass costs through. In order to show that the difference in the impact of the minimum wage rise varies when less than 100% of costs can be passed through, we examine two cases to more accurately measure the indirect impact. The results of the aforementioned research by the Bank of Thailand serve as a guideline in the analysis.

#### **1. Base Case**

There are five levels of pass-through rates, ranging from 10% to 50%, depending on the sector's ability to pass costs through. The average pass-through rate is 30%, close to the results shown in the Bank of Thailand's research.

#### **2. High Pass-through Case**

There are five levels of pass-through rates, ranging from 30% to 70%, depending on the sector's ability to pass costs through. The average pass-through cost is 50%, or 20 percentage points higher than the results shown in the Bank of Thailand's research. This is because the Bank of Thailand's research analyzes the impact of the weakening of the Thai Baht, while the rise in the minimum wage has a more immediate impact. If the rise in minimum wage happens within a short period of time, it can create a systemic shock that leads concerned businesses to attempt to raise prices as much as possible throughout the system.



## 6 A sector's ability to pass costs through varies depending on its bargaining power and demand outlook.

### Cost Pass-through Ability by Sector

Sector	Ability	① Base Case	② High Pass-through Case	Bargaining Power		Demand Outlook	
				Level	Reason	Level	Reason
Paper & Printing	Medium-	20%	40%	Low	Upstream business	Medium	Paper use reduction
Agriculture	Medium-	20%	40%	Low	Upstream business	Medium	Oversupply
Wholesale & Retail	High	50%	70%	High	Downstream business	High	Necessary goods
Hospitality	Medium-	20%	40%	Low	High competition	Medium	Oversupply
Oil & Gas	Medium	30%	50%	Low	Price controls	High	Necessary goods
Petrochemical Products	Low	10%	30%	Low	Upstream business	Low	Export contraction
Construction	Medium	30%	50%	Low	Contractual agreement	High	Public and private investment
Transportation	Medium	30%	50%	Low	High competition	High	Connectivity and urbanization
Telecommunication	Medium	30%	50%	Low	High competition	High	3G network
Auto & Parts	Medium	30%	50%	Low	Contractual agreement	High	First-car policy
Construction Materials	Medium	30%	50%	Low	Price controls	High	Construction growth
Textile & Garments	Medium	30%	50%	Low	Upstream business	High	Necessary goods
Food & Beverage	Medium+	40%	60%	Medium	Some price controls	High	Necessary goods
Electronics	Medium-	20%	40%	Medium	Midstream business	Low	Export contraction

### Cost Pass-through Rate

Level	Assumptions	
	① Base Case	② High Pass-through Case
High	50%	70%
Medium+	40%	60%
Medium	30%	50%
Medium-	20%	40%
Low	10%	30%

Source: SCB EIC analysis

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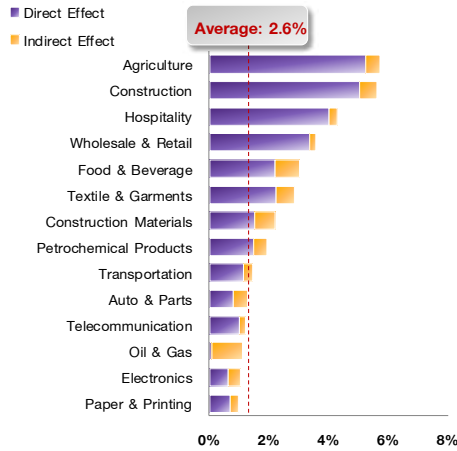
**When businesses are unable to pass through 100% of rises in prices of products and raw materials, operators in the next stage of the supply chain will be less indirectly impacted. In such case, the combined direct and indirect impact on the business sector averages 3%, considerably less than in the case where 100% of costs are passed through.** When considering only indirect impacts from pass-through costs, sectors with long and complicated supply chains are still more indirectly impacted than those with shorter supply chains. Oil & gas sector, in particular, is the most indirectly affected, due to the complexity of their supply chain. There is thus a higher chance of operators being affected by cost pass-through in one way or another. The food & beverage, construction materials, and textile & garments sectors are the next most affected. Businesses with shorter supply chains, such as transport and telecommunications, receive little indirect impact. Businesses with the most costs already coming from labor costs, such as wholesale & retail and hospitality, will also not experience a strong indirect impact. Furthermore, when comparing the overall effects in the base case and the high pass-through case, we found that the increase in the average (direct and indirect) impact from the base case to the high pass-through case is 23%, which is more severe than the difference in the average rate of cost pass-through (20%). This may mean that overall production costs are highly sensitive to the sector's ability to pass costs through.

**From consumers' perspective, the differing impacts of cost pass-through on various sectors will translate into different increases in prices.** Because the ability to pass-through costs from the minimum wage rise varies among sectors, consumers should start to see a variety of different increases in prices for their everyday purchases. For example, prices of fresh food products that are sold in the fresh market may increase only slightly, whereas prices of instant foods sold in grocery stores will increase more significantly. The hospitality sector will not see a large impact on service prices, due to current conditions of high competition in the absence of strong demand, especially in the hotel business.

## 7 The impact of the minimum wage hike on production costs has improved in cases where less than 100% of costs are passed through.

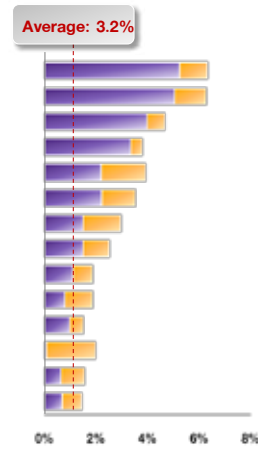
Direct and indirect effects in base case

Unit: %



Direct and indirect effects in high pass-through case

Unit: %

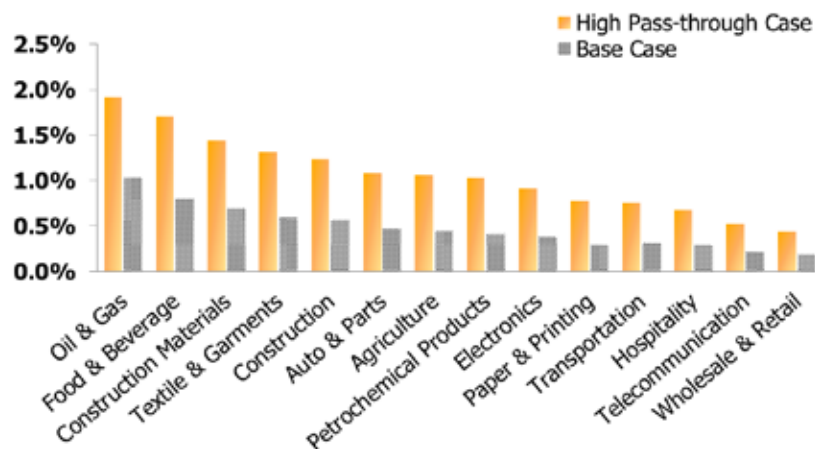


Source: SCB EIC analysis based on data from 1Q/2010 Labor Force Survey and NSO's 2005 Input-Output Table

## 8 Indirect effects on production costs from the minimum wage hike is higher in sectors with long and complex supply chains.

Indirect effect of minimum wage increase on production cost in both cases

Unit: %



Source: SCB EIC analysis based on data from 1Q/2010 Labor Force Survey and NSO's 2005 Input-Output Table

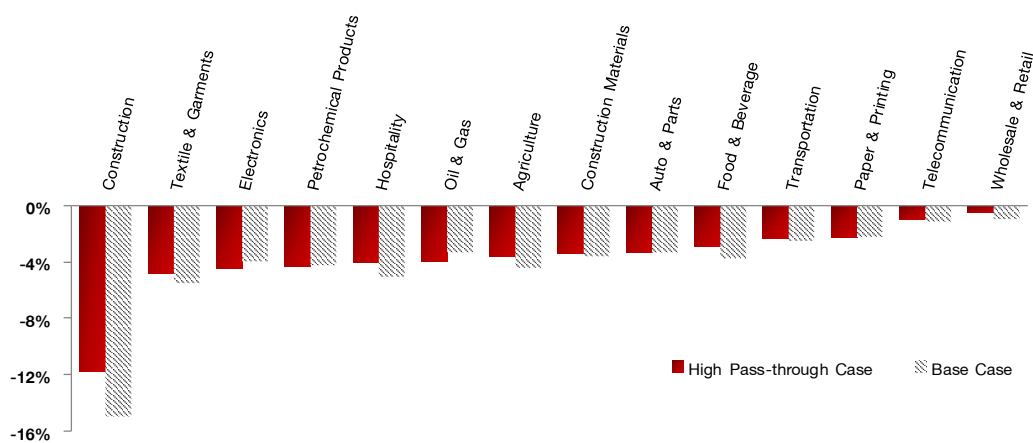
From a business perspective, even though costs may not rise by much if suppliers are unable to fully raise the price of their products and services, returns to the operators themselves will also decrease because the operators too will be unable to pass through costs to the business in the next stage of the supply chain.

In the two hypothetical cases where the business is able to pass through less than 100% of the increase in costs, SCB EIC's estimates using NSO's 2005 input-output table show that the overall returns of the system (excluding returns outside production) that have decreased as a result of lower passed-through costs will be around 230-240 billion Baht, or 3.3-3.4% of 2005's GDP. The margin between manufacturing income and manufacturing costs will be reduced by an average of 4%, which represents a large impact on the economy and turnover. When looking at individual sectors, it is apparent that margins in the construction, textile & garments, hospitality, agriculture, petrochemical products and electronics are the most affected. This results from the high impact of the minimum wage hike on production costs relative to the ability to pass-through costs as per our assumptions.

## 9 Production returns by operators are likely to decrease when the ability to pass-through costs decrease, because operators themselves are unable to fully raise prices of goods and services.

The decrease in the margin (production compensation less production cost) in the case of <100% pass-through rate

Unit: %



Source: SCB EIC analysis based on data from 1Q/2010 Labor Force Survey and NSO's 2005 Input-Output Table

# 3 Labor productivity: the big question for Thai SMEs

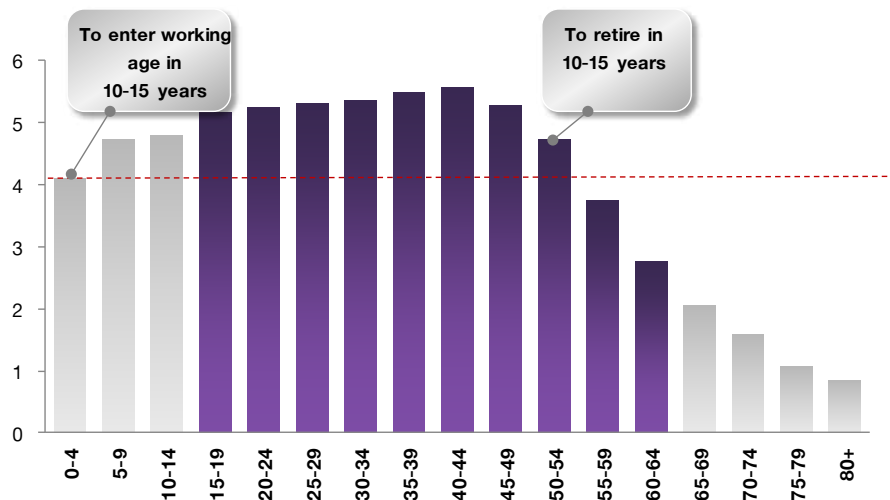
Because SMEs rely heavily on labor to operate, labor-related factors have a direct impact on the survival of businesses. Aside from problems regarding the rise in the minimum wage, labor shortages are also becoming a matter of concern for SMEs. Considering that labor shortages may worsen within the next decade, SMEs will have to increase their labor productivity in order to continue to grow.

Within the next 10 to 15 years, the Thai labor force, which has been a major factor driving Thailand's economic growth, will begin to decrease. In order for the economy to expand, Thailand will have to shift its workforce into sectors that can increase the value of labor and increase labor productivity. Expansion of the labor market has contributed more than half of the expansion of the Thai economy from 2005 through 2011. But the Thai labor force will start to shrink in the next 10 to 15 years, as the labor force that will retire during that period starts to outnumber the population entering working age. Due to this trend, Thailand's future economic stability will depend on increasing labor productivity. This could take place by shifting workers from business sectors with low labor productivity into sectors with high labor productivity, or by increasing productivity per worker in every business sector.

## 10 In the next 10 to 15 years, the Thai labor force will start to shrink as retiring workers outnumber those reaching working age.

Thailand's population structure, 2011

Unit: million persons



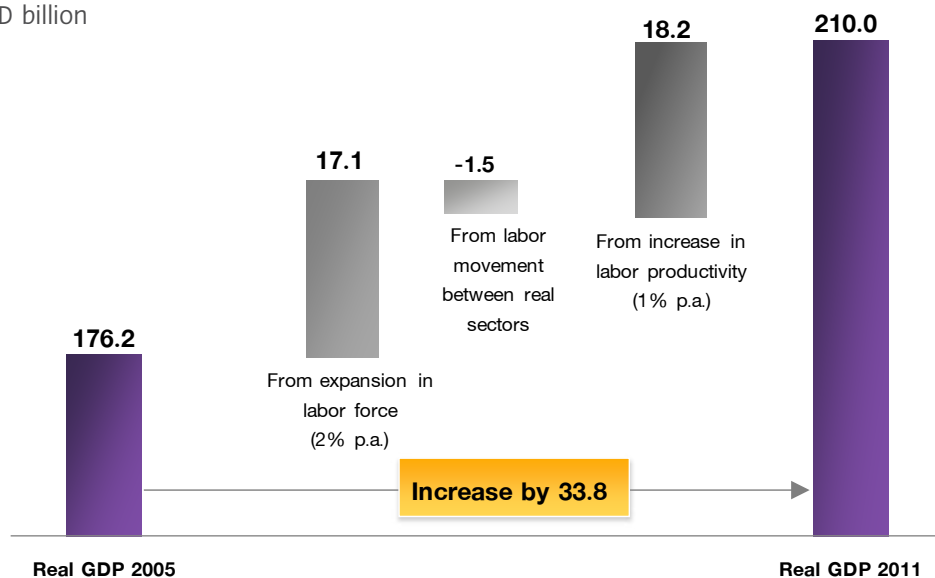
Source: SCB EIC analysis based on data from NESDB and APO Productivity Database 2012



## 11 Because the Thai labor force will shrink, the economic growth will depend on shifting workers from low productivity sectors into high productivity ones and increasing labor productivity in every sector.

Sources of GDP Growth of Thailand, 2005-2011

Unit: USD billion



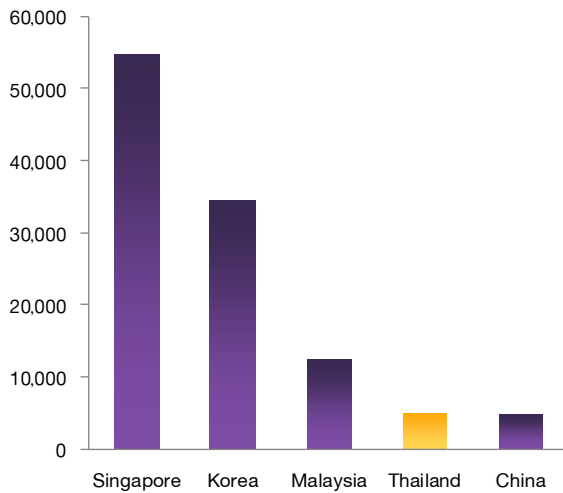
Source: SCB EIC analysis based on data from World Bank

The past few years, however, have seen low growth in Thai labor productivity. The current labor productivity also stands at a low level, especially compared to our closest competitor like Malaysia. Thai labor productivity stood at 4,900 US Dollars per person in 2011 (at year 2000 prices). Between 2005 and 2011, Thailand was able to increase productivity by only 1.4% per year, lower than during the period between 2000 and 2005, when there was a 3.8% increase per year. Compared to the major competitor Malaysia, Thailand's disadvantages are even clearer. Even though Malaysia's labor productivity growth has also been the same as Thailand, at 1.4% during 2005-2011, Malaysia already has a high level of labor productivity, at 12,000 US Dollars per person in 2011 (year 2000 prices). In China, which is a developing country with a labor productivity level now similar to that of Thailand's, the productivity of labor is growing at a high rate of 10% per year. It appears that Thailand will be stuck in the middle-income trap for some time and will soon be surpassed by China and left far behind by Malaysia if it is unable to increase labor productivity at a higher rate.

## 12 Thailand's labor productivity is weak compared to Malaysia's, and appears likely to soon be surpassed by China's.

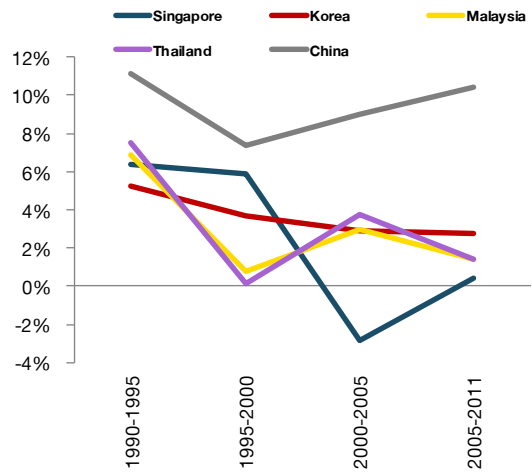
Thailand's labor productivity (2011)

Unit: USD at year 2000 prices



Labor productivity growth

Unit: %CAGR



Source: SCB EIC analysis based on data from IMF and World Bank

### Shifting workers into business sectors with high labor productivity is one way to increase labor productivity.

Thailand's manufacturing sector is a sector with high labor productivity, at 12,000 US Dollars per person in 2011 (at year 2000 prices), while agricultural sector productivity stands at just 1,700 US Dollars and services sector productivity at only 5,000 US Dollars. However, most of Thailand's labor force is employed in the less productive sectors, with 40% working in the agricultural sector, 46% in the service sector and only 14% in the manufacturing sector. As a result, the average labor productivity is skewed down to 4,900 US Dollars per person. It is clear that in order to push Thailand out of the middle-income trap, one solution involves shifting workers from the agricultural and service sectors into more productive sectors.

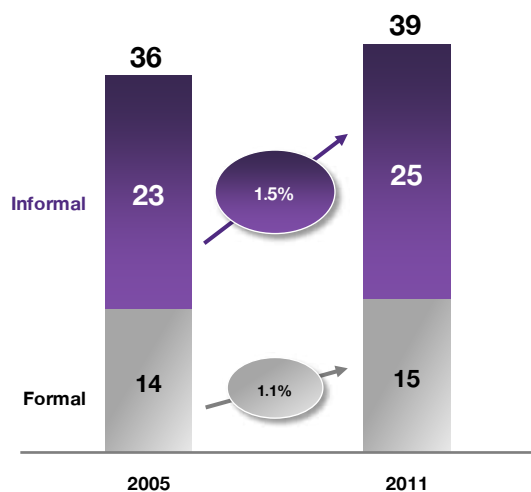
## BOX: Where has the Thai workforce gone?

Labor shortages will need to be considered before attempting to shift workers into the manufacturing sector. Thai manufacturers currently face severe shortfalls of workers. SCB EIC’s analysis found that, beyond the problem created by workers clustering in the agricultural and service sectors, many Thais opt for self-employed job instead of seeking steady jobs with employers like manufacturers. This only adds to the problem of labor shortages and underscores the importance of creating stronger employment incentives that are not just about financial rewards. The work freedom and income opportunities available in public transport services continue to drive growth in the number of transport drivers for hire. There are currently over 103,000 registered taxis. Adding this figure to the number of motorcycle and tuk-tuk drivers shows that there are around 260,000 workers in these three groups in Bangkok. Aside from work independence as a major motivator, the average earnings per month of these drivers are higher than that of minimum-wage workers in manufacturing plants. However, those figures do not count benefits and overtime, which are definite advantages of working as employees.

### 13 One factor leading to labor shortages in the manufacturing sector is growing employment outside the formal sector.

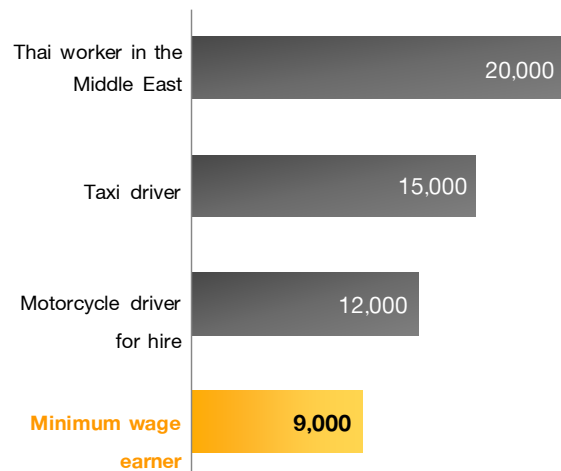
Growth in formal and informal labor force

Unit: million persons, %CAGR



Average salary of informal labor force

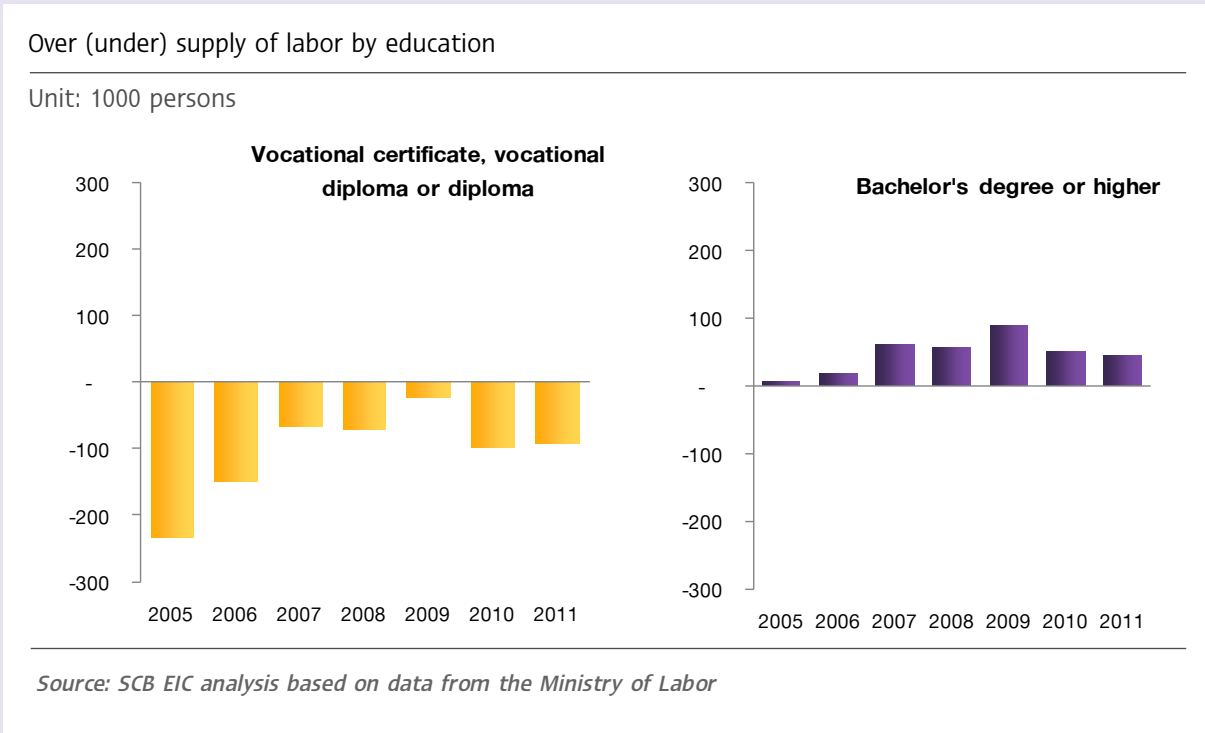
Unit: Baht per month



Source: SCB EIC analysis based on data from the National Statistical Office

**A skills mismatch also contributes to labor shortages.** Many businesses in Thailand, especially in the manufacturing sector, face shortfalls of semi-skilled workers, particularly those having vocational degrees. On the other hand, there is an abundance of workers who have a bachelor's degree or higher qualification. Workers with tertiary degrees are not fit for the demands of the manufacturing sector, because they have not received vocational training. Moreover, educational curriculums lack adaptation to suit the needs of industry. Research by the World Bank shows that over 30% of Thai workers with tertiary education end up working in jobs for which they are overqualified and in jobs that do not match their training. Thailand has always had to rely on foreign workers to meet needs in the manufacturing sector, but this reliance is not a long-term solution, because many foreign workers will be tempted to return home as the AEC is implemented.

**14** A major skills mismatch results from businesses' greater demand for workers with vocational degrees than actual supplies, while there are too many workers having qualifications at the level of a bachelor's degree or higher. This mismatch contributes to labor shortages.



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**Solving the problem of workers turning to self-employed work, as well as the skills mismatch problem, will require cooperation from many sides.** In order to increase labor productivity and production competitiveness, the educational sector should increase education quality, create more courses adjusted to suit the demands of the manufacturing sector, and change public attitudes about vocational schooling. The private sector should better incentivize workers beyond monthly salary in order to lure self-employed workers back into the manufacturing workplace. The private sector should also better recognize the importance of investment in labor skills development, and push for such investment as in the case of the “One School, One Factory” scholarship which has emerged within the automobile manufacturing sector. This program awards scholarships to students who wish to receive job training in factories while studying on the weekends within a timeframe of 3 to 7 years to earn a vocational or bachelor’s degree, with a job guaranteed after graduation. These kinds of programs can accommodate the demand for labor so that businesses can continue to grow in the future.

**But because Thailand is an agricultural country, we should also focus attention on adding values to farm products. Shifting from traditional agriculture into industrial agriculture is another way to increase productivity.** Since Thailand relies mainly on agricultural production, operators need to be persuaded to see the importance of transforming farm products to add value. For example, over 90% of natural rubber is exported in raw form, such as concentrated latex and smoked rubber sheet. Yet rubber can be used to make many middle-end and high-end products, including tires, gloves for medical or industrial use, and various types of engineering material. Spent rubber trees can also be used to make furniture and industrial crafts, which will add productivity to labor inputs.

**Another way to increase the nation’s overall labor productivity is to encourage each business sector to increase product value and use the opportunity presented by the minimum wage rise to sustainably improve the workforce’s quality. In particular, SMEs, which are most affected by the minimum wage rise, should be the first to act.** The minimum wage hike will force many SMEs to reduce their workforce to reduce costs. But in order to continue to grow, companies should adapt to increase labor productivity and sustain that increase. **This applies especially to businesses that are more directly affected by the minimum wage hike,** namely in sectors with high proportions of unskilled labor or those with labor costs as the main cost, such as agriculture, construction, hospitality, and wholesale & retail. **Businesses that are indirectly affected from costs passing through long and complex supply chains,** such as food & beverage, oil & gas, auto & parts, textile & garments, and electronics, should also increase labor productivity. Beyond those businesses that most need to adapt, other business sectors can also play their part in increasing the nation’s overall productivity. Compared to Malaysia, productivity in all of Thailand’s business sectors is still considerably lower. In part, this is because Malaysia is better equipped to add value to products, especially in the agricultural and services sectors.

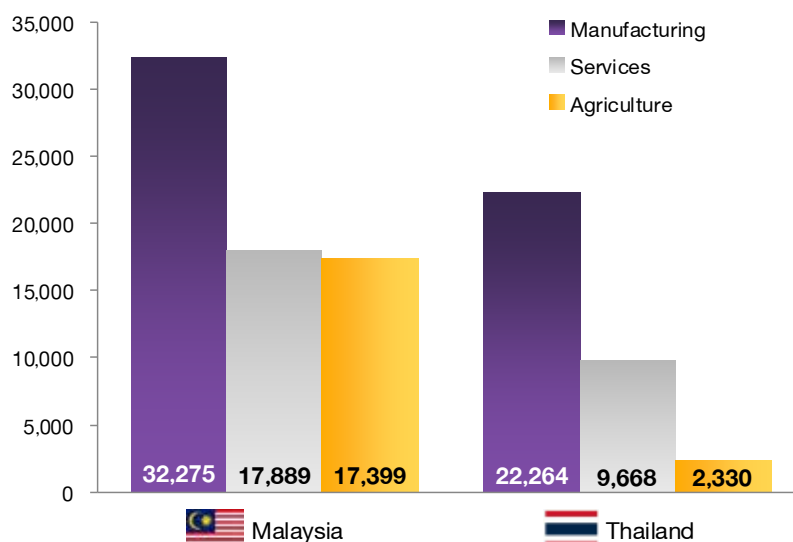
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## 15 Compared to productivity in the manufacturing sector, productivity in Thailand’s agricultural and service sector is considered still low.

Thailand’s and Malaysia’s labor productivity by real sector, 2010

Unit: USD per employment (year 2010 nominal price)



Source: SCB EIC analysis based on data from CEIC

Given Thailand’s labor shortages, increasing productivity is an inevitable need. SMEs in particular, because they rely heavily on labor, need to quickly adapt to boost productivity, such as by developing their workers’ abilities through training to improve skills so as to produce goods with higher quality and value. If SMEs are able to increase their labor productivity, the government’s minimum wage hike will have little impact, because companies will be able to pay their workers more than the minimum wage thanks to higher productivity.

## BOX: Examples of SME efforts to adapt to the minimum wage hike.

It is a well known fact that the government's raise of the minimum wage to 300 Baht per day will inevitably affect the operating costs of SMEs, especially those having a high proportion of labor costs. This situation has induced some companies to begin to adapt already. Interviews with SME owners and executives nationwide reveal that the following adaptations have been made, in addition to efforts to replace labor with technology:

- **Efforts to reduce other manufacturing costs to compensate for the increased cost of labor.** For example, rice mills in the northeastern region have begun to operate more night shift, because nighttime electricity rates are cheaper than daytime rate.
- **Raising labor productivity alongside the wage increase to help reduce cost pressures,** by boosting the development of labor quality, technology and effective management.
- **More outsourcing:** One beverage manufacturer, for example, has moved to outsource hires of truck drivers. This caters to the desire of drivers to be more independent, instead of working as company employees. Giving drivers their own vehicles is also an incentive.
- **Adding value to products and brand building.** One example is a company selling abalone that has invested in value-adding research and is able to manufacture its product as a beauty aid, using cold abalone extract mixed with collagen. Not only does this new innovation bring the operator increased and guaranteed profit, it also reduces risks from fluctuations in the price of abalone. Another example is manufacturers of souvenir snacks in various tourist destination provinces who have created their own brands and are therefore able to add value and generate more income compared to their white-labeling techniques in the past.
- **Adapting business models and expanding product lines** One case is textile companies that have refocused to produce for growth industries, such as by making seatbelt fabrics and seat coverings, or by producing high quality fabrics and fashions to sell in foreign markets.

Brainstorming with businesses has helped us identify some interesting ideas, including:

- **Gathering companies in an industry together with educational institutions in order to adjust the curriculum to build workers with the needed skills and knowledge.** This can help remedy labor shortages. So can school programs that facilitate work experience for students, who can be recruited after graduation.
- **Grouping hotel businesses having similar standards in order to source raw materials in large quantities so as to receive discounts.** Hotels that are fully occupied can transfer guests to cooperating hotels. But each hotel will need to differentiate itself and offer uniqueness in order to prevent competition within the group. They must also maintain standards and quality, such as guest room cleanliness and service levels. This kind of network can also be adapted to other service sector, such as restaurants and hospitals.

Operators can also study examples from countries that have had to adapt to minimum wage hikes before. One good example is adaptation by restaurants in Japan, which have changed store layouts so that waiters can serve customers more efficiently. As a result, one restaurant might need only three waiters, greatly reducing labor costs.

# 4 How do SMEs see the future and how have they prepared?

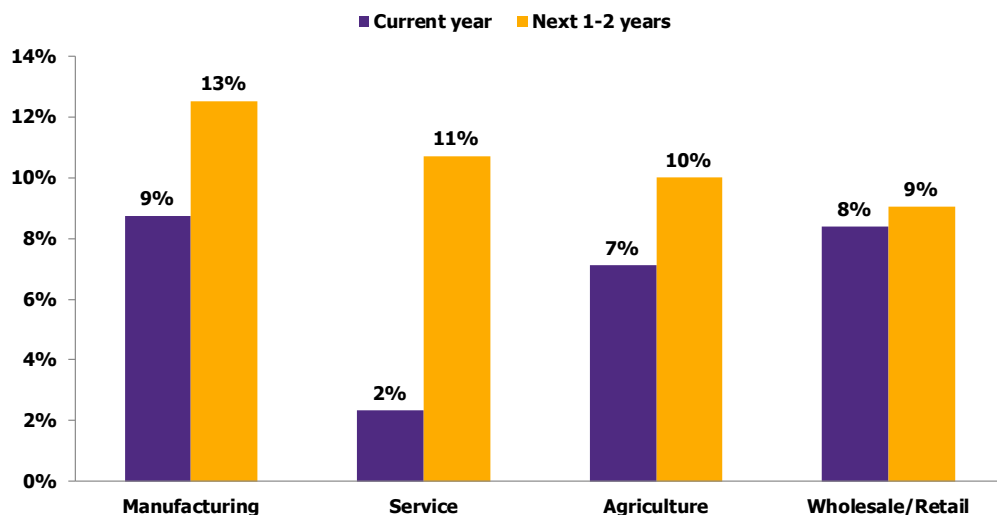
SME operators today need to prioritize long-term strategies in light of various factors, especially strategies for adapting to the minimum wage rise and for handling the opportunities and increased competition that will come with the ASEAN Economic Community (AEC). Siam Commercial Bank, together with the Federation of Thai Industries, has conducted a survey on SMEs’ opinions regarding the changes that will occur, including these companies’ methods and progress in adapting in various business sectors. The intention of the survey is to inspire SMEs to plan better for the long term.

SMEs on the whole<sup>1</sup> still have an optimistic outlook on business prospects for the next one to two years, despite such challenges as Europe’s economic crisis and rising costs, especially costs from the wage hike. The manufacturing sector believes that it can grow up to 13% and increase market share over the next one to two years, which probably reflects the fact that most companies have already somewhat prepared themselves to handle internal and external factors. SMEs in the service sector are the ones worth watching the most, because many such companies will experience exponential growth, especially in businesses like transport, logistics and interior decoration. On the other hand, SMEs in the wholesale/retail sector, despite having already made investment plans to trade in foreign countries to expand their markets in the future, should grow by only 9%, which is the lowest level of growth among the various business sectors. One reason is because companies worry that the AEC will bring more competition into Thailand from other ASEAN countries.

**16** In the opinion of SMEs, the manufacturing sector will have the highest potential for growth during the next one to two years, while the service sector growth will be exponential.

SMEs sales growth in the current year and the next one to two years by sectors

Unit: %



Questions in the survey: How much growth is your company experiencing compared to last year? Do you think your company’s sales in the next one to two years will increase or decrease, and by how much?

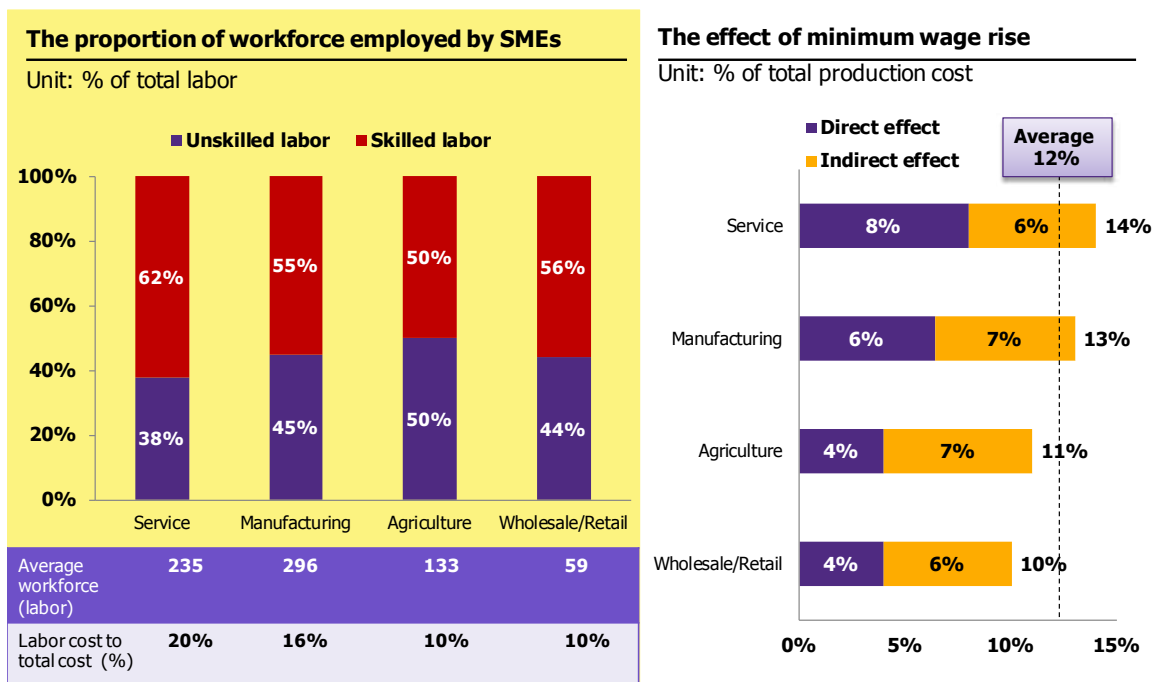
Source: SCB EIC analysis

<sup>1</sup> The results are based on SME survey conducted in 37 provinces nationwide. There are 308 respondents comprising of manufacturing, service, agriculture and wholesale/retail sectors.

SCB EIC surveyed SMEs by analyzing the two main new effects on them, which are the rise in the minimum wage to 300 Baht per day and implementation of the AEC. Survey results were quite consistent with expectations.

Regarding effects of the wage hike, SMEs estimate that their total costs will increase by an average of 12%. The service sector will be the most directly impacted because it has the highest proportion of costs from labor among overall costs and is unable to replace labor with machines as much as other sectors can. This is also a sector that is able to pass through relatively little cost to consumers, because consumers in this sector have high bargaining power. Not only does the minimum wage rise have a direct effect in increasing labor costs, it also has an indirect effect by increasing raw material costs and transportation costs throughout the supply chain. The businesses surveyed estimate that the indirect effects on their overall costs will be an increase of around 6-7%. While overall direct and indirect effects on SMEs are at 12%, analysis of the impact of the minimum wage rise on businesses overall, including SMEs and large companies, shows only an 8% increase in costs (from Chapter 2, analysis of the minimum wage rise and pass-through costs). This is probably because SMEs have less bargaining power and rely more on labor than technology, making them more vulnerable than overall industries.

## 17 SMEs in the service sector are the most affected by the minimum wage rise, because they have the highest proportion of labor costs as part of overall costs.



Questions in the survey: What proportion of your workforce is paid the minimum wage? What proportion earns more than minimum wage? By what percent will the minimum wage rise increase your production costs, as a percent of your current overall production costs?

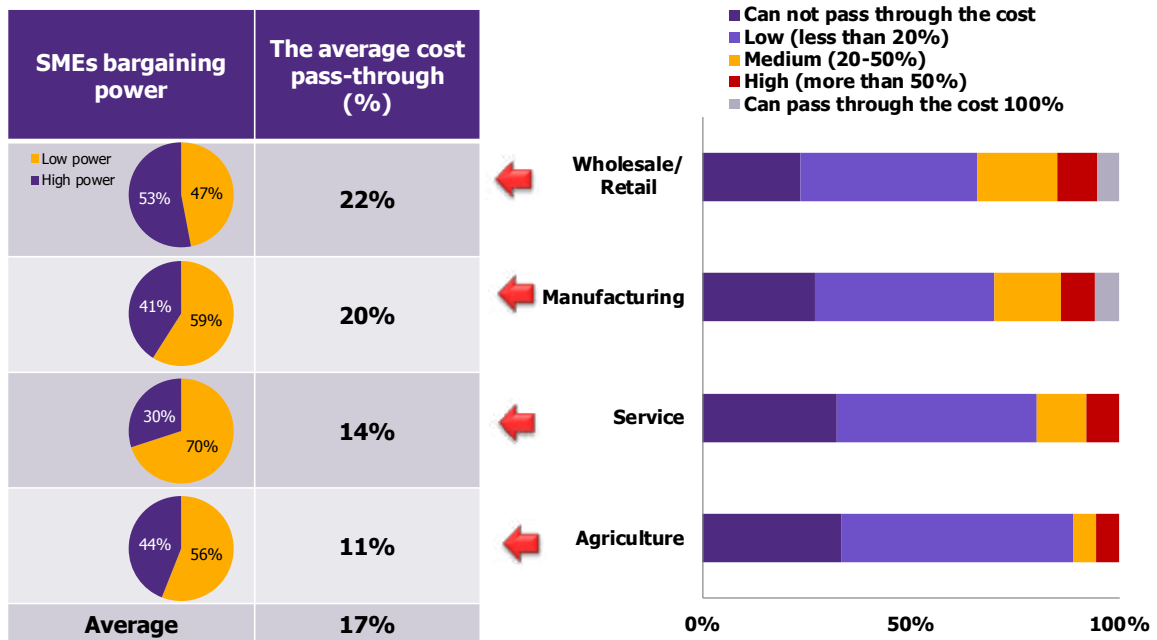
Source: SCB EIC analysis

In terms of passing through costs to customers, SMEs are able to pass through an average of 17% of their costs. Wholesale/retail businesses are able to pass through the most costs, at 22%, while service businesses and agricultural businesses are able to pass through only 14% and 11% of their costs respectively. This is because most SMEs in the service sector have lower bargaining power than their consumers do, while SMEs in the agricultural sector also have low bargaining power, and the prices of their goods are further determined by factors of supply and demand. Even the service and agricultural sectors of businesses with high bargaining power are unable to pass through much of their costs, at an average of only 16%, compared to wholesale/retail businesses and manufacturers with high bargaining power, which are able to pass through 27% and 24% of their costs respectively.

## 18 SMEs in the wholesale/retail sector are the ones that are able to pass through the most costs, while those in the agricultural sector are able to pass costs through the least.

SMEs cost pass-through by sectors

Unit: % SMEs

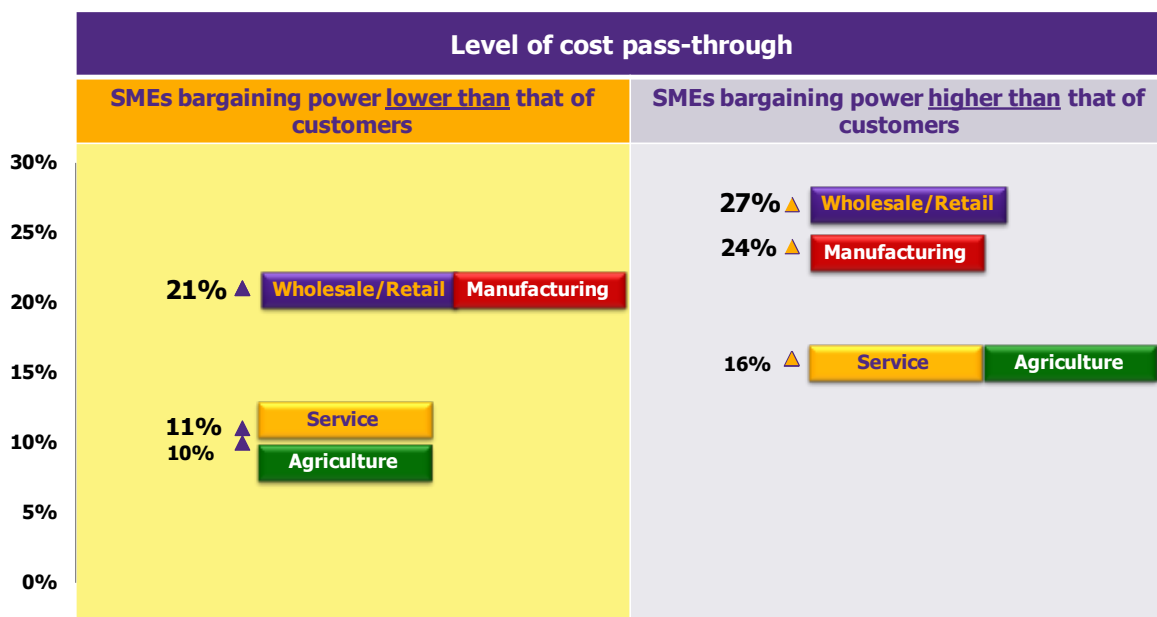


Question in the survey: How much cost can your business pass through to customers?  
 Source: SCB EIC analysis

# 19 SMEs in the service and agricultural sectors are able to pass through little of their costs, regardless of their bargaining power.

The level of cost pass-through by SMEs bargaining powers and by sectors

Unit: %



Questions in the survey: How much cost can your business pass through to your customers? How much bargaining power do your consumers or clients have?

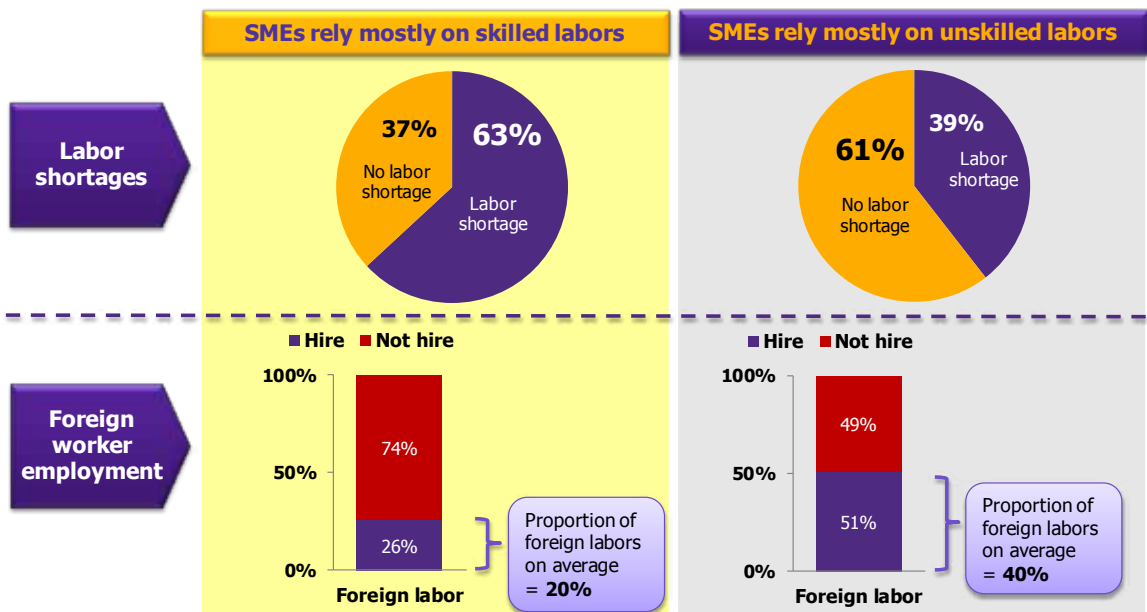
Source: SCB EIC analysis

Aside from higher costs, SMEs also face labor shortages. SMEs that rely on skilled labor face more severe shortfalls than those that emphasize unskilled labor, because companies can more easily hire unskilled foreign workers. Most SMEs that use skilled labor are in the service sector. They tend to require workers with special skills, knowledge and language ability, such as hospital workers or truck drivers in the transport business, which makes it less feasible to rely on foreign workers. Labor shortages will become a bigger problem in the future, because SMEs' labor needs for the next three years are expected to increase by an average of 8% per year, whereas Labor Ministry data show that the number of workers entering into the Thai labor market will increase by only 3%. The sector that will be the most affected is the manufacturing sector, whose required employment is expected to increase by 8.4% in the future.

**20** SMEs that rely mostly on skilled labor have relatively low proportions of employment of foreign workers and are more affected by labor shortages than SMEs hiring mostly unskilled labor.

Labor shortage situation and foreign labors employment of SMEs

Unit: % SMEs

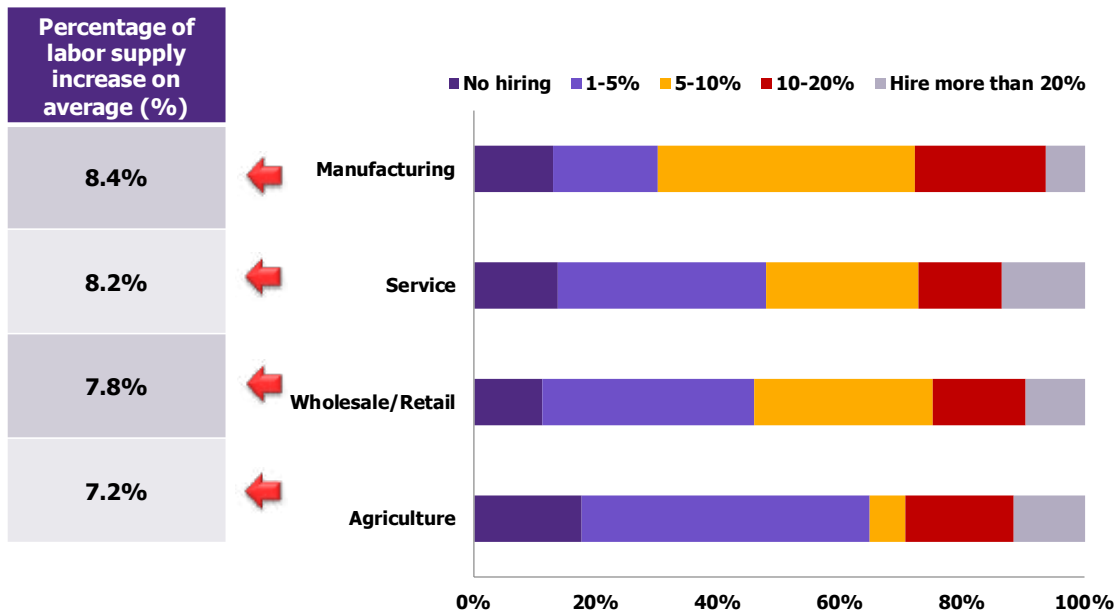


Questions in the survey: Does your business suffer from a shortage of labor? Do you employ foreign workers? If yes, how much of your entire workforce is foreign?  
Source: SCB EIC analysis

## 21 Manufacturing sector SMEs are the most likely to increase employment in the future.

The expected additional labor employment in the next 3 years by sectors

Unit: % SMEs



Question in the survey: How many more workers do you expect to employ in three years, as a percent of your current workforce?

Source: SCB EIC analysis

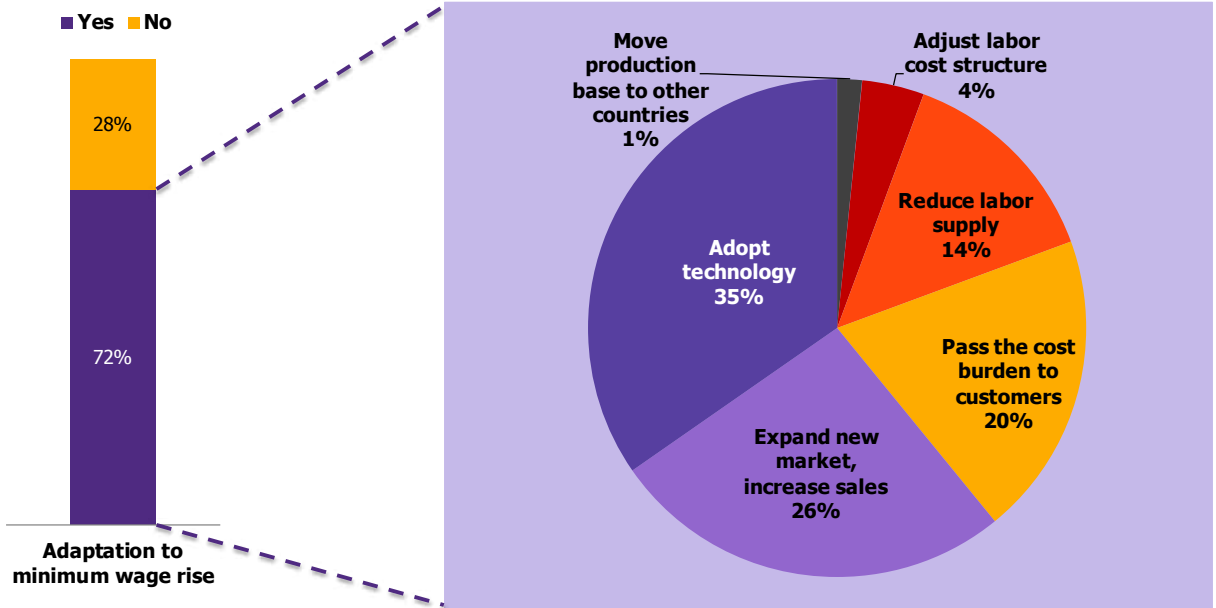


In terms of businesses' adaptations to labor constraints, most SMEs have begun to make changes. The adaptation most commonly used by SMEs is replacing workers with technology and machines, which occurs among 35% of SMEs. The least common method is moving production bases to foreign countries, with only 1% of companies opting for this solution. SMEs that have adopted more technology tend to be companies in the manufacturing sector that have replaced workers with machines, which will help these businesses reduce labor costs in the long run. SMEs in the manufacturing and wholesale/retail sectors have expanded their markets to improve sales, which is an important method of adaptation that will allow businesses to expand production to reduce costs per unit and achieve economies of scale. Moving production bases to foreign countries is difficult for most SMEs because investing in abroad requires significant expenditures and is subject to many rules and regulations, making it the least popular solution. Yet SMEs use still other methods of adaptation, such as by adding product value and reducing costs other than labor cost.

## 22 Most SMEs have adapted to the minimum wage rise by replacing workers with technology.

The adaptation of SMEs to minimum wage increase

Unit: % SMEs



Question in the survey: Have you adapted to the minimum wage rise? If so, how?

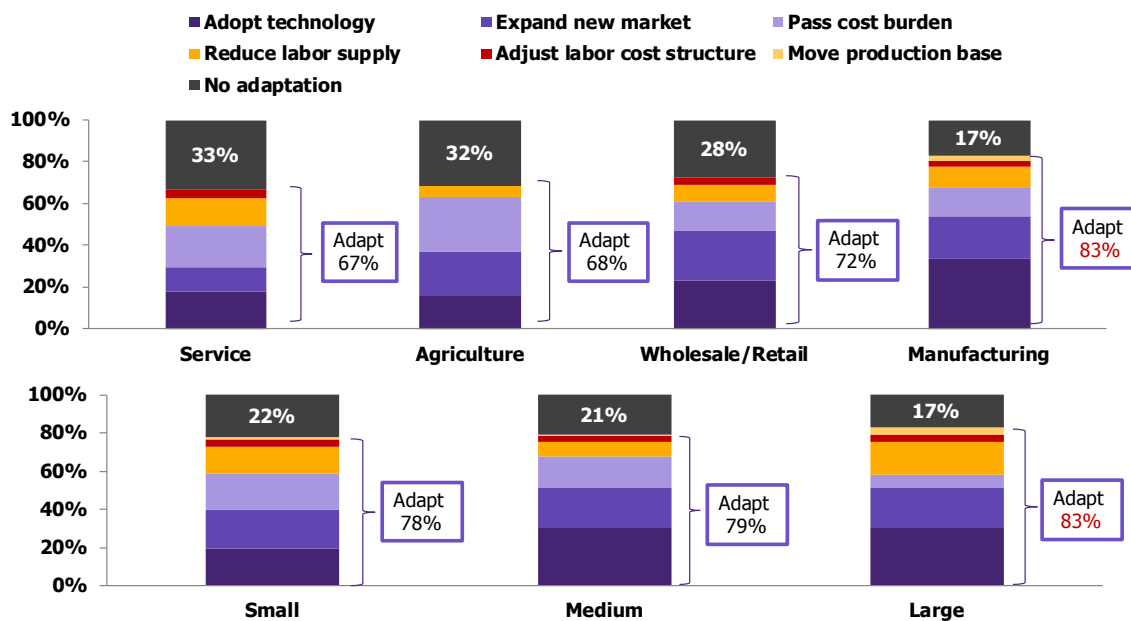
Source: SCB EIC analysis

When comparing adaptations to the minimum wage hike among small, medium and large SMEs, it is apparent that large SMEs are adapting more than small ones. Overall, SMEs of all sizes are adapting in a similar fashion, but large and medium-size SMEs are more able to adapt by bringing in technologies, while most small SMEs have to rely on passing costs through or accepting higher costs and reduced profits.

**23** SMEs in the manufacturing sector have adapted to the minimum wage rise more than SMEs in other businesses. Furthermore, large SMEs have adapted more than small SMEs.

The adaptation to minimum wage increase by sectors and size of SMEs

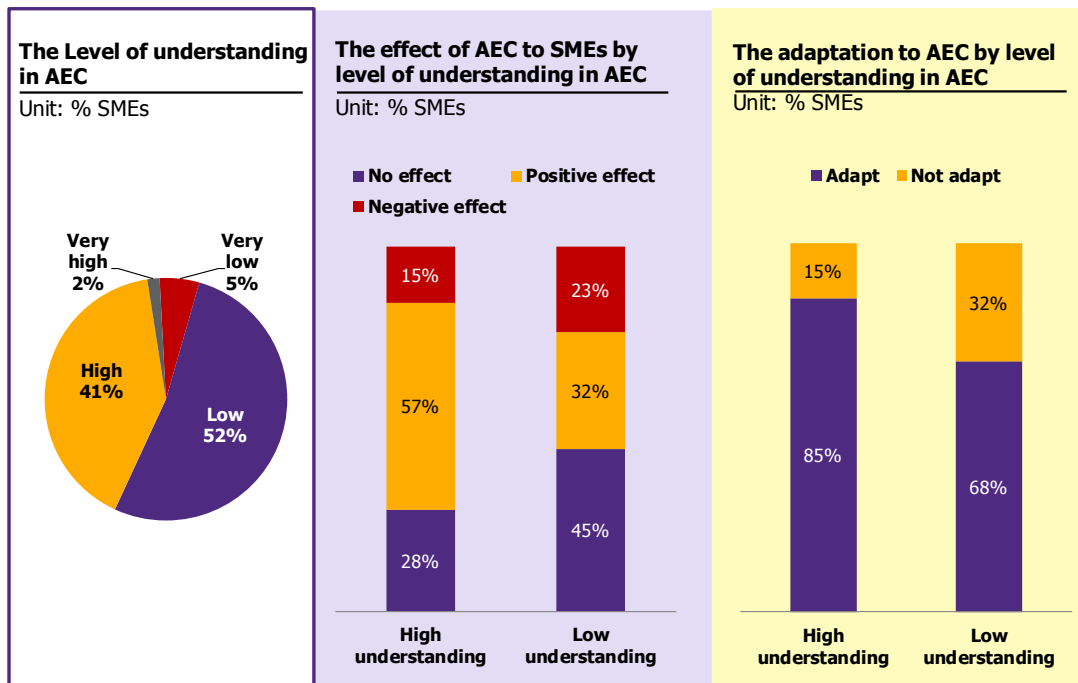
Unit: % SMEs



Questions in the survey: Have you adapted to the minimum wage rise? If so, how?  
 Source: SCB EIC analysis

Regarding the AEC, nearly 60% of SMEs still have a low level of understanding. This understanding plays a large role in how various business sectors assess the impact and adapt. 57% of SMEs that have a high understanding of the AEC are optimistic that it will be good for business, and over 85% have already made adaptations. Meanwhile, the 45% of SMEs that have a low understanding of the AEC believe that it will not affect their business, which results in these companies undertaking much less adaptation than those with high understanding. And SMEs with low understanding of the AEC only see opportunities for new sources of labor and raw materials from foreign countries, while SMEs that have a high understanding can also see opportunities for new markets.

**24** Most SMEs still have a low level of understanding of the AEC. Different levels of understanding lead to different assessments of the impact of the AEC and the need for adaptation.



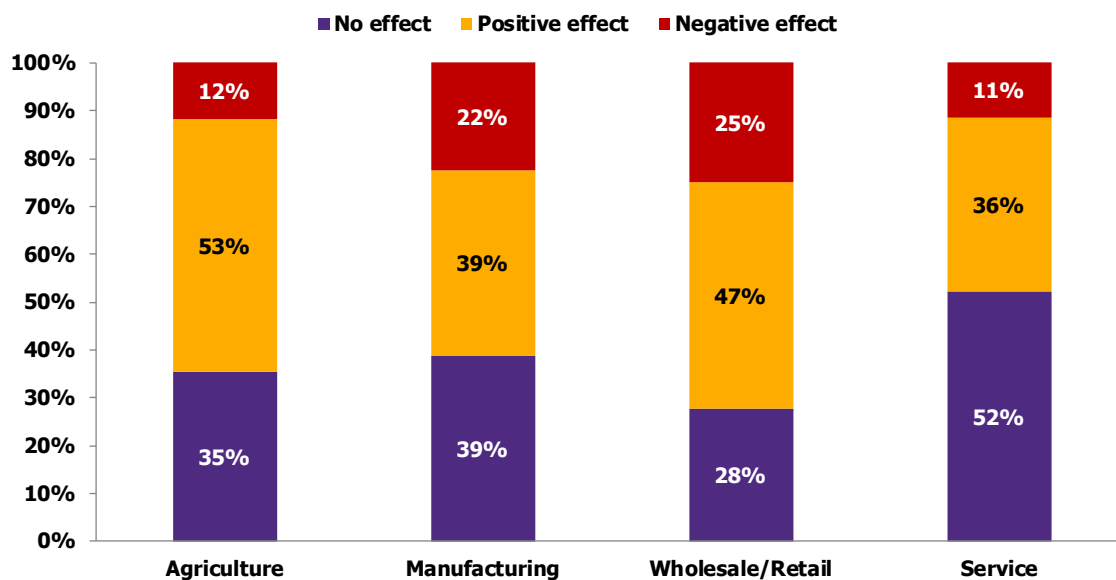
Questions in the survey: How much do you understand about the AEC? How does economic liberalization under the AEC affect your business? How has your business adapted to the AEC?  
 Source: SCB EIC analysis

As for the AEC’s impacts, most SMEs view the AEC as a positive development on the whole. Comparing between sectors, agriculture is the industry that most views the AEC as having a positive impact, at 53%, due to increased opportunities to export products into the ASEAN market. Conversely, the wholesale/retail sector is the sector that most views the AEC as having a negative impact; one out of four wholesale/retail SMEs are concerned especially with impacts from international factors, both the entry of foreign competitors and existing customers turning more to foreign products. These concerns lead the wholesale/retail sectors to have a more negative outlook for growth than other sectors over the next one to two years. Meanwhile, 52% of the service sector believes there will not be much impact from the AEC, and view it as an opportunity to create business alliances and networks to increase competitiveness. SMEs in the service sector should keep themselves informed of news on foreign investment, as the AEC will liberalize the service sector, allowing ASEAN companies to invest and buy up to 70% of stock in service firms, well above the current limit of 49%. Finally, the manufacturing sector expresses concern about the effects of new competitors but also sees opportunities to export to new markets, as well as to find new sources of labor to support business expansion.

## 25 SMEs from different sectors view the effects of the AEC differently. Most have a view that is positive or neutral.

The effect of AEC to SMEs by sectors

Unit: % SMEs



Question in the survey: How does economic liberalization under the AEC affect your business?  
 Source: SCB EIC analysis

## 26 The AEC affects different businesses differently, but the factor that concerns SMEs the most is increased competition from other ASEAN countries.

The positive and negative impact of AEC to SMEs by sectors

Unit: % SMEs



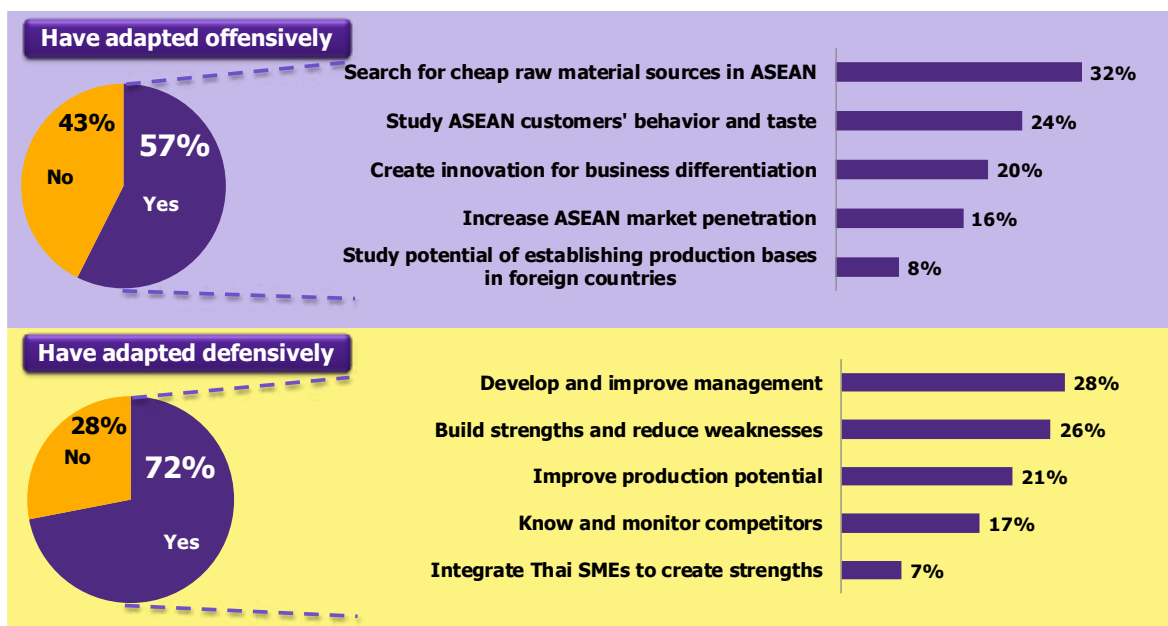
Question in the survey: What is the AEC's most important positive impact and negative impact on your business?  
 Source: SCB EIC analysis

Even though SMEs tend to view the AEC as a positive impact to their businesses, most of their adaptations have been defensive rather than offensive, with 72% of SMEs surveyed making defensive adaptations and 57% making offensive adaptations. The most common defensive adaptation is to develop and improve management within the organization, while the most common offensive adaptation is to find cheap material sources in ASEAN. SMEs in different business sectors have different methods of adaptation. The agricultural sector emphasizes building strengths and reducing weaknesses. The services sector has begun studying ASEAN consumers' behavior and creating new innovations for differentiation. The manufacturing sector is searching for sources of cheap raw materials and improving production potential, while wholesale/retail businesses focus on improving various systems in their organizations. Furthermore, small businesses tend to focus on studying the tastes and behaviors of ASEAN consumers in order to present appropriate goods and services, while large SMEs with high amounts of capital focus on penetrating the ASEAN market. Thai SMEs should not stop at defensive adaptations but should look for new opportunities from the AEC and use offensive strategies to fully reap the AEC's potential rewards.

## 27 Most SMEs have started defensive adaptations to prepare for the AEC in 2015, such as by developing and improving management within their organizations, by building strengths, and by reducing weaknesses.

The offensive and defensive adaptation of SMEs to AEC

Unit: % SMEs



Questions in the survey: Does your business have any offensive or defensive adaptations for the AEC? If so, what adaptations have you implemented?

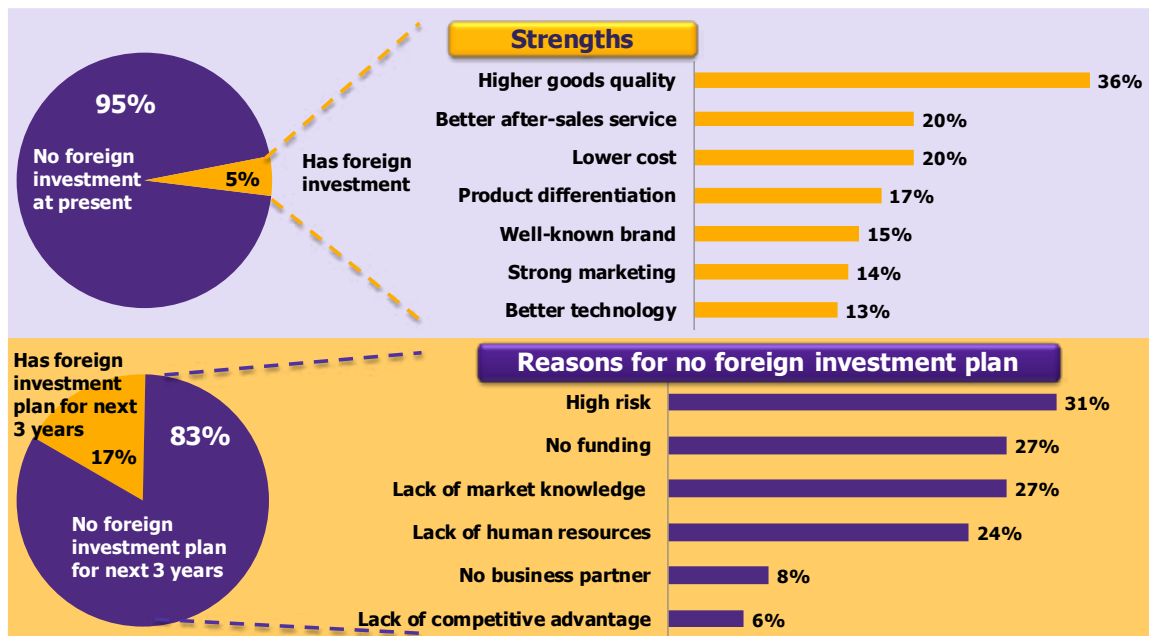
Source: SCB EIC analysis

One major opportunity from the AEC is the chance to increase international trade and foreign direct investment. But only a very few SMEs have yet invested abroad or plan to do in the future. Of the SMEs surveyed, only 5% have invested in foreign countries, and most of those are in the manufacturing sector. The main destinations for SME investment are Myanmar and Laos. The strengths that companies use to build their competitive advantages are emphasis on higher quality products, lower costs and better after-sales service than competitors. Of the SMEs that have yet to make foreign investments, around 17% plan to do so in the next three years, and most of these are wholesalers and retailers, construction materials businesses and consumer goods companies. SMEs show interest in investing in the CLMV countries and China. The main reasons that most SMEs are not investing abroad is because of the perceived risks, lack of knowledge of the market and lack of capital for investment.

## 28 Very few SMEs are investing abroad. Those that do so use better quality goods as their selling point. Most SMEs do not want to invest abroad due to a perception that the risks are high.

The strengths of SMEs having foreign investment and reasons of SMEs for no foreign investment plan

Unit: % SMEs



Questions in the survey: Is your business currently investing abroad? If you are, what strengths does your company have that will make the investment successful? If you have not invested abroad, do you plan to do so in the next three years? Why are not you interested in investing in foreign countries?

Source: SCB EIC analysis

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**SMEs that export their products abroad account for 26% of all SMEs surveyed, which is more than the amount of those with foreign investments,** most of which are in the manufacturing sector. The main export destinations are ASEAN countries, Japan, China and the United States. Major factors that lead the SMEs to decide to export include saturation of the domestic market, the desire to increase sales, and being able to clearly see demand abroad. Most SMEs did not much change their product to fit into foreign markets. In terms of distribution abroad, SMEs use two main channels almost equally; 44% use sales representatives while 42% have their own sales offices.

**As for border trade, 12% of SMEs surveyed currently engage in border trade, mainly involving Laos and Myanmar. The main driving factor for border trade is to expand the market into neighboring countries.** But most SMEs currently face obstacles in the form of trade regulations and complicated customs regulations and procedures. Among SMEs that do not currently engage in border trade, around 11% plan to do so in the next three years. Most of them are focusing on the border at Mae Sod in Tak province, which is the crossing border with the highest outlook for growth due to Myanmar's economic liberalization. Moreover, most SMEs agree that increased demand for goods and services, political stability and peace across the border are factors that will help border trade to grow.

**SMEs do in fact have many opportunities to undertake trade and investment in foreign countries. But a variety of factors such as the minimum wage rise and the global economic slowdown have caused SMEs to turn primarily toward defensive strategies. Now is a turning point for the growth of SMEs, and companies should adapt rapidly and seek out new business opportunities.**



# 5 Border trade: an opportunity that SMEs should not overlook

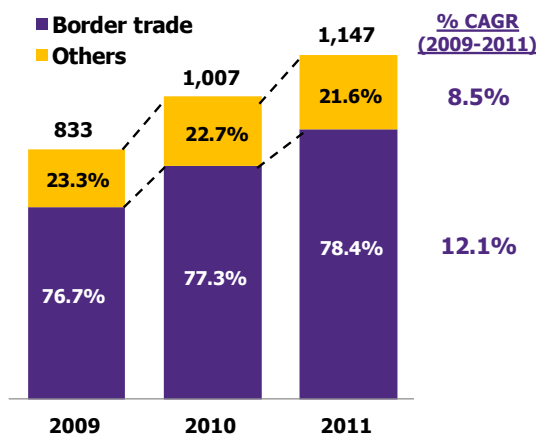
During the past couple of years, the value of border trade between Thailand and its four neighboring countries has grown steadily. This is partly due to more liberalization of economic and trade policies by these countries, as well as to the development of various cooperative frameworks and trade agreements throughout the region. These factors have led to continuous growth in international trade. Not only does border trade benefit those living near the borders, it also benefits the closeness and cooperation between countries involved in various issues.

Even though border trade makes up only 3-5% of Thailand’s overall value of international trade, 80% of trade transactions between Thailand and its four neighbors, namely Cambodia, Laos, Myanmar (CLM) and Malaysia takes place in the form of border trade. Recently, border trade has been growing by an average of 20%YOY. Most transactions involve low-price goods essential for everyday life, such as consumer goods, some agricultural goods and natural resources. Thailand currently has more than 70 border trading points including permanent border crossings, temporary border crossings and checkpoints for border trade in 30 provinces all over the country.

## 29 The value of border trade has been growing steadily, led by bilateral trade with Malaysia.

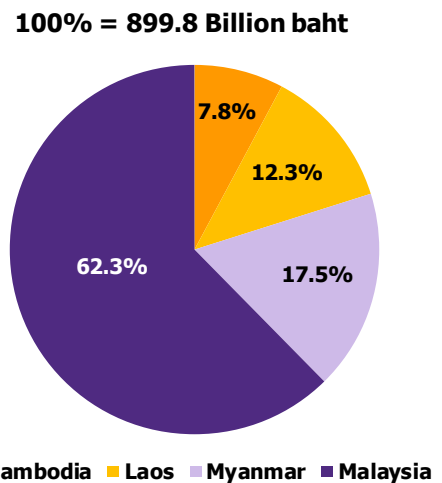
Value of international trade between Thailand and the neighboring countries\*

Unit: Billion baht



Proportion of border trade value in 2011 (classified by country)

Unit: %



\* including Myanmar, Laos, Cambodia, and Malaysia

Source: SCB EIC analysis based on data from the Department of Foreign Trade, Ministry of Finance

Among all of Thailand's neighbors, Malaysia is the most important trading partner, accounting for approximately two-thirds of overall border trade value. Part of the reason is that Malaysia is the country with the biggest economy of all of Thailand's neighbors, and it has more liberal economic and trade policies than other countries. Up to around 98% of all border trade with Malaysia take place at the Sadao and Padangbesa customs points in Thailand's Songkla province. In particular, the Sadao checkpoint, known widely as "the outer checkpoint", has become one of the most interesting economic zones in the south, attracting many types of businesses, especially entertainment venues. As many as 10,000 Malaysians travel across this border everyday. The Thai government is now preparing to develop a new customs checkpoint at Sadao and renovate the old one to make it a role model checkpoint that provides full, modern border trade services and to accommodate the coming implementation of the AEC, which will greatly increase the trade transactions.

### 30 Major border trading points between Thailand and its four neighbors.



Source: SCB EIC analysis based on data from the Department of Foreign Trade, Ministry of Finance

**Among the CLM countries, Myanmar is the market with the most potential for future growth.** During the past five years, border trade between Thailand and Myanmar has reached a yearly average of over 100 billion Baht, the most among CLM countries. One factor is geography, because the border is so extensive, at more than 2,400 kilometers in length. This translates into large trade volume between the two countries. The most important channel for trading consumer goods is the Mae Sod checkpoint in Tak province, which accounts for around 50% of all trade value. During the first half of this year, border trade through the Mae Sod-Myawaddy customs checkpoint valued at almost 20 billion baht, for a 90% YOY increase. This is a result of growth of Myanmar economy, which has begun to show more clearly positive signs, especially because Myanmar government has now adopted a policy of liberalizing its economy and opening itself up to the outside world.

**Changes in Myanmar present both opportunities and challenges for Thailand in expanding trade channels to a large consumer market with a population almost as large as Thailand's.** Opportunities are especially positive for consumer goods from Thailand that are essential for daily life, which are in high demand and very popular in Myanmar. Among these Thai goods are food, clothes and medicine, because Myanmar consumers have high confidence in Thai brands and quality. Moreover, Myanmar is also currently unable to produce enough of these goods to meet up with their huge, pending domestic demand.

**Myanmar's demand for construction materials has also been expanding steadily since the start of the year because the nation has been opening up and rapidly developing basic infrastructures and public utilities, which will further encourage economic activity there.** Demand is even rising for luxury goods and such products as electrical goods and electronics, furniture, home appliances, instant food, and cosmetics and healthcare products. This demand appears to be growing as Myanmar's consumer behavior changes and purchasing power grows. Myanmar therefore presents a golden opportunity for Thai business operators to expand trade routes to accommodate economic growth and rising consumer demand.

**31** Most of Thailand's exports to CLM countries are consumer goods, while around 60% of exports to Malaysia are primary agricultural goods, especially rubber and related products.

	Major exporting items	Major importing items
<b>(1) Cambodia</b>	Sugar, engines, non-alcoholic drinks, cosmetics, soap and fragrance products, rubber tyres	Vegetables and processed vegetables, steel, aluminium and products
<b>(2) Laos</b>	Diesel fuel, vehicles and parts, computer, gasoline	Copper and products, processed wood, garments, vegetables and processed vegetables
<b>(3) Myanmar</b>	Diesel fuel, alcoholic drinks, gasoline, non-alcoholic drinks	Natural gas (96.0%), marine products (1.5%)
<b>(4) Malaysia</b>	Natural rubber, rubber products, computer and parts	Electrical appliances and machines for telecommunication, computer parts

Source: SCB EIC analysis based on data from the Department of Foreign Trade, Ministry of Finance.

**The temporary border crossings at Baan Pu Nam Ron–Dawei and Ranong–Koh Song are trade routes worth keeping an eye on.** In the future, these border areas will become important economic zones because they will become gateways between Thailand, Myanmar and other countries around Bengal Bay. In particular, the Baan Pu Nam Ron route in Kanchanaburi province is interesting, because it is the closest area to Myanmar's Dawei deep sea port. The Thai government is pushing for Kanchanaburi to become a hub for Thailand's Western region and the nation's first border-province economic zone in order to support the construction of an industrial estate and deep sea port at Dawei, in preparation for liberalizations under the AEC and transformation into a logistics hub for ASEAN. Likewise, the Ranong customs checkpoint will soon become a Special Economic Zone (SEZ) for key regional manufacturing base relying on Ranong's port as a route for imports and exports of goods via the Bengal Bay. Ultimately, Kanchanaburi and Ranong will both become important outposts for trade and investment in the region, and will help increase the value of border trade between Thailand and Myanmar.

**At the same time, there are also tremendous opportunities for border trade with Laos.** Even though border trade between Thailand and Laos may not be as high in value as border trade with other neighboring countries, growth trends suggest that Laos is still a very promising market with many opportunities. This can be better reflected in the value of trade between Thailand and Laos last year, which has grown by 27%YOY, the highest growth rate among the neighboring countries. Moreover, Thailand is also the most important trading partner of Laos, with a market share of up to 45%. This is because most Laotians prefer Thai products and have high recognition of Thai brands. They view Thai products as being high in quality. Around 60% of border trade between Thailand and Laos occurs at the customs checkpoint in Nong Khai province, which is directly connected to Laos' major economic center, namely the nation's capital, Vientiane.

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**At present, several Thai SMEs have already expanded their businesses into Laos in response to changes in Laotian lifestyles and spending patterns, which are becoming modernized and urbanized.** These changes include the increasing popularity of dining outside, buying instant food instead of fresh food and purchasing fashionable products, appliances, mobile phones and electronic devices. These changes are undoubtedly a result of Laotian consumption of Thai media, including television, radio and print media like newspapers. This media consumption trend is shaping Laotian attitudes in ways that promote overall consumption patterns similar to those of Thais. This makes it a lot more easier for Thai companies to operate and expand in the Laotian market. Products that might become more popular in the Laotian market as the economy and purchasing power grow are luxuries such as vehicles, cigarettes and alcoholic drinks. These are some opportunities for Thai companies to find channels to build up their exports in the Laotian market.

**Aside from the consumer goods market, the service sector also has great opportunities to invest in Laos.** A clear example is the opening of beauty and skin care centers by Wuthisak Clinic, which launched their first branch in Laos at the start of the year and received a great response from the growing middle class. Wuthisak Clinic currently has three branches in Laos, namely Vientiane, Pak Sae and Luang Prabang. It is clear that in order for businesses to be successful in Laos, they need to have a clear brand and business model, and a clear target consumer. If Thai operators recognize the opportunities and channels to undertake such businesses, they can easily become successful in Laos.

**Border trade between Thailand and Cambodia is likely to grow healthily.** This is because bilateral relations are recovering now that troops have been withdrawn from the disputed area around the Preah Vihear temple. Both governments have set a target of increasing bilateral trade among them by an average of 30% per year between 2012 and 2015. The largest, most important trade channel is Rong Klua Market at Aranyaprathet district in Thailand's Sakaeo province, which is connected to the Poi Pet checkpoint in Cambodia's province of Bun Tia Mian Jey, an important economic center. Not only is this market an important trading center and source for various goods from both countries, it also creates income and jobs for locals and serves as a key tourist attraction for Sakaeo province. Both governments have also expanded economic cooperation and developed communications networks between the two countries to improve efficiency. They are also considering the possibility of establishing an economic zone along the Thai-Cambodian border to boost trade flows. This will add still more opportunities for operators who are interested in trading there.

**But limitations and business obstacles may affect border trade between Thailand and neighboring countries as well.** These include problems involving international relations and unrest across borders, which may lead to temporary checkpoint closures, especially at the Thai-Malaysian border. Likewise, some checkpoints like the one in Sadao, Songkhla province, are very crowded, creating bottlenecks that slow the movement of vehicles and goods, thus raising costs for operators.

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**Trading rules and regulations may also involve complications.** For instance, in the case of Cambodia, there are frequent changes in trade regulations, which may differ between different points on the border. Goods and accompanying documents coming into Cambodia need to be checked by SGS, a customs representative company hired by the Cambodian Ministry of Commerce. If goods do not clear customs, they will not be allowed to enter and sell in Cambodian markets. In the case of Laos, transaction fees also vary between checkpoints, and there are many checkpoints that are crowded and inconvenient, especially the checkpoint in Nong Khai province. The Thai-Myanmar border also has problems, a main one being Myanmar's limitations on imports of luxury goods, intended to control the outflow of foreign currency and remedy the trade deficit. Another main problem is fighting between government troops and minority groups, which sometimes forces border checkpoints to close down. These are some related risks and challenges that Thai operators must be prepared to face.

**Aside from such problems and a lack of readiness in basic infrastructure and regulations, there are also problems involving money and trade settlements, which businesses must study carefully.** In the case of trade with Cambodia, transactions are usually done without contracts, which is a direct risk to operators. In the case of Myanmar and Laos, around 80% of payments made along the borders are done not through commercial banks but using traditional methods that rely heavily on trust between business partners. One restriction prohibits bringing more than 500,000 Baht across the border per border crossing, which is a major obstacle for Thai businesses. Myanmar plans to use letters of credit for imports that require use of only credit from exports. At the same time, Myanmar monetary and banking system remains outdated compared to other countries. However, Myanmar has recently made some major reforms in banking and finance, such as by planning to cooperate with the Bank of Thailand (BOT) to create a direct quote for currency exchanges between the Thai Baht and the Myanmar Kyat, which should accommodate the trade transactions between the two countries in the foreseeable future.

As for the format of trade along the border, there are both trades that occur through a representative company abroad as well as direct trade between seller and buyer without an agent, such as at the Rong Klua market, Aranyaprathet province, which is the most important base for trade between Thai and Cambodian consumers. In the case of border trade with Myanmar, more Myanmar merchants have begun to open agencies in Thailand to acquire and sell their own products into Myanmar, which has considerably reduced the role of Thai agents. As for trade with Laos, Thai exporters have organized distribution channels by relying on Laos's major importers to distribute goods to retailers and wholesalers in various markets. Not only will this reduce costs and the risk of damaged goods, it will also increase the penetration and speed of distribution of goods into the local market.

**Thailand should therefore utilize the benefit of close relations and proximity with these neighboring countries to help expand business and engage growing markets.** Businesses should start to find opportunities and channels now before other competitors, especially those from Western nations, start to enter and compete for market share. We believe that integration into the AEC in less than three years from now will be a major game changer that will help reduce trade obstacles and encourage cooperation between Thailand and neighboring countries. This will mean bigger business opportunities close to home that Thai operators should not overlook.

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**Beyond increasing economic value via border trade, another channel that may be of interest to Thai SMEs is cross-border trade.** Thailand is involved in cross-border trade with three countries, namely China, Vietnam and Singapore. In the first six months of this year, the value of cross-border trade between Thailand and these three countries totaled 47.999 billion Baht, a 3% increase from the same period last year, with Thailand claiming a trade deficit from this trade. The main exported items include computers; computer parts and accessories; refrigerated, frozen and dried fresh fruits; and alcoholic drinks. The main imported items include magnetic tapes and disks for computers; electrical circuits; computer parts; and industrial machinery.

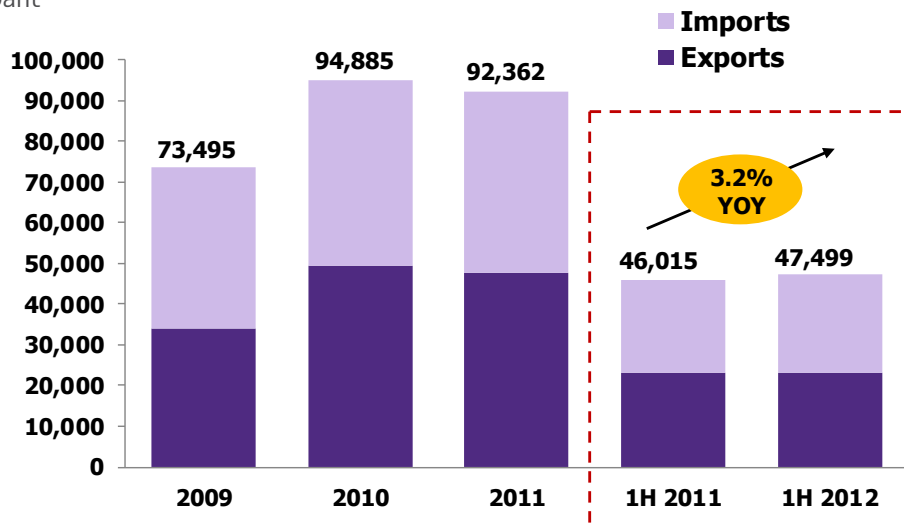
**Currently, the main limitation on cross-border trade is the lack of an integrated transportation system and network within ASEAN,** due to a lack of transportation routes in many countries and the fact that basic infrastructures and public utilities are still insufficient in many places. For instance, most major roads in Vietnam only have two lanes, and they pass through crowded communities. These problems mean that transportation into southern China is slow. If these transportation routes become more connected in the future, trade opportunities will grow, especially those involving cross-border trade to China, which has high, rising demand for food products from Thailand. Thailand can make use of transportation routes that connect Thailand, via Chiang Rai province, to Laos and China's Yunnan province, which is another route with high potential for trade growth that can handle increasing transport and communication in the future.

**Thai companies should make use of closer cooperation and logistics development under the AEC to build up their trade opportunities.** They can create trade alliances with transportation operators in neighboring countries where they engage in border trade. They also can also create ASEAN agreements regarding the facilitation of transport of goods across borders and ASEAN agreements on ongoing, pass-through transportation of goods. These will help make transportation of goods within ASEAN countries faster and more convenience, which means more business opportunities from developing and connecting logistics and transport systems in ASEAN. One noticeable example that has already happened is the Memorandum Of Understanding (MOU) between Thailand and China in April 2011 to facilitate and streamline processes in exporting Thai fruits to China via a third country. Not only does this MOU reduce transportation times for perishable goods and reduce logistics costs, it also increases the competitiveness of Thai fruits in the Chinese market.

## 32 Value of cross-border trade during the first 6 months of this year was up 3% compared to the same period last year

Total value of cross-border trade between Thailand, Southern China, Vietnam, and Singapore

Unit: Million baht



Source: SCB EIC analysis based on data from the Department of Foreign Trade, Ministry of Finance

There are even opportunities for business development and investment as a result of the creation of Special Economic Zones across the border, which have gradually been opened both in Thailand and in neighboring countries. This is another channel to add trade value and investment opportunities in neighboring countries. An example is the establishment of the Mae Sod Special Economic Zone in Thailand's Tak province, where policies encourage three targeted industries having the most potential, namely fabrics and fashion garments; canned fruits and vegetables; and wood products and furniture. SME operators can use this opportunity to expand their markets and consumer base into Myanmar and on through to China.

Another example is the establishment of the Sihanoukville Port Special Economic Zone last May, where many companies from Japan, the United States and the European Union have made investments. Thai SME operators should use this opportunity to expand their business, both in providing raw materials and constructing such facilities as apartments for workers, serviced apartments for expats, gas stations and grocery stores. These facilities will cater to the projected growth of demand for goods and services by workers in these industrial areas.



## 33 Major Special Economic Zones in neighboring countries.

### Cambodia



#### Koh Kong SEZ



Koh Kong SEZ has total area of more than 2,100 rais. Cambodian Government has aimed to develop this SEZ as industrial zone as well as tourism and electricity hub. Currently, plenty of foreign investors from all over the world has come and invested here, especially Chinese and Japanese investors.

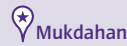
#### Poipet O' Neang SEZ



Cambodian Government has aimed to develop this SEZ as "sister cities" of Sa Kaeo province, Thailand, which is in accordance with the strategic cooperation under ACMECS regime. During the first phase, emphasis will be placed on the development of cargo shipment center in order to accommodate international trade and minimize the cost of shipping between Thailand and Cambodia.

### Laos

#### Savan Seno SEZ



Savan Seno is the first SEZ in Laos, which is established as export processing zone as well as hub for supporting industries and integrated business services.



### Myanmar

#### Dawei SEZ



Dawei SEZ has total area of around 6,000 rais. The main objective is to develop this area as hub for light and heavy industrial zone as well as center for upstream industry and deep sea port to connect with the Western region.

#### Myawaddy SEZ



Myawaddy SEZ has total area of around 1,600 rais. Myanmar Government has aimed to develop this SEZ to support increasing trade and investment upon the official opening of AEC in 2015. It also serves its role as distribution and shipping center as well as industrial zone.

### Vietnam

#### Lao Bao SEZ



Vietnamese Government has targeted to attract FDI into this SEZ in order to develop it as industrial hub for the country, with supporting infrastructure provided by the Government. Foreign investors are allowed to hold up to 100% ownership coupled with several privileges given.



Source: SCB EIC analysis

## 34 Major export items between Thailand and its neighboring countries.

Top 10 exporting item from Thailand	2011	2011	Jan-Aug	Jan-Aug	Cambodia
	Export Value (Million Baht)	Growth Rate (%YOY)	2012 Export Value (Million Baht)	2012 Growth Rate (%YOY)	
1 Sugar	5,075.2	5.2	2,453.9	-28.1	
2 Rubber tyres	2,531.3	20.7	1,945.9	18.3	
3 Cosmetics, Soap and Fragrance products	2,500.1	56.1	1,960.9	32.9	
4 Internal combustion engine and parts	2,375.7	8.0	2,232.9	21.7	
5 Non-alcoholic drinks	2,310.6	43.7	2,053.7	38.5	
6 Fabrics and yarns	2,073.8	-10.4	1,289.8	-5.3	
7 Vehicles and parts	1,936.5	-0.6	1,534.2	13.8	
8 Machine and parts	1,767.4	60.5	1,080.0	27.3	
9 Alcoholic drinks	1,716.1	1.7	1,681.3	49.3	
10 Motorcycle and parts	1,658.3	-2.1	1,781.5	48.3	
Others	35,120.3	16.9	30,150.4	29.8	
<b>Total</b>	<b>59,065.3</b>	<b>15.6</b>	<b>48,164.5</b>	<b>23.6</b>	

Top 10 exporting item from Thailand	2011	2011	Jan-Aug	Jan-Aug	Laos
	Export Value (Million Baht)	Growth Rate (%YOY)	2012 Export Value (Million Baht)	2012 Growth Rate (%YOY)	
1 Diesel fuel	13,916.7	40.1	11,879.9	27.6	
2 Vehicles and parts	7,792.8	19.3	7,824.2	64.5	
3 Gasoline	4,932.1	36.0	3,597.7	9.3	
4 Construction machine and parts	3,411.1	-14.8	2,901.3	64.1	
5 Iron and steel	3,029.1	12.4	2,830.4	43.9	
6 Other vehicle and parts	2,518.6	60.8	1,448.2	-8.0	
7 Steel products	2,261.9	19.7	1,878.8	31.0	
8 Chicken products	1,960.0	326.3	1,325.7	16.3	
9 Computers and parts	1,850.6	121.4	5,353.8	474.6	
10 Fabrics and yarn	1,804.9	-20.1	908.7	-25.4	
Others	37,646.9	24.2	33,694.0	39.6	
<b>Total</b>	<b>81,124.8</b>	<b>26.5</b>	<b>73,642.7</b>	<b>42.9</b>	

## 35 Major export items between Thailand and its neighboring countries.

	2011	2011	2012	2012	
	Export Value (Million Baht)	Growth Rate (%YOY)	Export Value (Million Baht)	Growth Rate (%YOY)	
<b>1</b> Diesel Fuel	7,360.1	10.4	4,793.1	-6.7	 <p>Myanmar</p>
<b>2</b> Non-alcoholic drinks	3,631.3	51.1	2,595.0	16.7	
<b>3</b> Gasoline	3,312.6	39.3	3,333.9	64.0	
<b>4</b> Alcoholic drinks	3,232.6	47.0	3,190.8	53.5	
<b>5</b> Vehicles and parts	2,926.2	33.7	936.3	-59.7	
<b>6</b> Fabrics and yarn	2,696.7	21.8	1,919.6	14.1	
<b>7</b> Iron and steel	1,836.5	-5.0	1,294.8	2.8	
<b>8</b> Steel products	1,719.3	78.8	865.7	-39.7	
<b>9</b> Palm oil	1,646.8	-9.4	1,286.2	34.9	
<b>10</b> Cosmetics, soaps and fragrance products	1,521.4	19.1	1,218.7	21.1	
Others	30,715.7	14.6	24,184.8	18.4	
<b>Total</b>	<b>60,599.3</b>	<b>19.2</b>	<b>45,618.9</b>	<b>12.5</b>	

	2011	2011	Jan-Aug	Jan-Aug	
	Export Value (Million Baht)	Growth Rate (%YOY)	Export Value (Million Baht)	Growth Rate (%YOY)	
<b>Top 10</b> exporting item from Thailand					 <p>Malaysia</p>
<b>1</b> Natural rubber	207,324.4	45.7	98,811.9	-30.3	
<b>2</b> Computers and parts	29,780.0	-21.1	13,853.9	-25.9	
<b>3</b> Rubber products	25,908.2	5.7	17,027.4	-3.9	
<b>4</b> Processed wood	12,387.1	38.0	8,557.7	16.1	
<b>5</b> Motors and generators	8,104.1	-9.8	4,864.2	-15.1	
<b>6</b> Rubber gloves	6,118.0	13.9	4,323.5	7.6	
<b>7</b> integrated circuits	6,069.5	5.5	3,123.9	-33.2	
<b>8</b> Vehicles and parts	4,948.2	-30.4	4,203.4	19.7	
<b>9</b> Electronical appliances and parts	3,992.7	-12.7	1,220.0	-58.3	
<b>10</b> Steel products	3,710.0	-22.0	2,578.6	2.0	
Others	71,022.0	1.0	50,706.0	4.7	
<b>Total</b>	<b>379,364.2</b>	<b>18.4</b>	<b>209,270.4</b>	<b>-18.7</b>	

# 6 Changing world, changing opportunities: How can Thai SMEs capitalize on global trends?

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The changes in various external factors due to globalization will present challenges to SMEs, but will also create bigger opportunities for companies that can respond and adapt effectively. Globalization will bring about new market opportunities as a result of technological innovations as well as from changes in demographics and consumer lifestyles. These are the conditions that will affect the business models of SMEs in the future and that Thai companies need to pay attention to.

The first major trend concerns changes in consumers' lifestyles and behaviors. Social networking has become extremely popular today, making it a business opportunity and marketing tool that can help SMEs to compete equally with large ones. Today we are witnessing many business uses for technological innovations, especially social networking sites like Facebook and Twitter, which help disseminate up-to-date information and advertising while expanding customer bases and increasing sales. This is reflected in rapidly increasing advertising sales via online media, showing the clear trend of marketing communications moving toward digital media. If Thai SMEs can utilize these technological innovations, they can save costs and other resources as well as can manage their operations to better handle global trends.

One clear example is rapid growth of the business of selling clothes online through Facebook. There are now over 11 million Facebook users in Thailand, the 16th highest total of any country in the world (August 2012 data), showing that many Thai consumers are adopting digital lifestyles and that the online world has become a major part of their lives.

Although online business may not yet be the main market today, it cannot be ignored. One business that is receiving a lot of attention from Thai SME operators is the business of selling clothes online. Even though competition in this business is already fierce, there is still room for future growth, especially for low-priced women's fashions. Online selling allows businesses to reach large numbers of consumers without restrictions of time and place. Companies do not need to spend on renting or furnishing stores, or stocking goods for display. Furthermore, advertising costs for online media are also lower than traditional channels. One indication of the popularity and success of online clothing sales by SMEs is their number of Facebook "likes." A single Thai SME that sells clothes via Facebook has already accumulated over 1 million likes on its fan page, whereas a famous clothing brand has earned only some 6,000 likes.

Using the internet to search for products is becoming popular among young Chinese consumers. A marketing survey by TNS International covering 1,200 middle-class Chinese in ages ranging from 20-45 years old found that up to 30% of those surveyed use the internet more than once a week to find information on brand name products. They report that internet shopping is cheaper and more convenient for comparing prices, and saves time compared to buying clothes via traditional channels. Data from iResearch found that online sales of brand name products in China during 2011 totaled 10.730 billion Yuan (51.611 billion Baht), or 70% growth compared to the previous year. Growth is expected to continue by around 30% per year for the next four or five years, increasing brand name online sales to 37.240 billion Yuan (184.710 billion Baht). This marketing channel is therefore one that SMEs should utilize to increase sales the same way that brand names have done.

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## 36 Online sales of brand name products in China are likely to triple by 2015.

Online sales of brand name products in China

Unit: Million RMB



Source: SCB EIC analysis based on data from "China Insight" on the Prachachat Business Newspaper Website.

**Another opportunity for SMEs around the world and in Thailand is awareness of global warming and the "greening" of businesses.** Many consumers are switching to environmentally friendly products, or eco-products. SMEs should pay attention to eco-designs, and try to capture markets with products and packaging that are environmentally friendly. Companies can look into producing goods from recycled material, for example, to cater to growth of this market segment.

**"Eco-shops" are another way for SMEs to capture the green market.** These are stores that specialize in environmentally friendly goods. These goods include products made from recycled materials and products that are made in ways that are environmentally friendly throughout the entire production system, from using the most efficient means of transport, choosing materials that do not damage the environment, and using the

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manufacturing processes that utilize the least materials and energy possible. Not only does this business model differentiate its products, it has been well received by young consumers who pay attention to the environment. A good example of a **Thai SME that makes environmentally friendly products is one that crafts tableware from rice husks and naturally extracted protein**. Not only has this SME succeeded in the domestic market by differentiating its product, it is also able to meet the needs of overseas consumers who look for green products. As a result, the company receives many orders from hotels, restaurants and shopping malls around the world.

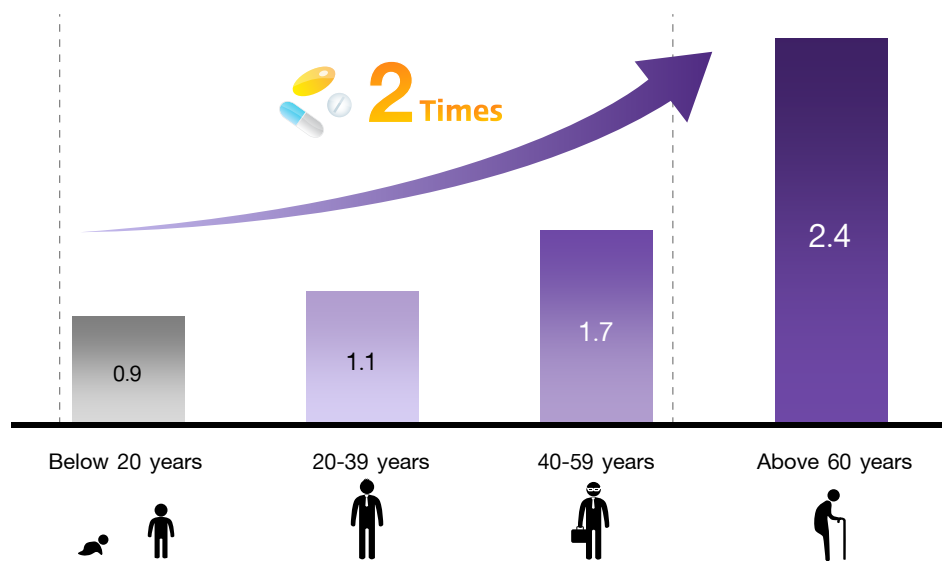
**Similarly, demand for products and services serving niche markets is growing.** Niche marketing is a factor that has created success for many businesses, because when a company responds to the needs and lifestyles of a particular group of customers, it adds value to its products and services. Examples of niche market businesses include gyms exclusively for women or men, yoga for mothers, or pet hotels, all of which are SME trends that are currently receiving a lot of attention.

**Another important trend is looking for new business opportunities as a result of demographic change, especially responding to needs of growing middle-income classes, especially those in emerging markets with high purchasing power such as India and China.** Even though people in these countries do not yet have high incomes, their countries' economic growth means that consumers are undergoing a transition in income levels and have begun to demand more luxury products and services. Thai SME export products that have a chance to penetrate markets in these countries are mainly everyday essential goods, as well as other products that follow trends in IT and health. Research by the China Brand Association found that the popularity of snack food is increasing in China, involving both higher quantities and quality. For instance, China's market for ice cream is currently valued at over 3 billion US Dollars and is growing at around 20% each year. This is clearly a massive business opportunity for Thai SMEs that want to expand their opportunities, much like in other markets that are also very open, such as the BRICS countries (Brazil, Russia, India, China and South Africa) or the Middle East.

### 37 Aging consumers are spending twice as much on vitamins and supplements per their overall retail spending compared to other age groups.

Ratio of vitamin and supplementary diets expenditures to overall retail spending (classified by age groups)

Unit: %



Source: SCB EIC analysis based on data from the survey of National Statistical Office (NSO) in 2009

**Another business opportunity is the aging society.** Medical innovations have decreased death rates around the world, while birth rates have also declined in many countries including Thailand. As a result, demographic structures are changing towards that of an aging society, and this group of consumers will soon become the largest consumer group in the global market. This is reflected in the growth of various products and services that cater to the specific needs of older people.

**One type of SME that is popular and growing well in Thailand is the elder care business.** This includes nursing homes, special transportation services, natural therapy for elders who require medical services, and such products as dentures, electric wheelchairs, medicine, supplements and vitamins. These businesses are currently small in Thailand considering the size of the senior population, and there has not been much serious marketing. So this is another interesting business opportunity for Thai SMEs.

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**There are also opportunities to sell to health-conscious consumers.** Many people around the world, including in Thailand, have started to pay more attention to their health and begun to consume more organic foods because of their health and nutritional value. The organic food market was valued at 1.4 trillion Baht in 2007 and is expected to increase to 2.2 trillion Baht in 2012, a 54% increase. As a result, growing health-consciousness is a trend that SMEs should not overlook. Moreover, healthy products do not necessarily require advanced technology as they depend more on quality and cleanliness. Thai SMEs thus have a great opportunity to capitalize on the world's growing demand for organic products. These companies need to produce goods that meet international standards, are hygienic and free of toxins.

**One interesting example is organic tea grown by a tea farm in Chiang Rai province,** which has received the "Organic Thailand" certification since 2003 and is about to receive organic certification from the United States Department of Agriculture (USDA). This operator's tea farming technique uses natural fertilizers and herbs such as neem to prevent insects. The initial costs of operating this organic farm were higher than at normal tea farms, but in the long term the organic products are able to generate higher income and profits, thanks to premium prices. And these products create the opportunity to accommodate a customer base that is growing.

**Another example is "vegetable tablet" supplements made by a small Thai company, which caters to health conscious consumers and increases the value of vegetable farm output.** This product is currently a great success and is expected to expand internationally in the near future, starting with ASEAN countries like Myanmar, Indonesia, Malaysia and Singapore. The company also plans to expand to the Middle East market, which has shown considerable interest in this particular product, as it is hard to purchase fresh vegetables there for consumption. Fish oil is another good example of a product for health conscious consumers, because it can be consumed by people of all ages, from students to workers to seniors. A Thai SME that has started selling this product has seen large growth during the past couple of years, and is targeting nearly 100% growth in the next five years.

**As outlined here, global trends are generating diverse new business opportunities for SMEs. Thai companies should pay attention and adjust their business strategies accordingly to benefit and grasp opportunities from these changes and trends.**




# 7 Where should SMEs target?

Even though Thai SMEs still need to adjust to the changing environment and increase their labor productivity, they are still much stronger than SMEs in neighboring countries, especially the CLMV countries. Therefore another way to adjust is to take advantage of AEC liberalizations to expand trade and investment in nearby countries having an abundance of resources and lower manufacturing costs, which will help increase competitiveness.

SMEs play a key role in ASEAN economies and are a major driving force, especially in Thailand and Malaysia, which both have potential to generate many new SMEs. Most enterprises in ASEAN are SMEs, accounting for an average of around 98% of all businesses throughout ASEAN, with around 85% of all employment. But the ability to create new SMEs varies from country to country. In the past 10 years, Thailand’s number of small enterprises has grown considerably more than Indonesia’s and the numbers among the CLMV countries, at around 30% per year. But the Thai figure is still less than Malaysia’s 45% growth per year. Malaysia has also seen higher growth in medium-size enterprises, at 28% per year. This is partly a result of substantial support by the government, especially in terms of investment funds. Malaysia has lately been preparing its SMEs for the AEC by setting aside 30 billion Baht in funds to increase liquidity and 5 billion Baht to encourage new innovations.

## 38 The proportion of SMEs to the overall number of enterprises and their share of employment is around the same in all ASEAN countries, but the increase in new enterprises differs across the region.

The role of SMEs*	 Thailand	 Malaysia	 Indonesia	 Vietnam	 Laos	 Cambodia
<b>Share (%) to</b>						
 Total enterprises	99.7	97.3	99.9	97.0	95.7	99
 Employment	84	59	97	85	83	88
 GDP	37	32	58	39	N/A	76
<b>Growth of SMEs (%CAGR 2000-2007)</b>						
 Micro and small enterprises	28.5	44.7	3.3	21.3	N/A	-1.1
 Medium enterprises	11.9	28.2	3.0	8.3	N/A	-1.7

\* Comparison of data regarding SMEs in different ASEAN countries is constrained by the fact that various countries have different definitions of what constitutes an SME.

Source: SCB EIC analysis based on data from Economic Research Institute for ASEAN and East Asia (ERIA), Office of Small and Medium Enterprises Promotion (OSMEP), IMF, Department of Statistics Malaysia, General Statistics Office Of Vietnam and National Institute of Statistics of Cambodia








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**Thai SMEs are considered to be strong, but need to develop their capacities. Comparing Thai SME GDP growth with Malaysia's, Thai SMEs' output value is still growing less than Malaysia's. From 2007-2011, the output value of Malaysian SMEs has increased by around 6% per year, compared to 2% annual growth by Thai SMEs.** Thai manufacturing capabilities are also not as good as Malaysia's, especially technology development. Malaysia is constantly improving the skills of its workforce. As a result, Malaysia's labor productivity is 2.6 times that of Thailand's. **Thai SMEs should therefore quickly develop their manufacturing capabilities and labor productivity to increase competitiveness,** especially under current economic conditions characterized by high competition and rising costs for raw materials and labor. **But another way for SMEs to adapt is to capitalize on AEC liberalizations by expanding trade and investment into neighboring countries with lower operating costs.** This is another way to increase the competitiveness of Thai SMEs, but the question of which businesses are worth expanding and investing in depends on market conditions and restrictions in each country.

**The best trade and investment opportunities for Thai SMEs are Indonesia and the CLMV countries.** Considering ease of doing business indicators in ASEAN, even though Malaysia is alluring because of the ease of starting a business, competition is difficult there due to high labor costs and other costs. Other competitors there, both international and Malaysian, are financially strong and have higher levels of utilization of technology and labor skills. So the best business opportunities for Thai SMEs are in the CLMV countries and Indonesia. Comparing the initial indicators of investment attractiveness, these are some points of interest:

- **Market size and ease of doing business:** Indonesia and Vietnam both benefit from having large markets thanks to their large populations. It is easier and faster to start business operations there compared to other CLMV countries.
- **Initial public utility costs:** Costs for electricity and water are still quite low in Vietnam, but are high in some countries like Cambodia. Some countries, such as Laos, have different rates for residential and non-residential use of public utilities. A major obstacle in both Cambodia and Myanmar is hidden costs resulting from underdevelopment of public utilities. Electricity shortages will raise the costs of some SMEs there, especially manufacturers, who will have to pay for contingency measures in case of blackouts.
- **Labor costs:** Investment in labor-intensive industries should be appropriate in Cambodia and Myanmar. Vietnam, which used to attract investments focused on low labor cost, is not as attractive as it used to be. Due to labor shortages, Vietnam has had to increase its minimum wage. In 2012, the minimum wage was increased around 25-30%, making wages 1.5 times higher in Vietnam than in Myanmar and Cambodia. Although Laos increased wages by 80% at the beginning of 2012, wages there are still three times lower than in Thailand.
- **Import-export costs:** Indonesia and Vietnam also benefit from being in prime locations for transport, reducing their import-export costs considerably.

**39** The CLMV countries have a considerably large market and lower labor costs than Thailand.

Ease of doing business indicators	Thailand 	Malaysia 	Indonesia 	Vietnam 	Laos 	Cambodia 	Myanmar 
<b>Market size (population in 2011) (million person)</b>	69.5	28.8	242.3★	87.8	6.2	14.3	48.3
<b>Starting a business</b>							
➤ <b>Procedures (number)</b>	5	4★	8	9	7	9	N/A
➤ <b>Time (days)</b>	29	6★	45	44	93	85	90
<b>Utility expense</b>							
➤ <b>Electricity (USD/kWh)*</b>	0.08	0.07	0.06	0.05★	0.07	0.21	0.06
➤ <b>Water (USD/m<sup>3</sup>)**</b>	0.5	0.44	0.36	0.3	0.6	0.4	1.05
<b>Minimum wage (USD/month)</b>	254	297	167	96	75	61★	65
<b>Cost to export (USD/container)</b>	625	450★	644	580	1,880	732	N/A
<b>Cost to import (USD/container)</b>	750	435★	660	670	2,035	872	N/A

\*Average electricity rates for SMEs.

\*\* Water rates for some countries, namely Indonesia, Laos and Malaysia, are at per m<sup>3</sup> per month and do not include the minimum charge. For example, Laos's water rates for non-residential companies are 4.8 USD for the first 10 m<sup>3</sup> and 0.6 USD for each subsequent m<sup>3</sup>.

Source: SCB EIC analysis based on data from CEIC, World Bank, ASEAN Centre for Energy and ASEAN Secretariat

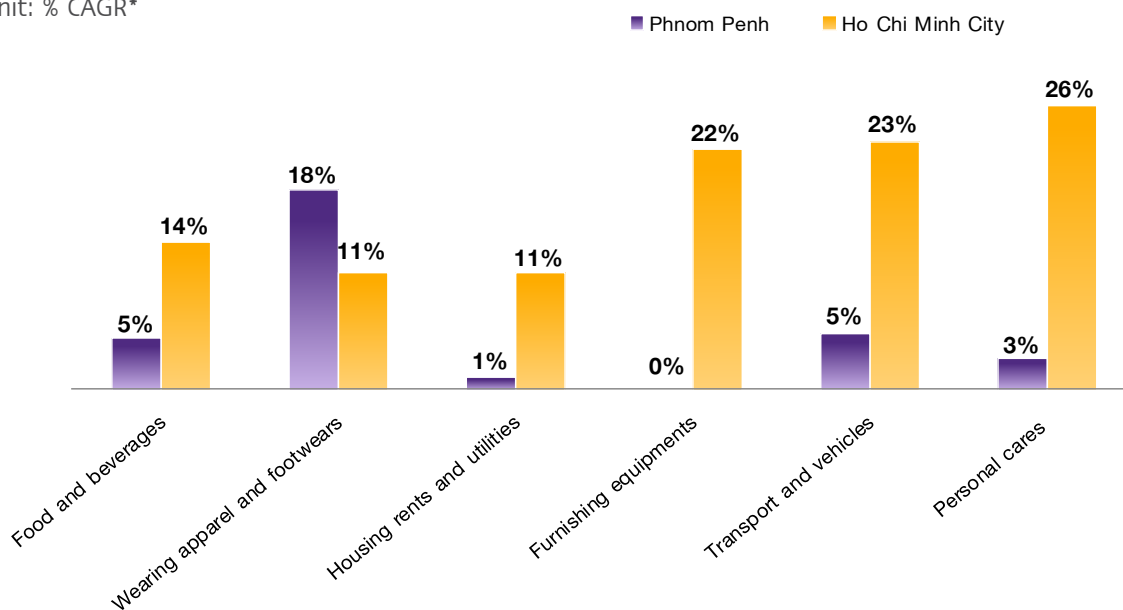
Besides the factors mentioned above, operators should consider other factors such as the tax system and investment regulations that restrict certain kinds of businesses. For example, Indonesia has rules against SME ownership in some sectors, such as a ban on foreign ownership of small retail businesses. Companies should study the types of investments that are allowed to foreign investors in each country, as well as costs such as land rents, which are likely to rise in Vietnam and Myanmar, especially in big cities like Ho Chi Minh, Hanoi, Rangoon and Mandalay. SMEs should invest in manufacturing operations outside of cities, or locate in industrial estates where rent is not as high. Industrial estates in Myanmar charge rents that are around the same rate as at Laem Chabang Industrial Estate in Thailand. So when deciding which markets to target for investment, SMEs should study to determine which advantages their business would like to build upon.

The growth in household spending in CLMV countries is an opportunity for SMEs in the trading business, especially in consumer goods, household goods, construction materials, construction services and car and motorcycle repairs. Considering the structure of household spending on goods in Cambodia and Vietnam, spending per capita is continually rising both for food and beverages and other household goods. Ho Chi Minh City consumers' spending on miscellaneous goods such as personal consumption goods has increased by 26% per year from 2000-2010. Meanwhile, increasing use of cars and motorcycles has resulted in increasing spending on repair and maintenance as well as higher demand for car and motorcycle parts. There is also growing demand for residences. Housing construction has grown by 20% per year from 2005-2010, which is a factor that supports demand for construction materials; household products and decorations; and construction and design services for residential buildings. The CLMV countries' growth in household spending is an opportunity for Thai SMEs to engage in trade businesses, such as selling consumer goods or construction materials, operating small retail businesses, garages, car care centers and restaurants, because Thai goods and services are well known, in good standing and popular in these countries.

## 40 The expansion of household spending will help SMEs in the trade and services sectors to keep growing.

Household expenditure growth by product category in Phnom Penh (Cambodia) and Ho Chi Minh City (Vietnam)

Unit: % CAGR\*



\*Data for Phnom Penh is from 2009-2011. Data for Ho Chi Minh City is for 2000-2010.

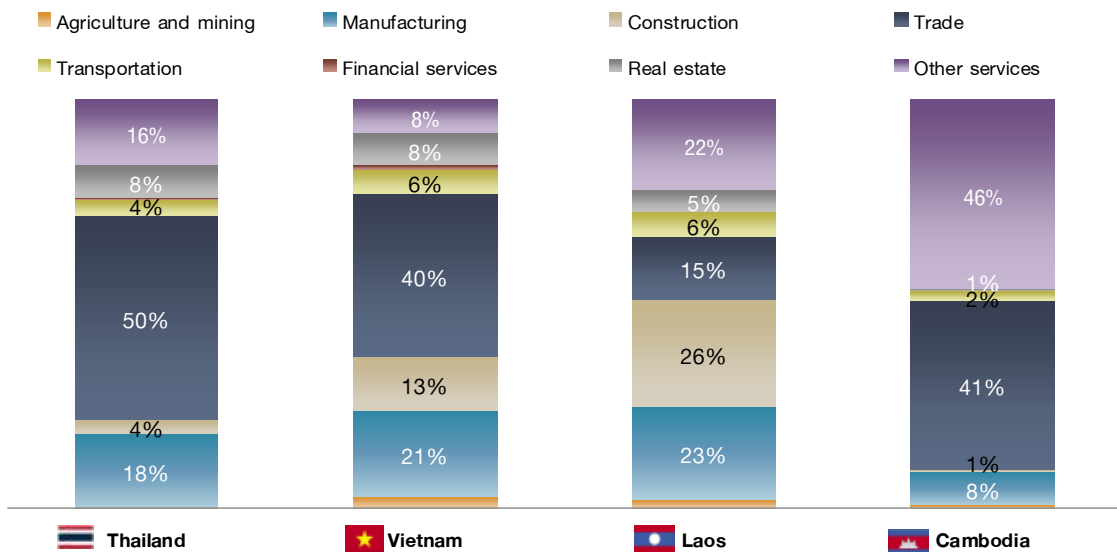
Source: SCB EIC analysis based on data from National Institute of Statistics Cambodia and Ho Chi Minh City Statistical Office

However, in order to implement a model for penetrating trade and services markets, Thai SMEs should find business partners both from Thailand and from the countries they plan to invest in. SMEs in the trade business should join up with various manufacturers to create product diversity and to find local business partners. This kind of business penetration model is appropriate for operators who are just beginning market diversification and are inexperienced. This is important because there are already lots of SMEs in the trading sector in these countries, and competition is high. Comparing the specializations of Thai SMEs to those in CLMV countries, most Thai companies are still clustered in the trading sector, accounting for 40-50% of all SMEs. Thai SMEs that join together to expand their markets will not only increase their bargaining power, but will also reduce management costs. Furthermore, once goods have started to create a market base, operators may expand their business into other forms of investment, such as establishing trade and investment representative offices, selling franchises to local operators or joint ventures. But before entering, operators should study regulations and market needs as well as both foreign and local competitors.

## 41 Most Thai SMEs are clustered in the trading sector.

Share of SMEs by sector

Unit: % of total SMEs



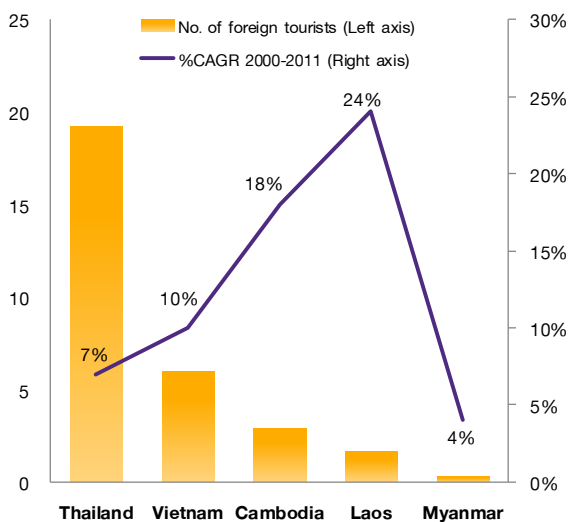
Source: SCB EIC analysis based on data from Economic Research Institute for ASEAN and East Asia (ERIA), OSMEP, General Statistics Office of Vietnam, and National Institute of Statistics of Cambodia

**Businesses involving tourism, hotels and restaurants in CLMV countries are growing rapidly, which is an opportunity for SMEs to penetrate the market.** Even though the numbers of tourists visiting the CLMV countries are still less than those visiting Thailand, the figure is growing. In particular, the numbers of tourists going to Cambodia and Laos have been increasing by 18% and 25% per year from 2000-2011 respectively. While the number is still small for Myanmar, the opening up of that country will generate more tourists. The number rose by 30% YOY in the first quarter of 2012 and is expected to increase by 100% throughout 2012, reaching 1.5 million tourists, because Myanmar has many beautiful and interesting destinations. As for accommodations, the CLMV countries still have low numbers, with an average of just 1 place of accommodation for every 1,500 foreign tourists, compared to Thailand’s figure of 1 place per every 250 foreign visitors. This ratio includes hotels as well as other forms of accommodation like guesthouses. When considering only hotels, Cambodia and Laos have only 1 per 5,000 foreign tourists, showing that there is an insufficient supply of hotels for such a growing market. Tourists are paying more, especially in Cambodia and Laos, which have seen an 18% and a 39% increase per year respectively from 2000-2010, reflecting the opportunity for SME operators to invest in hotels, a specialization in which Thais have an advantage, as well as in other related businesses such as restaurants, tours and souvenirs.

## 42 Tourism in the CLMV countries has high potential for growth.

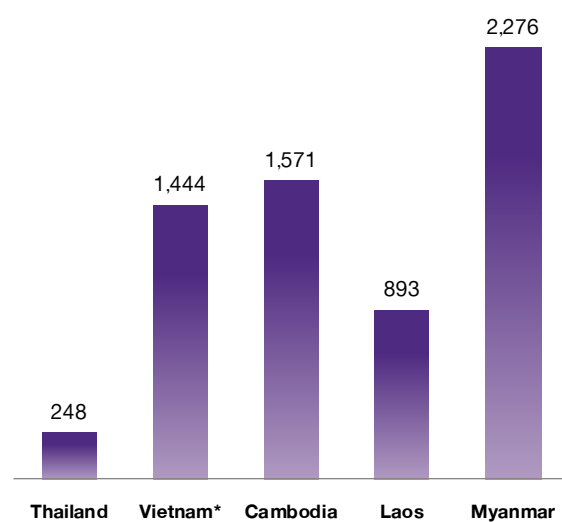
Number of foreign tourists

Unit: Million person



Ratio of foreign tourist per accommodation

Unit: person per place



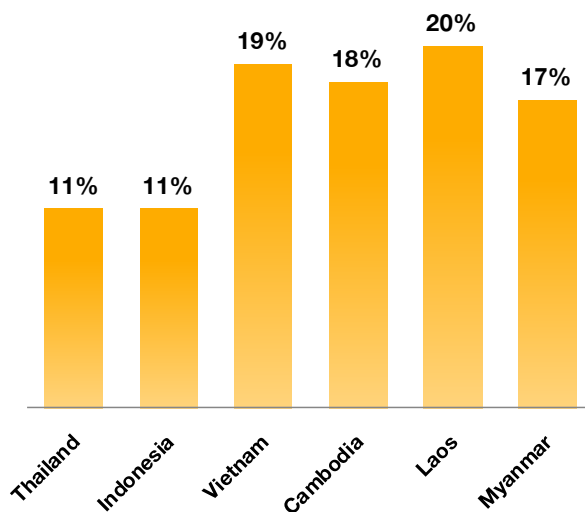
Remark: The ratio of foreign tourists per accommodation includes hotels and guesthouses as forms of accommodation.  
 \*Data for Vietnam is calculated from the numbers of tourists and accommodations in Ho Chi Minh City and Hanoi.  
 Source: SCB EIC analysis based on data from CEIC

**SMEs in the manufacturing sector having linkages with a value chain to export are interesting. The potential for export in the CLMV countries is growing continuously.** The past 10 years have seen exports grow at around 20% per year, which is a significant opportunity for Thai SME operators to expand investment and trade into these CLMV countries. In terms of capabilities for manufacturing for export, companies should look at the ability to network with the export sector involving SMEs within CLMV countries as an indicator. Even though the ratio of direct exports by SMEs in CLMV countries is still considerably lower than Thailand's, the CLMV countries have increased production that indirectly connects with exports, especially among medium-size companies in Vietnam and Laos. This shows the ability of SMEs to build production networks, especially in the form of subcontracting for multinational corporations. This specialization seems likely to increase, resulting in more clustering of SMEs in industries with sizeable exports.

### 43 SMEs that emphasize exports or those working within export business networks are worth investing in.

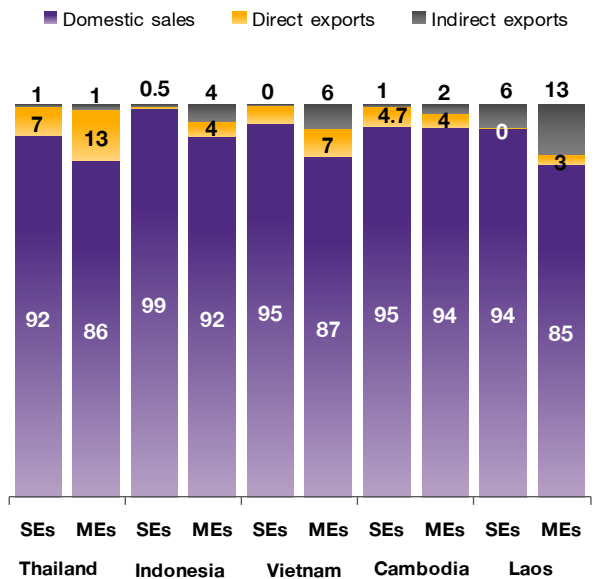
Export growth

Unit: % (CAGR 2000-2011)



Share of exports by enterprise type

Unit: % of total sales



Source: SCB EIC analysis using data from CEIC and the International Finance Corporation's Enterprise Survey

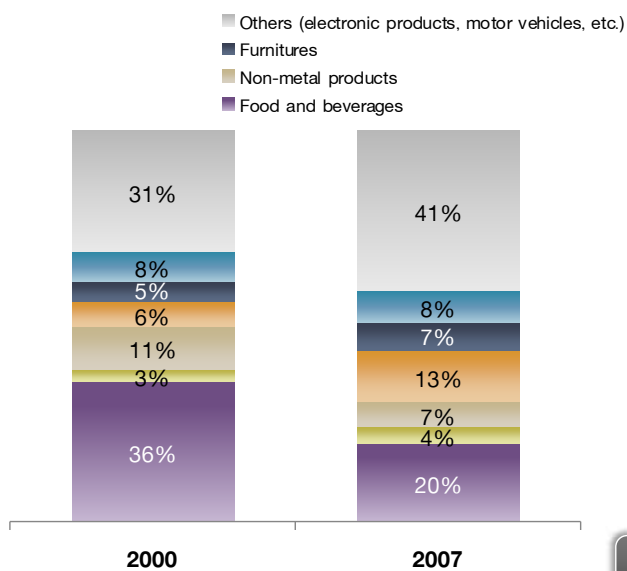
**High-tech industries in Vietnam are likely to grow substantially as a result of continued investment.**

The rise in the minimum wage in Vietnam has reduced the attraction of labor-intensive industries, because these businesses are now less competitive. Foreign investors have therefore switched to invest in high-tech industries, such as in the south of Vietnam, which is the region that has attracted the most multinational corporations. From mid-2012 data, 85% of investment projects that registered in the Dong Nai province involved high-tech industries. A look at the proportions of SMEs in various industries in Vietnam shows that the proportion of enterprises in the food and beverage industry, which requires high levels of labor, has been in decline, while other industries, such as electronic parts, have seen increases of around 30% per year in the number of enterprises. Thai SMEs can use this opportunity to find business allies. This might involve joint ventures with Vietnamese SMEs or large Thai manufacturers in order to manufacture in industrial estates that contain clusters of producers. The idea is to become part of manufacturing networks that supply to large operators, particularly multinational corporations, which are likely to increase their levels of investment. Vietnam has created more and more high-tech industrial estates to handle this growth; such special industrial estates grew from 1% of the sector in 2000 to 8% of all industrial estates in 2010.

**44 High-tech industries are likely to grow significantly in Vietnam.**

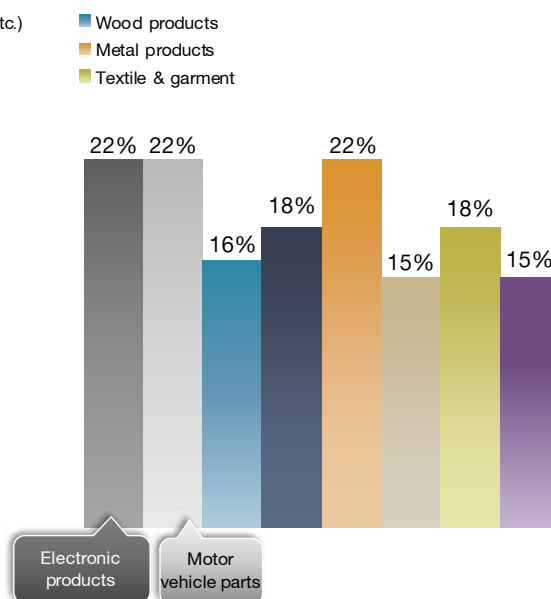
Share of SMEs in manufacturing sector in Vietnam

Unit: %



Manufacturing production growth in Vietnam

Unit: %CAGR (2000-2010)



Source: SCB EIC analysis based on data from CEIC and General Statistics Office Of Vietnam



**There are still many other trade and investment opportunities for SMEs from the AEC, but these opportunities also contain major obstacles that Thai SMEs must consider before engaging in business in neighboring countries.** Research into survey responses of SMEs in CLMV countries by the Economic Research Institute for ASEAN and East Asia (ERIA) and the Business Environment and Enterprise Performance Survey of the World Bank found that the main problems and obstacles faced by SMEs in these countries are similar to those faced by Thai SMEs. The problems include a lack of skilled labor, limits in the ability to develop technology, lack of management skills, uncertainty in investment regulations, and problems in marketing and distribution channels. Comparing the abilities of SMEs in Thailand to those in CLMV countries, Thai SMEs are still much stronger, be it in terms of product quality, ability to produce goods and services to respond to the demands of target customers, the ability to adjust to changing business environments, or better general management skills. If a Thai SME has already made a careful assessment of the risks and opportunities, it should expand its trade and investment into the CLMV countries, all of which have plenty of natural resources and lower labor costs than in Thailand despite recent increases. These countries are open to plenty more foreign investment.

**In considering where to invest, another factor that will lead to success aside from considering market potential and cost factors is choosing the right type of business to match the nation's investment policy.** For example, Cambodia is encouraging investment into food processing industries, textiles, machinery and machinery parts, and tourism. Laos is encouraging agricultural production, industries for export, construction and tourism. Vietnam is encouraging export manufacturers and goods that require technology and skilled workers, having set up a Special Economic Zone to handle such investment. Vietnam is also encouraging investments into construction and tourism. If operators choose to invest in businesses that enjoy state backing, the obstacles will be reduced and returns on investment will increase accordingly.

## Case study: Thai-owned real estate and construction businesses in Cambodia

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**Analysis into investment opportunities for SMEs in CLMV countries shows that the construction services business is growing well and is one good opportunity for Thai firms. However, there are risks that companies should consider carefully before investing.**

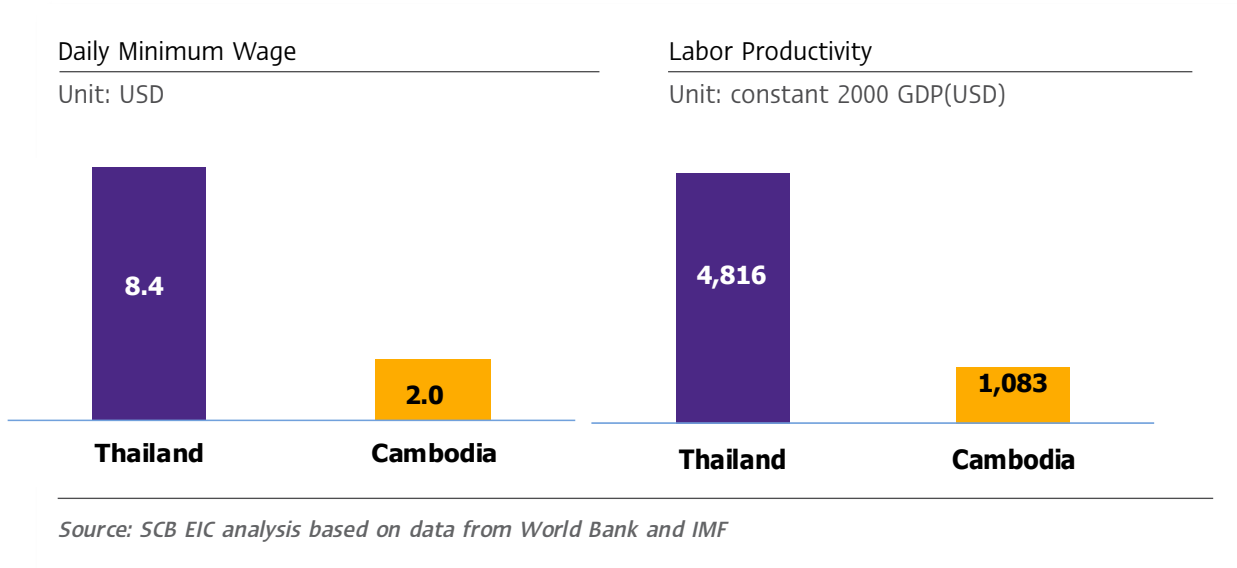
**Real estate and construction are businesses in which Thai companies have an advantage, thanks to more experience and expertise among other countries in the CLMV countries.** Real estate and construction businesses have been growing well in the last 10 years due to increased demand, especially in Cambodia. That nation is in the midst of developing basic public utilities such as roads, bridges, railways, ports, industrial estates and urban infrastructure. Real estate and construction services are therefore in demand, and many Thai real estate firms have been investing in Cambodia.

**Opportunities for Thai SMEs in the real estate and construction businesses' supply chain focus on subcontracting, because the skills and working standards of these Thai companies are well accepted.** But subcontracting abroad requires consideration of many factors, such as culture, law, public utilities, business processes and external risks. Companies should have no illusions about the actual costs, taking into account not only all direct costs but also hidden costs that have often led to projects in Cambodia being less successful than expected.

Thai companies should be especially careful to gain a realistic picture of labor costs and the minimum wage in the countries where they want to invest. Even though Cambodia's minimum wage is four times lower than Thailand's, workers there have low productivity, which may mean that an investment there does not actually reduce labor costs.

**A common misconception is that the Thai construction contractors, which are in a labor-intensive industry incurring over 40% of costs from labor, should benefit from lower labor costs in Cambodia.** Cambodia's minimum wage in the construction sector is at 2.00 US Dollars per day, four times less than Thailand's 8.50 Dollars per day, which should mean that the cost of building is lower. But Cambodian workers' productivity is likewise four times less than that of Thai workers, which means that with the same amount of workers, construction projects in Cambodia will take four times as long to complete as projects in Thailand, and may result in actual labor costs not being much lower than in Thailand. Furthermore, Cambodia also has a severe lack of such specialized workers as carpenters, electricians and plumbers, all of whom are needed in construction projects.

## 45 Even though Cambodia’s minimum wage is four times lower than Thailand’s, its labor productivity is also four times less.



Problems involving labor productivity will also affect other costs aside from production costs such as higher financial cost due to delayed delivery times. If a Thai company borrows from commercial banks, it will face higher interest costs due to a longer period of borrowing. Labor productivity in Cambodia will not improve any time soon, so companies should consider the possibility that costs might be higher than expected and that products might not get finished on time. Thai companies should find ways to communicate in the local language to reduce mistakes in work processes.

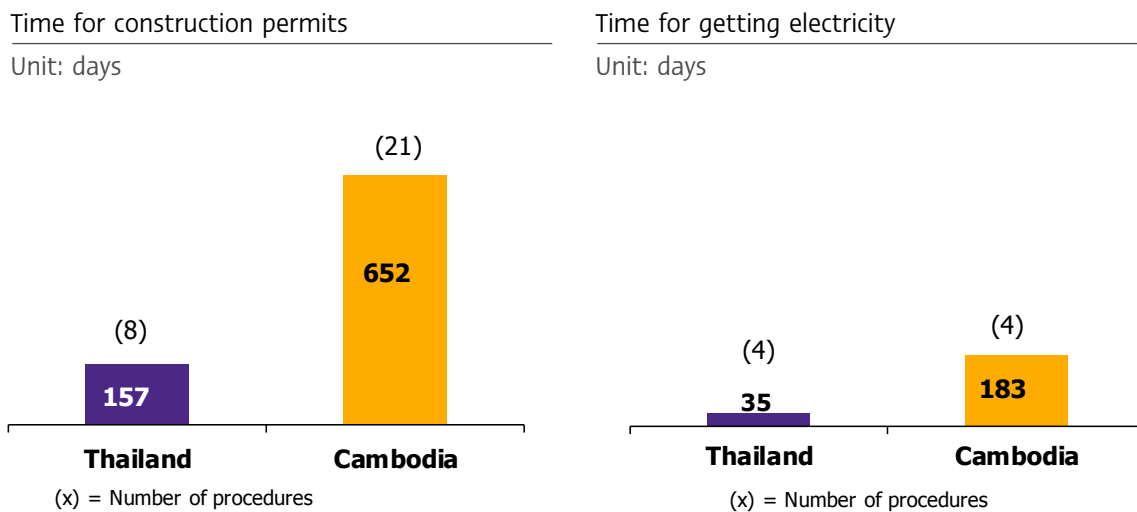
Furthermore, there are other hidden costs that may be obstacles to work and that may increase the overall costs of construction in Cambodia. These include:

- 1. Hidden costs that impact inouts of production<sup>1</sup>** This includes the lack of adequate public utilities and transport, which will result in increased transportation costs for materials, most of which are imported from foreign countries, including Thailand. The tax rates for imports are the same for all products, and importing construction materials will result in a 10 percent tax that cannot be redeemed.
- 2. Hidden costs that impact the work process** – The long and complicated process of getting construction permit<sup>2</sup> in Cambodia will be a major obstacle in operating real estate and construction businesses. The Doing Business (2012) report by the World Bank found that the process of getting construction projects approved in Cambodia contains 21 procedures and takes over 652 days, compared to much easier processes in Thailand, which have only 8 procedures and take 152 days. The long and complicated process often requires bribes to officials to speed things up, which increases costs.

<sup>1</sup> This means domestic conditions or factors that create obstacles to production, including the adequacy of public utilities, like roads that connect construction sites, or power and water supplies.

<sup>2</sup> The World Bank examined Cambodia’s process for getting a warehouse construction project approved in order to compare with other countries. The processes that waste a lot of time are getting construction approval from local authorities, which takes over 365 days, and getting electricity and plumbing installed, which takes up to 42 days.

## 46 Hidden costs in Cambodia result from a long and complicated process for getting projects approved.



Source: SCB EIC analysis based on data from World Bank

Aside from risks to the production process, there are also social, cultural and political factors that Thai companies should consider before investing. These include hostile attitudes toward Thai firms due to diplomatic frictions between the two countries; safety of life and property; language; intellectual property laws and their enforcement; tax and accounting systems; and the process of making payments between countries.

Yet Cambodia has high potential for growth. Its economic growth in the last five years has averaged at around 6.5% per year. Also, it has attracted significant foreign direct investment. The currently positive outlook for economic reforms by the Cambodian government should drive further growth. Thai businesses should therefore consider the opportunities for investment by considering the overall context that affects actual costs rather than the mere advantage of cheap labor.

# BOX: Simulation to compare the costs of constructing one standard house<sup>1</sup>

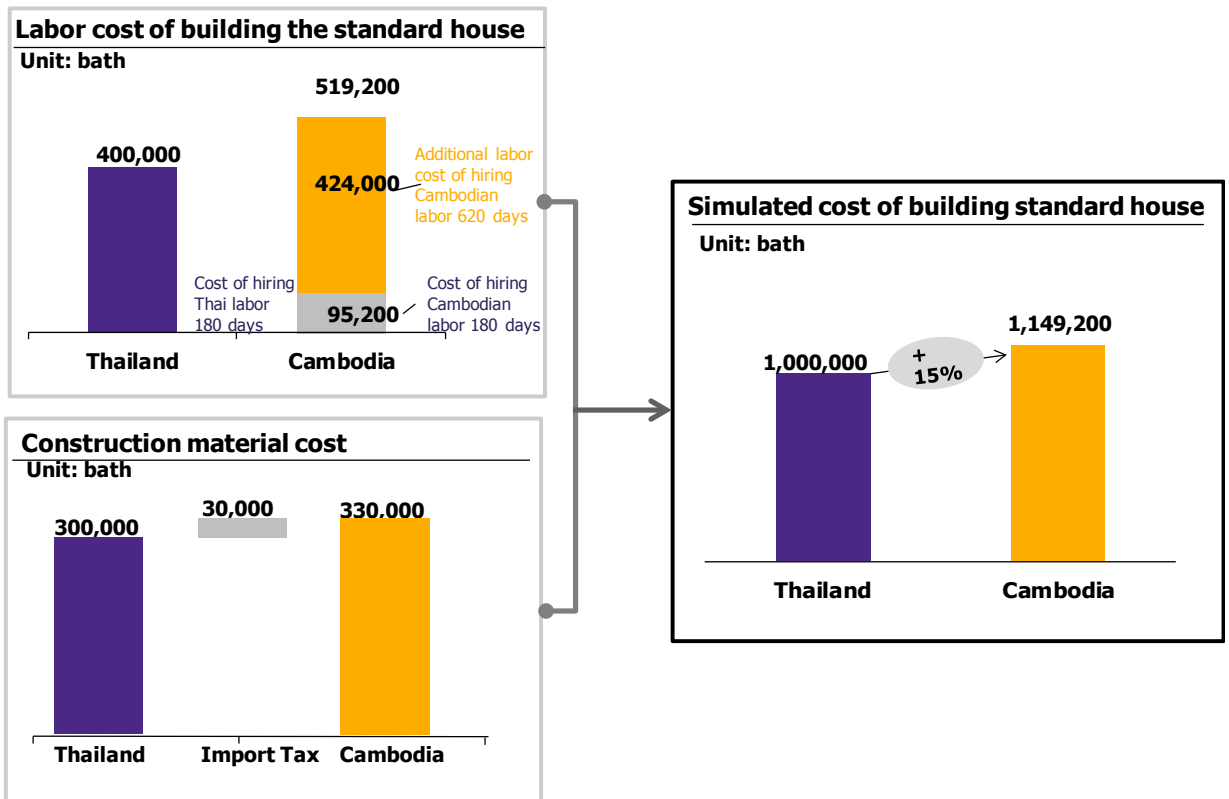
The costs of constructing a standard house in Thailand, taking 180 days to complete, include:

- (1) labor costs 40%
- (2) material costs 30%
- (3) other operating costs 30%

Assuming the cost of construction of a standard house in Thailand is 1,000,00 Baht, labor costs will be 400,000 Baht, material costs will total 300,000 Baht and other operating costs will add 300,000 Baht.

Assuming the cost of construction of a standard house in Thailand is 1,000,00 Baht, labor costs will be 400,000 Baht, material costs will total 300,000 Baht and other operating costs will add 300,000 Baht. If the same house is to be constructed to the same standards in Cambodia using only Cambodian labor, operators may face 15% higher costs than in Thailand, and 80% of those increased costs are in the form of higher total labor costs.

**47** Even though Cambodia's minimum wage is four times lower than Thailand's, its labor productivity is also four times less.



Source: SCB EIC analysis

<sup>1</sup> A standard house is defined as the kind of house that the Real Estate Information Center (REIC) uses to calculate its costs of building. It is defined using the prototype of the Department of Public Works as a two-storied house with 169 meter squared of space in an area of 256 meters squared. Costs exclude land costs, and construction takes place over 180 days.

The labor cost for constructing one standard house in 180 days in Thailand is 400,000 Baht. The same project in Cambodia also completed in 180 days would only cost 95,200 Baht in labor costs because the Cambodian minimum wage is four times lower than Thailand's. However, because productivity is four times lower<sup>2</sup>, the project may actually take up to 800 days to complete. As a result, labor costs will in fact be more than when operating in Thailand, and longer operating days in the project will lead to higher financing costs that companies should consider about the interest bearing costs of project loans.

Cambodia is unable to produce raw materials that are essential to construction projects, such as steel, concrete and cement. Therefore all these materials will have to be imported. The system of import tariffs on foreign goods imposes a 10% tax on all types of goods. This cannot be refunded and will therefore increase the cost of raw materials.

Furthermore, operators have to face other costs due to the lack of adequate public utilities, such as higher transportation and electricity costs, which will also increase overall operating costs.

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<sup>2</sup> Due to the lack of data on Cambodian Industries, this number is based on overall Cambodian labor productivity, which is not industry-specific and may be more or less than 4 times in real life.

# BOX: Relaxation of The Bank of Thailand's Capital Control Policies

Thailand's capital controls are a policy that SMEs should understand before investing in foreign countries. The Bank of Thailand recently relaxed its capital control policy regarding investments in other countries for 2012-2013 to help companies increase capacity, encourage diversification of risks in investment, and prepare for the AEC.

## 48 The relaxation of Thailand's capital controls should make it easier for SMEs to invest in foreign countries.

	New policy	Old policy
Foreign direct investment	Allows for individuals and SMEs to invest <u>unlimited amounts</u> of capital in foreign countries.	Individuals can invest no more than 100 million USD per year. Juristic person can freely invest unlimited amounts of capital since 2010.
Investing in foreign securities	Added companies registered in the stock exchange as a 9 <sup>th</sup> type of investing institution and <u>unlimited amounts of capital</u> placed on investors. New instruments that can be invested into cover foreign currencies that are issued and sold in Thailand.	Only 8 types of institutional investors, such as state funds, securities companies, insurance companies or large companies. Outstanding investment is limited to 50 million USD per year.
Deposits in foreign currency	Allows for individuals in the country to deposit foreign currency in any domestic monetary institutions with obligations <u>without financial or time limits</u> .	Limits on amount and duration of deposits of foreign currencies in Thailand (1 million USD per year for individuals, 100 million USD per year for companies).
Risk management	Allows for individuals in the country who have made transactions to prevent exchange-rate risks in foreign investments to <u>freely unwind hedges</u> .	Unwinding hedges to offset exchange rate risks in foreign investment is considered and allowed on a case-by-case basis and must be approved by the Bank of Thailand.
Others	Relaxed qualifications and increased financial limits for money changers / money transfer agent businesses so as to increase efficiency in the exchange and transfer of foreign currencies.  Relaxed transactions involving the Thai Baht for nonresidents (NR), such as by expanding the financial limits for liquidity allowance of domestic monetary institutions. Non-underlying investment loans for NRs are supported at 500 million THB per NR group per monetary institution, and allow for domestic monetary institutions to give out direct loans in Baht for nonresidents for domestic trade and investment.	

Source: SCB EIC analysis based on data from Bank of Thailand

These capital control relaxations should make it more convenient for Thai businesses to take funds out of the country, create flexibility in exchange rate risk management, and generate more opportunities to expand markets and manufacturing bases, which will increase competitiveness.

# 8 Conclusion

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**Thailand's SMEs will face challenges that require adaptation to ensure survival. In the medium and long term, the minimum wage rise will have significant impacts on the structure of business in Thailand.** Labor costs of business will not only increase from a direct result of the minimum wage rise, but also from pressure to raise wages in other positions. In addition, a business may face with an increase in other expense indirectly caused by pass-through costs.

**These increases in total cost may cause some Thai SMEs to incur such high losses that they have to close, especially manufacturers that rely heavily on labor.** Moreover, SMEs have few options in adapting, because it is difficult for them to move operations abroad to expand their market and increase sales to compensate for lost earnings or to upgrade to using more machinery. Ultimately, some SMEs working within the supply chains may have to be acquired vertically.

Adaptation to the minimum wage rise will become a question of survival for Thai SMEs that are earning low profits and rely heavily on labor, perhaps because they do not have capital to invest in machines. Most SMEs normally are subcontracting companies whose labor costs can be as high as 40% of total operating costs, and most of this involves unskilled workers who simply process raw materials and pass on to the next manufacturer in the supply chain. Thus cheap labor has always been a major factor and key advantage of Thai SMEs. Raising the minimum wage will greatly affect these SMEs, because it is already difficult for them to control most of their other costs, especially energy costs like electricity and fuel since SMEs do not have economies of scale. So most SMEs are likely to see lower profits due to the minimum wage rise.

**But SMEs are vital to many downstream businesses as initial suppliers. Therefore, they are likely to merge with businesses next in line in the supply chain, rather than close down. This is especially true among manufacturers of small parts for large industries, because a lack of these small parts would impact the entire supply chain.** If SMEs face financial problems to the point where they are unable to continue their business, industries at the next level of the supply chain may have to provide assistance or take over operations to keep the supply chain going. The manufacturing sector, in particular, requires a tight supply chain, as in the case of automobile manufacturing, which requires many parts and needs to plan production and find suppliers beforehand for all parts required. The survival of SMEs that manufacture small parts as initial suppliers in supply chains is therefore very important to the entire automobile manufacturing process. Industries in the next level of the supply chain may be forced to take over these operations, especially when the required parts have to come from within the country.

**Another solution is to increase the size of SMEs, which may occur by merging with larger businesses in order to achieve economies of scale and improve technologies and machinery used in manufacturing or other operations.** Increasing business size will enhance sales in the face of profit margin declines related to increased labor costs, while increase capital investment will help increase labor productivity. However, there is

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also a chance that very small businesses may have to close down and lose market share to larger ones, which may include not only large Thai businesses but also large foreign companies that will begin to play a bigger role, especially because the AEC will increase investment opportunities for companies from other ASEAN nations.

**Furthermore, because labor costs will no longer be different across the country, businesses will cluster around industrial areas. Traditionally, manufacturing industries that require lots of workers, particularly unskilled workers, tend to expand their manufacturing bases into areas with cheap labor.** This is akin to opening factories in areas with cheap raw material, sacrificing transportation costs and some infrastructural problems. The rise in the minimum wage means the minimum wage will be equal across the country, leading to most factories expanding into traditionally industrial areas or near city centers.

**Bargaining power will also be transferred to workers, especially unskilled workers who are in demand and tend to choose to work in industries with better conditions.** Factories whose working environments involve “the 4 Ds” – dirty, dangerous, difficult and demeaning – will find it even more difficult to hire unskilled labor, which is already scarce. One example is the bleaching and dyeing industry, where factories tend to have problems involving dust and noise. Workers are more likely to join companies with less pollution, such as electronics component factories.

**Labor shortages will therefore become a bigger problem, because there will be more competition for workers in nearby areas.** The manufacturing industry has been suffering from shortages of unskilled labor for a while already, because many workers have moved back to work in the agricultural sector (beyond temporary returns only for the harvest season). The main motivators of this move are the continued rise in prices for agricultural goods, one clear example being higher prices for rubber, which has led to an expansion in the total land area in which it is grown.

Some industries also have certain advantages and disadvantages in terms of working conditions. We expect that companies will therefore try to offer new and different attractions to workers. In the past, these attractions have included higher wages, increased job benefits or overtime. The rise in the minimum wage will mean that simply using wages as a motivator will be more difficult to do. Improving working conditions may be another way to attract workers.

**If SMEs can adapt effectively, Thailand’s labor productivity will increase and push the economy out of the middle-income trap. However, increasing SMEs’ labor productivity by 75% will be difficult to do alongside raising the minimum wage twice in one year.** In the short term, the government should assist in SMEs’ efforts to adapt. Assistance could take many different forms. The government could help increase labor capabilities such as by giving funds to support the development of skills to increase productivity and to match employer needs, as well as by providing financial support for Thai workers to study foreign languages to prepare for the AEC.

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The government can also support the restructuring of SMEs to reduce costs and increase income opportunities, such as through business matching between SMEs or by providing advice on adding value to products. It can also provide assistance through short-term remedial measures, which entrepreneurs agree should provide them with some basic assistance, such as decreasing income taxes or reducing mandatory payments to social insurance funds. The government can also begin rehabilitation programs, similar to ones in the United States, to protect small businesses and encourage contracts between small businesses and the government.

**Because adaptation to rising labor costs is inevitable, increasing income is one method that needs to be implemented through effective channels.** These channels might include border trade, which is expanding at around 12% every year, whereas overall foreign trade is growing by only 8% per year. Another channel is **capturing new market and consumption trends**, such as marketing through online social networks, which has low operating costs but can reach a wide range of consumers; targeting niche markets such as health-conscious consumers; and tapping markets for environmentally friendly products.

Another channel is to **engage in the AEC's new opportunities**, because trade will be easier both in terms of taxes and processes, especially trade within the CLMV countries, which have high growth in terms of their overall economies and per-capita income. Some of these channels will require government support to assist SMEs, such as for increasing competitiveness in the AEC.

**But Thai SMEs cannot simply wait for help. Adapting only defensively by decreasing costs will not be enough. Companies should become proactive.** This means they should create uniqueness and branding for their products and services or form industrial groups to strengthen themselves and gain collective bargaining power.

Companies can also look for partners or customers in growing industries in order to expand their businesses together. Changing business models to increase competitiveness is also an appropriate way to adjust in an environment where labor constraints and costs are major problems that cannot be easily avoided.

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for effective decision making

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# NOTES

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