



## **EXPLORING THE NEXUS BETWEEN MICRO SMALL MEDIUM ENTERPRISE, FINANCIAL INCLUSION, AND ECONOMIC GROWTH IN ASEAN 3**

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### **Abstract**

Small and medium enterprises (MSMe) are one of the major contributors of economic growth. The Philippines, Indonesia, and Thailand (later referred to as ASEAN 3) have identified this sector as the major component of the respective economy. However necessary to the sustainability, the lack of access to capital and credit necessary for the inception and sustainability of its operation(s) has proven to be a key complication. Financial inclusion is one of the solutions for small and medium-sized micro enterprises related to access to financial services. This paper analyzed the relationship of financial inclusion to the growth of micro, small and medium enterprises; and economic growth of the ASEAN 3. The authors have investigated financial inclusion using variable numbers of Automatic Teller Machine (ATM) per 100,000 people, commercial banks per 1,000 adults, and a number of bank branches. Panel vector auto regression (PVAR) were used in this study to investigate the relationship of financial inclusion and MSMe during Q12004 - Q42016. The results of the AR showed that the MSMe variable responded to the dynamics of financial inclusion, then the variable of economic growth also responded to the dynamics of MSMe in ASEAN 3.

Keywords: Financial Inclusion, MSMe, Economic Growth, ASEAN 3, VAR.

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### **INTRODUCTION**

Micro Small and Medium Enterprises are independent businesses which recruit a small number of workers. The definition of which, may vary among countries. For simplification, authors define MSMe under two categories: theoretical and operational [1], [2]. cited that a specific qualitative criterion for theoretical definition must be met by MMSMe: independence, firsthand comprehension, the financial and personal commitment by the owner. On the other hand, operational definitions may be based upon annual income, total number of workers and capital disbursement. Categorizing small and medium enterprises may be attributed to their financial assets [3]-[5]. MSMe generate more jobs, provide lower costs of trading, promote efficiency and stimulate the regional economies [6]. The industrial pyramid tells us that small and micro enterprises encompass the huge part of the percentage while large firms consist the smallest fraction, followed by a substantial amount of medium enterprises. As the country develops, this basic industrial scale structure will remain [7].

Financial inclusion is defined as a high level of inclusion wherein formal systems allow individuals to obtain easy access to financial services and capital. It can also be defined as a process to ensure access to financial and credit services required by vulnerable and low-income groups [8]. Efficient channeling of surplus funds to credible individuals via financial intermediation would be achieved through financial inclusion [8]-[12]. According to [13], financial inclusion will help create jobs and provide income to MMSMe. A wide range of inclusivity in financial services is an essential requirement for economic growth, considering its ability to expand capital and induce investment [14], [4], [15].

In recent years, the global economy is driven by the rapid progress experienced by Asian countries. Micro Small Medium Enterprises (MSMe) are the cornerstone of these local economies [16]. MSMe in the ASEAN 3 dominate the market share. In the Philippines, out of all the business establishments, 99.5 percent are MSMe [17]. Meanwhile, in Indonesia, MSMe comprise 99 percent of the business sector [18]. On the other hand, MSMe in Thailand represent 99.8 percent of the total firms [19]. However, MSMe face problems that may affect their operations and growth. Constraints in finance, technology, availability of inputs and access to the market are the major bottlenecks. Banks are highly reluctant to lend funds because of higher transaction costs, lack of collateral and higher perceptions of risk [20]. Often MSMe as well have the low and poor level of technology, which leads to inefficiency, idleness, and dissipation [20]. High logistics cost and poor infrastructure serve as a barrier in transporting raw materials. Furthermore, MMSMe experience problems due to market imperfections and government regulations [6].

MSMe for a long time have struggled in acquiring the needed capital. The firm's progress is often impeded by limited access to credit, equity, and payment services. An enterprise survey by World Bank shows that small firms have restricted access to funds and often resort to informal lending which hampers growth and performance [21]. Major disparity in access to financial services is observed in the least developed economies,

41% of the MSME in these countries revealed that acquiring funds is a major constraint compared to 30% in middle-income countries and 15% for high-income countries [21]. Majority of the firms in the Philippines have said the accessing financial services is still a major constraint. Only 33% of the firms are reported to have bank loans [16]. Financial illiteracy and ineptness to manage businesses contribute to roadblocks in attaining financial inclusion in Indonesia [22]. Only 6% of the firm's funds come from [23]. In Thailand, a huge amount of MSME relies on personal savings and informal borrowing: 58% of which are ineligible to acquire financial services [23].

The impact of general financial inclusion is on long-term economic growth and efforts to alleviate poverty (Uddin, Shahbaz, Arouri, & Teulon, 2014). Given financial inclusion, vulnerable and low-income populations are expected to invest in physical assets and education so as to increase revenues and can contribute to economic growth [12]; Zins & Weill, 2016). Through financial inclusion, the capital needed by MSME will be acquired and thus firms will be able to improve the operations and systems in place, create more jobs and promote competitiveness. This, in turn, will lead to increase in money supply and banking credit, translating to an increase of well being for the poor and the growth of financial transactions will stimulate a room for asset accumulation and smooth spending [24]. A study by [25] reveals that innovation brought about by MSME is an important agent in export performance. The jobs produced by MSME leads to higher productivity which in turn results in business expansion. Furthermore, the business expansion will contribute to increase in investment and consumption [26].

As observed, financial inclusion for MSME will lead to economic growth. This paper aims to examine in detail the relationship between the three variables using different indicators. This study will focus on ASEAN 3 countries consisting of Philippines, Indonesia and Thailand. These countries were chosen based on their similarities in economic structure that small open economic. We use Panel vector auto regression (PVAR) to investigate the relationship of nexus between micro small medium enterprise, financial inclusion, and economic growth in ASEAN 3.

## METHODOLOGY

ASEAN 3 Indonesia, the Philippines, and Thailand are the main focuses of this research, then this research seeks to provide an overview of the integration in MSME nexus analysis, financial inclusion and economic growth. Based on this objective, this study uses the VAR Panel analysis method to analyze the Nexus MSME, financial inclusion, and economic growth in ASEAN 3. The research refers to a research model built by Kim et al., 2017 built on the dynamics model of panels and then transform into the VAR Panel model, the model is written as follows:

$$gdp_{it} = \sum_{j=1}^p a_j gdp_{i,t-j} + \beta_1 inf_{it} + \beta_1 pop_{it} + \beta_1 sep_{it} + \beta_1 trade_{it} + \beta_1 unep_{it} + \begin{pmatrix} \beta_1 atm_{it} \\ \beta_1 branch_{it} \\ \beta_1 depo_{it} \\ \beta_1 borr_{it} \\ \beta_1 lissur_{it} \end{pmatrix} + v_{it} + \epsilon_{it} \quad (1)$$

Based on the model we add variable indicator of micro small medium enterprises, the model built is as follows:

$$\varphi SMEs = f(\varphi FI, \varphi EG) \quad (2)$$

$$\varphi FI = f(\varphi SMEs, \varphi EG) \quad (3)$$

$$\varphi EG = f(\varphi FI, \varphi SMEs) \quad (4)$$

Where  $\varphi SMEs$  is a vector of the MSME indicator, then  $\varphi FI$  is a vector of financial inclusion indicators, and  $\varphi EG$  is a vector of economic growth indicators.

The VAR method can only analyze the time series data is not for panel data, therefore in accordance with Love and Zicchino 2005 to eliminate endogeneity in model and autocorrelation, this research also uses the Arellano-Bond dynamics model and can be resolved as follows.

$$\varphi SMEs_{it} = \sum_{j=1}^p a_j \varphi SMEs_{i,t-j} + \beta_1 \varphi FI_{it} + \beta_2 \varphi EG_{it} + v_{it} + \epsilon_{it} \quad (5)$$

$$\varphi FI_{it} = \sum_{j=1}^p a_j \varphi FI_{i,t-j} + \beta_1 \varphi SMEs_{it} + \beta_2 \varphi EG_{it} + v_{it} + \epsilon_{it} \quad (6)$$

$$\varphi EG_{it} = \sum_{j=1}^p a_j \varphi EG_{i,t-j} + \beta_1 \varphi FI_{it} + \beta_2 \varphi SMEs_{it} + v_{it} + \epsilon_{it} \quad (7)$$

Then the model is transformed into Panel VAR model to be as follows:

$$Y_{it} = C + \sum_{s=1}^m A_s Y_{i,t-s} + \eta_i + d_{c,t} + e_t \quad (8)$$

## RESULT AND ANALYSIS

### VAR Estimation Results on Testing Nexus between Micro Small Medium Enterprise, Financial Inclusion, and Economic Growth in ASEAN 3

The empirical results of the P-VAR analysis can show different behavior between macroeconomic variables and financial inclusion variables in influencing MSMe in ASEAN 3 both in the long term and short term. P-VAR has several important tests including Test Stationary data, cointegration test, optimum lag selection, impulse response function (IRF), and variance decomposition (VD). Levin, Lin & Chu t, Im, Pesaran and Shin W-stat, ADF - Fisher Chi-square, PP - Fisher Chi-square stationer test is used to test the unit root test of the data used in this study, if the probability value of  $\text{prob} < \alpha$  then it can be said that the data is stationary. The estimation results show that all the variables in ASEAN 3 have stationary at the first difference level indicated by the probability value  $< \alpha$ .

**Table 1. Stationerity Data Test**

Variables	Statistical Value	LLC	IPS	ADF-Fisher	PP-Fisher
GDP	Statistic (prob)	0.53951 (0.0000)*	-6.40426 (0.0000)*	49.3266 (0.0000)*	91.3107 (0.0000)*
Inflation	Statistic (prob)	-2.91881 (0.0018)*	-6.43096 (0.0000)*	49.5862 (0.0000)*	91.5549 (0.0000)*
Population	Statistic (prob)	-12.2167 (0.0000)*	-13.8284 (0.0000)*	117.905 (0.0000)*	84.3592 (0.0000)*
Trade	Statistic (prob)	-2.54840 (0.0000)*	-6.96241 (0.0000)*	55.2975 (0.0000)*	96.0779 (0.0000)*
Unemployment	Statistic (prob)	-7.68749 (0.0000)*	-7.10248 (0.0000)*	56.2025 (0.0000)*	97.6416 (0.0000)*
ATM	Statistic (prob)	-12.1216 (0.0000)*	-13.0801 (0.0000)*	112.494 (0.0000)*	55.2620 (0.0000)*
Branchles Banking	Statistic (prob)	-8.41173 (0.0000)*	-8.64328 (0.0000)*	71.3441 (0.0000)*	112.650 (0.0000)*
MSMe	Statistic (prob)	-11.5948 (0.0000)*	-10.8557 (0.0000)*	92.5437 (0.0000)*	100.105 (0.0000)*

\*Stationer 5%

The next important test used in the P-VAR analysis is the cointegration test. Table 2 shows the cointegration test results of various variables in ASEAN 3. Cointegration test results show that the overall variable used is not cointegrated so that the model used in P-VAR is a short-term model. This result is obtained from the trace statistic value which is smaller than the critical value in each ASEAN 3.

**Table 2. Cointegration Test**

Degree	Critical Value	Trace Statistic	Information
1%	171.0905	260.6060	Cointegrated
5%	159.5297	260.6060	Cointegrated
10%	153.6341	260.6060	Cointegrated

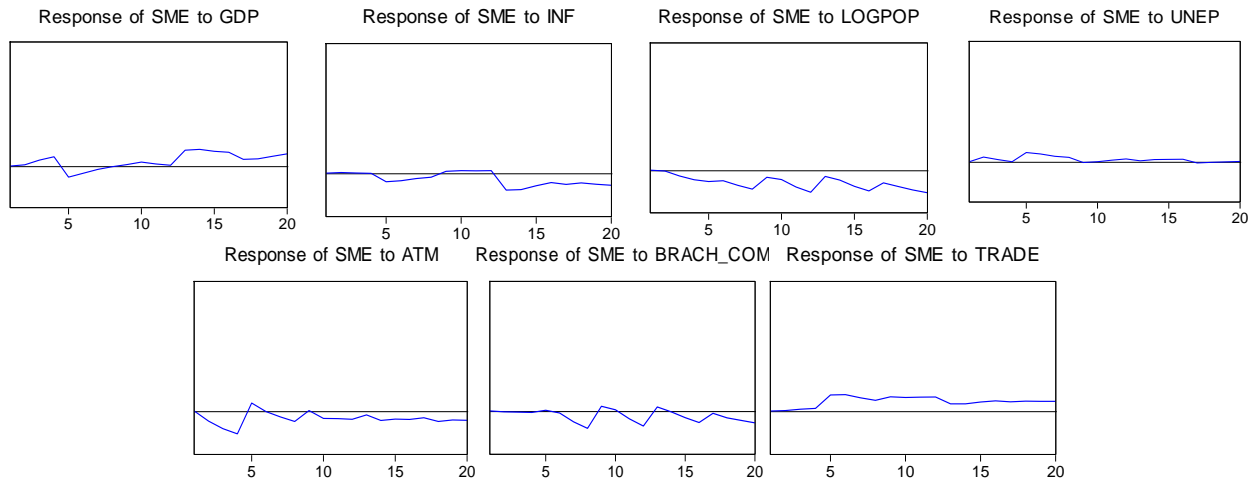
The next important test conducted in the P-VAR analysis is the optimum lag test. In this research optimum lag test is used to determine the best optimum lag value in P-VAR model. Determination of appropriate lag aims to free the model of the problem of autocorrelation and aims to determine the vulnerability of the time period of the influence of a variable to the variable of his past as well as to other endogenous variables. Determination of lag used in this research is Akaike Information Criteria (AIC). Then in accordance with the case then in this study, the optimal value chosen is the optimal value that has the smallest value. Optimum lag estimation result with AIC (Akaike Information Criterion) method can be seen that the best lag optimum value is at lag 5.

**Table 3. Optimum Lag Test**

Lag	LogL	LR	FPE	AIC
0	-3984.6	NA	2.58E+16	60.49394
1	-2252.65	3227.719	273949.4	35.22202
2	-2230.95	37.81713	525110.1	35.86287
3	-2187.33	70.72511	733514.9	36.17159
4	-1837.59	524.5994	10156.7	31.8423
5	-1570.99	367.5898	512.4958*	28.77255*

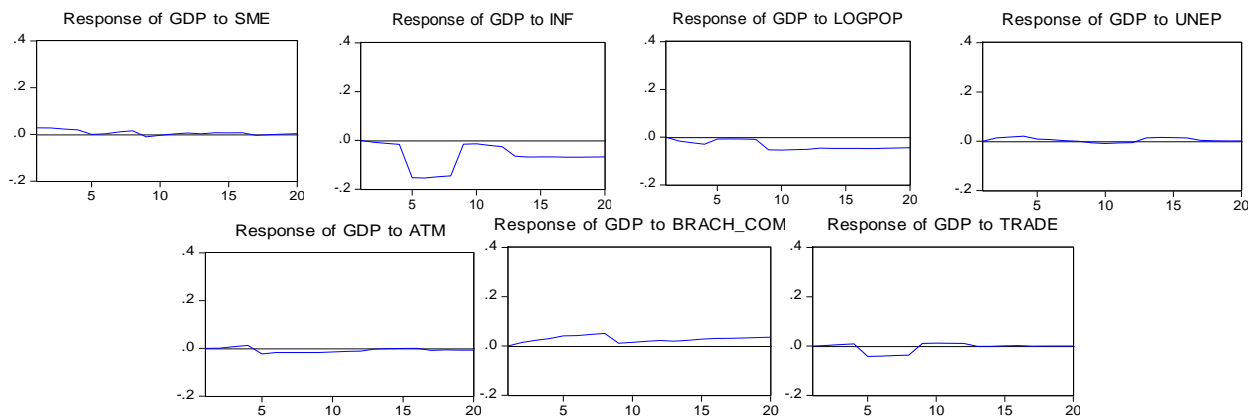
\*Smallest AIC Value

The next important tests used in the P-VAR analysis are impulse responses function and variance decomposition. Impulse responses function aims to see the response of one of the variables due to shocks in other variables. Meanwhile, analysis of variance decomposition to see the magnitude of contribution due to shocks on the variable. Analysis of impulse responses function and variance decomposition in ASEAN 3. The following will explain the result of Impulse Response Function and Variance Decomposition test analysis in each model in ASEAN 3.



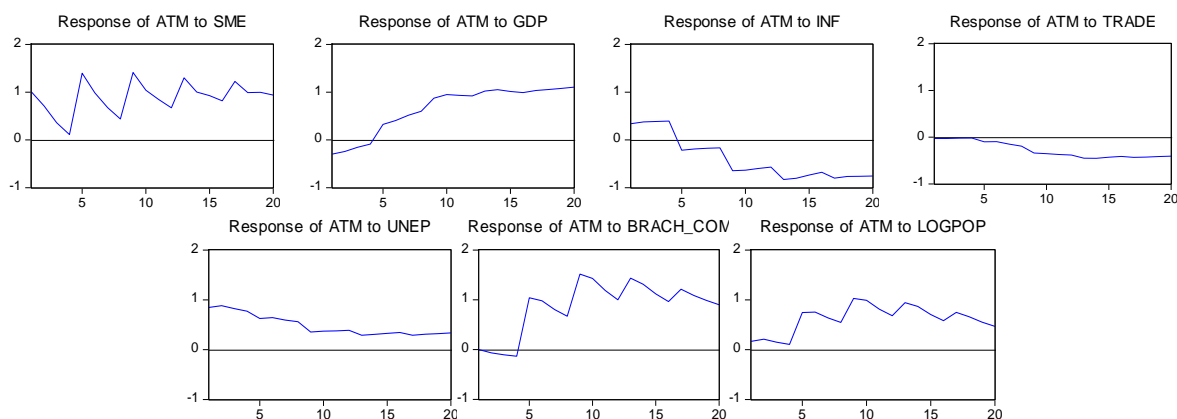
**Figure 1. Impulse Response of MSME in ASEAN 3**

The Impulse Response function results in the MSMe model are illustrated in Figure 1. Overall the MSMe variable has different responses in response to changes that occur in macroeconomic variables and financial inclusions. When shock occurs on the variable GDP responded volatile by MSMe until the end of the period. Then for the variable Inflation, population, and unemployment, responded negatively by variable MSMe. Then for the variable number of ATM, branchless banking, and trade responded positively by variable MSMe.



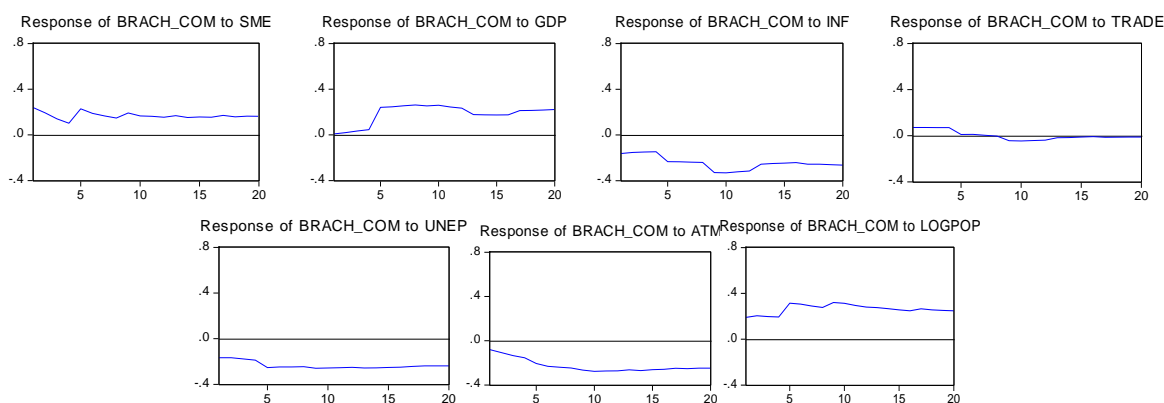
**Figure 2. Impulse Response of Economic Growth in ASEAN 3**

Figure 2 shows the impulse response on the economic growth variable of MSMe and financial inclusion. When there is a shock on the variable inflation and the population will be responded negatively by economic growth. Then in the event of fluctuation in variable MSMe, ATM, branchless banking, and trade will be responded positively by economic growth in ASEAN 3.



**Figure 3. Impulse Response of ATM in ASEAN 3**

Figure 3 shows the results of impulse response function on ATM variables to MSMe and economic growth, which is known that ATM is one indicator of financial inclusion. When shock occurs on the variable MSMe, GDP, banking branches, and the population will be responded positively by the ATM. Then in the event of turmoil on the variable inflation, trade, unemployment will be responded negatively by ATMs in ASEAN 3.



**Figure 4. Impulse Response of Branch of Commercial Bank in ASEAN 3**

Figure 4 shows the results of impulse response function on the variable branchless banking to MSMe and economic growth, where it is known that banking branches are also one indicator of financial inclusion. When there is a shock on the variable MSMe, GDP, the population will be responded positively by branchless banking. Then in the event of fluctuation in variable inflation, trade, unemployment, ATM will be responded negatively by banking branches in ASEAN 3.

**DISCUSSION**

The results of PVAR testing on the nexus between micro small medium enterprise, financial inclusion, and economic growth in ASEAN 3 can be seen that all macroeconomic variables and financial inclusion contribute to the dynamics of MSMe. Then for variable MSMe and financial inclusion is also known to contribute to economic growth. In the financial inclusion model, it is known that the variable of economic growth and MSMe also contribute to financial inclusion in ASEAN 3. This condition provides an overview of the relationship between the three indicators, where there is a link between MSMe, financial inclusion and economic growth. MSMe's growth is intended to provide stimulus to economic activity in the lower middle class, then it is expected to be supported by financial inclusion inductor and then will be responded by economic growth [27, 28, 29]. It also provides an overview of how important the nexus is between the three indicators.

MSMe is one of the main supporting economic growth in various countries, especially in developing countries such as ASEAN countries 3. MSMe growth is expected to provide stimulus to the economy, where most MSMe did by middle-class people down [30, 31]. MSMe is one of the obstacles to MSMe's development in ASEAN 3. Market access, credit, capital is one of the problems faced by MSMe in ASEAN 3. Then Lack of suitability (occurrence mismatch) between available funds that can be accessed by SMEs, not a systematic approach to MSMe financing, high transaction costs, caused by complicated credit procedures that take a lot of time while the amount of credit disbursed is small [32, 33]. Lack of access to formal sources of funds, whether caused by the absence of banks in the remote and unavailability of adequate information. Interest rates for investment and working capital are quite high. Many MSMe are not bankable, either due to lack of transparent financial management or lack of managerial and financial capability [10, 34, 8, 11]

Financial inclusion as one of the instruments to provide a solution to the problems faced by MSMe in ASEAN 3. Financial inclusion provides financial access to MSMe through access to financial services and credit services [8]. In addition, financial inclusion is broadly defined, referring to universal access to various financial services at a reasonable cost [8]. It also provides an overview of the functions of financial inclusion that provide access to financial services at the lowest possible cost. Financial inclusion has become a major pillar of policy-development in most countries around the world. This comes from the realization that an inclusive financial system is vital in reducing extreme poverty, promoting common prosperity, and promoting inclusive and sustainable economic growth and development (Chang, 2014; McKinley, 2010).

The impact of general financial inclusion is on long-term economic growth and efforts to alleviate poverty and inclusive economic growth (Uddin, Shahbaz, Arouri, & Teulon, 2014). With financial inclusion, vulnerable and low-income populations are expected to invest in physical assets and education so as to increase revenues and contribute to economic growth [12] ; Zins & Weill, 2016) . The pattern of economic development in developing countries which is still focused on economic growth without considering the aspect of evenness is one of the causes of the problem of inequality. The phenomenon of inequality and poverty is a classic problem faced by developing countries.

ASEAN countries 3 as a developing country that has the potential to develop MSMe to increase its economic growth. Economic inclusion in the ASEAN 3 region has become one of the potentials to boost economic growth together through increased MSMe and financial inclusion. ASEAN countries 3 make MSMe and financial inclusion a major focus in its economic activities. Indonesia has a policy on financial inclusion through enhancement of financial services and facilitates access to financial services. Utilization of technology and communication services further facilitates the development of financial inclusion in ASEAN 3.

## CONCLUSION

Lack of awareness of the importance of financial services, lack of access to finance, and credit is a problem faced by MSMe. This study analyzes the dynamics of the macroeconomic variables (GDP, inflation, trade, population) used to investigate the dynamics of the nexus between micro small medium enterprise, financial inclusion, and economic growth in ASEAN. The contribution of economic growth to MSMe growth dynamics and financial inclusion in ASEAN 3. Then the variable of financial inclusion indicator (ATM and Branches banking) is used to measure the contribution of the variables to economic growth and MSMe. Then the variable of financial inclusion and MSMe is intended to investigate economic growth in ASEAN. The empirical findings provide results that macroeconomic variables and financial inclusions have contributed to the determination of MSMe in ASEAN 3. Then for MSMe variables and economic growth also contributes to financial inclusion, and for MSMe and financial inclusion variables also contribute to economic growth. This can provide an overview of the relationship between nexus between micro small medium enterprise, financial inclusion, and economic growth in ASEAN 3. The policy of increasing financial inclusion in ASEAN 3 is expected to provide an increase to MSMe growth and will have an impact on economic growth. ASEAN countries 3 can boost integration and jointly can contribute to the importance of financial inclusion in MSMe as an effort to increase economic growth.

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