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Penang Small and Medium Enterprises: Struggle, Accommodation and Challenges

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ABSTRAK

Perjanjian Kawasan Dagangan Bebas ASEAN (AFTA) telah mula berkuatkuasa di Malaysia sejak bulan Januari 2003. Pada masa yang sama proses globalisasi yang bergerak pantas telah memaksa pembukaan sempadan ekonomi nasional berdasarkan peraturan Pertubuhan Perdagangan Dunia (WTO). Kedua-dua fenomena tersebut telah menimbulkan soalan sama ada syarikat tempatan berupaya menghadapi cabaran-cabaran baru ini. Apakah akan terjadi kepada kesejahteraan penduduk Pulau Pinang jika pengeluar tempatan tidak dapat bertahan menghadapi cabaran-cabaran tersebut? Sektor pembuatan menyumbangkan sebanyak 40 peratus jumlah pekerjaan di Pulau Pinang. Adakah Pulau Pinang akan lenyap daripada arus pembangunan? Makalah ini memberi analisis pengalaman industri kecil dan sederhana (IKS) di Pulau Pinang dalam menghadapi cabaran-cabaran yang dibawa oleh AFTA dan WTO.

ABSTRACT

The ASEAN Free Trade Area (AFTA) agreement has come into effect in Malaysia since January 2003 and the rapid process of globalisation has forced the opening up of national economic boundaries according to the rules of the World Trade Organization (WTO). These raise questions on whether the local companies are able to face up to the new challenges. What will happen to the wellbeing of the Penang people if the local manufacturers are not able to withstand these challenges? The manufacturing sector contribute 40 percent of the total employment in Penang. Will Penang suffer a slow death? This article will analyse the experience of Penang SMEs in meeting the challenges of AFTA and WTO.

INTRODUCTION

Penang's economy has gone through two major shifts in the past five decades. Before the 1960s, its economy was largely dependent on trade, and its free port status had made Penang into an important entrepot for trade and commerce for the northern region of Malaya, South Thailand, Indonesia, Brunei and India.

However, subsequently, external and internal factors caused a sharp fall in Penang's trading and commercial economy. The external factors included the effect of the ending of the Korean War, economic nationalism in Thailand, Burma and Indonesia, and the period of Konfrontasi, when Indonesia opposed the formation of Malaysia. All these caused a rapid decline in trade with those countries (Tan 2002). Internal factors included the progressive removal of free port status after the mid-1960s, and the development of other growth areas, particularly in the Klang Valley and the Federal Capital. According to one analyst, Penang at that period faced slow death as a "sleepy hollow" (Tan 2002). Both external and internal factors had altered the whole economic scenario for Penang. To ensure the future survival of the state, its leaders were forced to look for other alternatives in order to revive Penang's economy, create job opportunities and improve its people's well being.

In the early 1960s, the first industrial estates were established on the mainland portion of Penang in Mak Mandin and Prai by the Alliance government led by Wong Pow Nee, Chief Minister from 1957 till 1969. This measure had succeeded to increase productivity and employment, but it was not sufficient to provide enough jobs for the labour force of Penang in the 1960s that was engaged primarily in trading activities (Tang 1993). By the end of the 1960s, the rate of unemployment had reached 14.5 percent, much higher than the national rate, which was only 7.3 percent (PDC 1990).

On May 10, 1969, the Alliance was toppled in the state election and gave way to the newly-formed multi-ethnic opposition party, Parti Gerakan Rakyat Malaysia, led by Dr. Lim Chong Eu. Under the leadership of Dr. Lim who was Chief Minister from 1969 till 1990, Penang was able to introduce dynamism into the economy. Industrialisation was identified as the major engine of growth for Penang. The Free Trade Zones (FTZs) concept was promoted to encourage foreign investment in export- oriented activities. In 1971, the Free Trade Zone Act was introduced and Malaysia's first FTZ was established at Sungai Kluang in Bayan Lepas, Penang. In 1972 the first electronics transnational corporation (TNC) was established in Penang (Ismail 1982).

The post-1969 economic policy of industrialisation, which has been promoted until the present day, has not only encouraged foreign direct investment (FDI) and created employment opportunities for Penangites but has also opened up opportunities for local entrepreneurs, especially those operating small and medium enterprises (SMEs) as support industries for foreign TNCs. Small and medium enterprises mushroomed along with the establishment of TNCs in Penang and the economy was at its peak in the mid 1990s. However, in the third quarter of 1997, the East Asian Financial Crisis started in Thailand and then spread to other East and Southeast Asian countries. Almost every sector of the Malaysian economy was affected.

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SMALL AND MEDIUM-SCALE ENTERPRISES AND SOURCES

The terms Small and Medium-scale Enterprises (SMEs) and Small and Medium Industries (SMIs) are often interchangeably used. Lee and Lee (2003) use 'SMIs' to refer to enterprises primarily involved in manufacturing and 'SMEs' to refer to the larger group that includes non-manufacturing industries such as retail organisations. According to the Small and Medium Industries Development Corporation (SMIDEC), SMEs are divided into two broad categories: (1) manufacturing, manufacturing-related services and agro-based industries with full-time employees not exceeding 150 or with annual sales turnover not exceeding RM25 million, (2) services, primary agriculture and information and communication technology (ICT) sectors with full-time employees not exceeding 50 or with annual sales turnover not exceeding RM5 million (*SMIDEC*).

Sources used in this study include personal interviews conducted at 30 SMEs in the Klang Valley between 1996 and 2000, and at forty SMEs in Penang in the third quarter of 2003. A survey of 100 SME companies in Penang in the third quarter of 2003 by the Socio-Economic and Environmental Institute (SERI) is also used. Other sources used are the 1999, 2000 and 2001 nation-wide survey reports on economic recovery in Malaysia by the Associated Chinese Chambers of Commerce and Industry of Malaysia (ACCCIM), and the 1998 survey of SME performance in the manufacturing sector by SMIDEC. Twenty percent (59) of the respondents in 1999, 27 percent (91) in 2000 and 29 percent (73) in the 2001 ACCCIM surveys are SMEs from the northern region of Peninsular Malaysia. Since no research has been conducted specifically on Penang SMEs in the aftermath of the 1997 financial crisis, the ACCCIM and SMIDEC surveys are used to give a general representation of Penang SMEs. These surveys provide us with descriptions of how the financial crisis affected SMEs in Malaysia and how the SMEs adjusted to the protracted financial crisis.

THE FINANCIAL CRISIS AND THE STRUGGLE AND ACCOMMODATION OF SMEs

The financial crisis that spread through a large swathe of Asia from 1997 was a manifestation of the adverse impact of the globalisation process. Economically, Malaysia suffered its worse setback in development since Independence in 1957 when its Gross Domestic Product (GDP) plummeted by - 6.7 percent in 1998 after nine consecutive years of robust growth. Between 2 July 1997 and 1 September 1998, the Malaysian ringgit depreciated by 45.2 percent in relation to the US dollar, and the Kuala Lumpur Stock Exchange (KLSE) lost 57.9 percent or RM421.0 billion of its capitalization (Ong 1999). Following this, Malaysia's GDP per capita fell 9.0 percent from RM9,065 in 1997 to RM8,245 in 1998 (Ragayah and Saadiah 2002). In social terms, the crisis disrupted official efforts to achieve a more equitable distribution of the nation's wealth among the ethnic groups. In effect, it acted to exacerbate income differentials and widened disparities in development both within and among different states (Ishak 1999, 2001). On the other hand, the crisis enabled foreign interests to increase their control of the nation's wealth from 27.7 percent in 1995 to 31.8 percent in 1998 and then to 32.7 percent in 1999 (Malaysia 1999, 2001).

The regional financial crisis adversely affected the performance of domestic SMEs. As a result of the depreciating ringgit and tight liquidity beginning in the third quarter of 1997, SMEs were saddled with escalating operating costs and cash flow problems. The surveys by SMIDEC and ACCCIM highlighted some challenges faced by the local SMEs. These included currency instability, decline in foreign and domestic demand, domestic competition, cash flow problems and dependence on imported raw materials. The ringgit slipped from RM2.50 (to US$1) to RM2.61 (July 14) and gradually to RM2.72 (August 11), RM2.83 (August 12), RM3.00 (September 2) and finally sank to 4.88 on January 7 1998. Many SMEs suffered severely from having to purchase raw materials, machinery, equipment, components and other requirements in foreign currency. A survey by SMIDEC in 1998 revealed that one of the immediate actions taken by SMEs was the retrenchment of workers as a response to the financial crisis in 1997. This was especially so in the electrical and electronics as well as the machinery and engineering sectors, while the transportation and equipment sectors remained unaffected.

The depreciation of the ringgit had a severe impact on SMEs that relied on the domestic market but obtained most of their inputs from imports paid for mostly in US currency. On the other hand, export-oriented SMEs such as those in the resource-based sector and those in the electrical and electronic sectors benefited from higher sales to foreign countries thanks to the depreciating ringgit and showed better performance than before (*SMIDEC* 1998). Nevertheless, the overall shrinkage in foreign and domestic demand remained a lingering obstacle to improved business performance for 46 percent of SMEs in 2000 and 50 percent in 2001 (*ACCCIM* 2000, 2001)

The SMEs in general also faced increased domestic competition that arose in various forms. Local corporations and traders resorted to price-cutting (to below the cost of production) in an effort to raise cash to survive the economic crisis. Declining foreign orders led to keener competition for a share of the domestic market. Certain export-oriented companies also dumped their goods in the local market to the detriment of domestic market-oriented SMEs. To cope with the increasing competition and deliberate lowering of market prices and to avoid going out of business, a study of thirty Malaysian Chinese SME entrepreneurs in 2003 showed that survival was achieved through adopting stringent measures such as dealing strictly in cash and denying credit terms except to long-standing customers in order to minimize risks. Cash commitments to property were avoided and investment was made in machinery to increase productivity (Chin 2003a). Thus, ways to ensure survival included attempts to expand market share (36 percent), maintain the existing size of operations and to wait for better times (20 percent). Some nine percent were forced to scale down their production as demand shrank. All these remained the major measures taken by the SMEs up to the first half of 2000 (*ACCCIM* 2000). At a later stage (in 2001), it was found that increased competition was caused by greater consumer selectivity in purchases, price-cutting by competitors to generate cash in expectation of further worsening of the economy, and the influx of cheap basic consumer items resulting from trade liberalisation with the implementation of the AFTA and WTO agreements. Hence, 37 percent of SMEs in the 2001 ACCCIM study sample confirmed the adverse effect of increased competition in the domestic market. A survey of 100 SMEs in Penang by SERI indicated that this trend persisted into 2003.

Other struggles that local SMEs had to overcome included the severe cash flow problems arising from ringgit depreciation and the need to tolerate credit terms on purchases stretching in excess of 100 days. This was reported by 30 percent of the respondents in the 1998 SMIDEC survey. Hence, many had to resort to borrowing from banks to overcome shortages with respect to internal financial resources.

Much affected were manufacturers who relied on imported raw materials whose prices escalated in tandem with the depreciation of the ringgit. Finished goods that necessitated the inclusion of imported components were rendered less competitive both domestically and internationally with consequent inroads on profitability (*ACCCIM* 1999). On the other hand, the ringgit depreciation enhanced the competitiveness of Malaysian exports to trading partners whose currencies had gained substantially on the ringgit. Until the first half of 2000, escalating operating and raw material costs continued to plague business performance. Fortunately, the pegging of the Malaysian ringgit to the US dollar at a fixed rate of RM3.80 in late 1998 stabilised the costs of imported raw materials and components somewhat (ACCCIM 2000).

Some of the Chinese-owned SMEs had suffered heavily from the crisis. Those entrepreneurs who were badly affected and who did not have access to alternative sources of funding faced bankruptcy or liquidated their businesses to settle their debts as banks, especially foreign ones, demanded repayment or reduced their loans. However, there were enterprises that survived through moderate-sized loans of RM100,000 or so provided by family members or relatives. A few enterprises that failed to secure loans from the government were forced to seek easily available loans from local loan syndicates. Many of these operate outside the law and levy exorbitant interest rates of 12-16 percent per annum. Notorious in their use of physical threats in the recovery of repayments for their loans, these syndicates have become a menace and the indebted often have to pay heavily for their ill-advised actions (see, for example, The Star, 24 March 2002).

Other factors that affected business performance included management styles, government policies and the domestic political situation. The Malaysian Chinese business community is generally conservative and prudent in their business activities. Low rates of borrowing enable Chinese businessmen to have a certain degree of flexibility in making quick adjustments to tide through an economic downturn. Besides this, the moderate scale of operation of SMEs makes it easier to adjust management practices and production activities in response to changing circumstances.

Overall, the Malaysian SMEs managed to weather the protracted financial crisis with the help of the state and through the SMEs' own immediate responses (see Chin 2003b). Although the storm is over, bigger waves of economic challenges that are more difficult to resist are sweeping onto the shores of our domestic economy and proper and effective measures need to be taken to handle this threat.

NEW CHALLENGES FOR PENANG SMEs: AFTA AND WTO

Though the economic crisis had generally set back the SMEs in Malaysia, some SMEs managed to emerge stronger after the crisis. Nevertheless, Penang-based SMEs are facing the challenges imminent with globalisation and trade liberalization. This section will discuss the state of SMEs in Penang in relation to the liberalization associated with AFTA and WTO. My study of over forty Chinese SMEs in Penang from June to September 2003 in Butterworth, Prai, Mak Mandin, Bukit Mertajam, Bukit Tengah, Bukit Minyak, and Bayan Lepas revealed that the SMEs are now facing stiff competition from other ASEAN member countries. The SMEs interviewed in Penang revealed that most of the sectors covered in this study are facing stiff competition. Some TNCs have shifted sources of supply from local original equipment manufacturers (OEMs) to overseas OEMs which are more cost competitive such as those based in China and Thailand. Some local SMEs also suffered with the relocation of their TNC customers to the rest of ASEAN coupled with the influx of cheap China-made products into the local market.

In 1996, Hewlett-Packet left the disk-drive industry in Penang and put 600 workers out of employment. In 1999, Read-Rite, one of the first disk-drive makers to invest in Penang, shuttered its Penang operation and laid off 4,000 employees while maintaining its plants in the Philippines and Thailand (*SERI* April 2001). In January 2000, Applied Magnetics, a U.S. maker of disk-drives, shut down its Malaysian plant in Penang and laid off 1,200 employees because of a global oversupply of disk-drives (Elegant 2000). In 2001, Seagate closed its low-end drive-assembly plant in Penang and moved to its new location in China. Seagate's total workforce in Malaysia peaked at 24,000 in 1986-87 and was gradually reduced to about 5,500 in 2002. Also in 2001, Advanced Micro Devices chopped nearly 1,300 employees from its chip-making operations in Penang (Chowdhury 2002).

The total number of SME establishments in Penang as of September 2004 stood at 23,774. When the SMEs are divided according to industry sectors, a clearer picture of SMEs in Penang is obtained. They consist of the following firms: chemical and petrochemical (237); electrical and electronics (634); food, beverages and tobacco (480); machinery and engineering (431); manufacturing-related services (394); metal products (301); non-metallic mineral products (140); palm oil-based products (38); paper and printing (415); plastic products (330); rubber products (157); textiles, apparel and leather (570); transport equipment (108); wood and wood products (355); pharmaceuticals (322); supporting products and activities (na); logistics (2001); retail and wholesale (14,270); professional management services (2591); and miscellaneous (na) (SMIDEC).

Industry sectors discussed in this article will be limited to the electrical and electronics (EE), textiles and garments (T and G), plastics, wood-based products and footwear sectors.

ELECTRICAL AND ELECTRONICS

The electrical and electronics sector accounts for 56.0 percent of all manufacturing workers in Penang, the largest (EE) employer in the manufacturing field. This is followed by the second largest employer, the fabricated metal sector employing 8.0 percent of all manufacturing workers (*SERI* December 2003).

SMEs helped by foreign direct investment (FDI) such as those in the EE and fabricated metal sectors have created vast job opportunities and entrepreneurial or technopreneurial openings in Penang. For instance, since Intel's establishment in Penang in 1972, …100 companies were set up to serve Intel operations in Penang, with over 100,000 employed. Until now seven of them are on the main board and five on the second board of the Kuala Lumpur Stock Exchange… (*Business Times* 2 September 2003).

My interview conducted in July 2003 with a homegrown TNC in the EE sector shows that there is a lack of relevant local human resources that can contribute to research and development (R&D) in this company. Another interview in July 2003 with a different SME in the EE sector confirmed the widespread existence of this problem. The availability of skilled workers can be a major factor in the decision of the TNCs to either stay or to relocate their manufacturing plants to lower cost countries. A question that arises is whether Penang will continue to be a favoured destination for FDI in the EE sector. Research show that 68 percent of Japanese TNCs listed China as one of the top 10 locations in 1996, 65 percent did so in 2000 and 82 percent did so in 2001. These responses indicate that China is a frequently identified and promising location for FDI. Furthermore, China was ranked first in the list of 10 competing country locations (McKibbin and Wang 2003).

Managers from the SMEs interviewed in this sector indicate that as long as the local SMEs can maintain their cost competitiveness, they would continue production. Local SMEs in this sector continue to be competitive in term of product quality. To maintain their competitiveness, one strategy used by local SMEs in this sector is to employ cheap foreign workers to cut down on manufacturing and operating costs. However, the rising costs of production may prompt more TNCs as well as local companies to relocate to lower cost locations such as China and Thailand. For example, the cost of labour is about RM240 per month in Canon's plants in Suzhou, China compared with the Malaysian average of about RM700 a month, giving China the edge over Malaysia in terms of cost of production (*The Star*16 April 2004).

If Penang SMEs can no longer compete on labour cost in the EE sector, they could shift their focus to other areas of competency such as Information and Communications Technology (ICT). However, Penang SMEs do not show much evidence of doing so. In a recent study of SMEs in the EE cluster in Penang, How (2001) investigated 50 SMEs between March-April 2001 in Penang in relation to their ability to participate in e-commerce. The analyses showed that 73 percent of the firms interviewed had very little or no basic ICT infrastructure in place. These firms had no websites, had no access to Local Area Networks (LAN) and their workers had little or no access to computers. On top of that, most of the management staff possessed very little knowledge about ICT facilities. In terms of training, only 14 percent of the firms provided formal training to equip their staff with knowledge of ICT. This shows that SMEs in the EE cluster in Penang may not be ready for the challenges of globalisation. According to one analyst, … the main reasons for this sad state are the lack of appreciation of the full potential of e-commerce, the high perceived cost of start up and maintenance of ICT infrastructure, the lack of ICT savvy personnel to tap the full benefits of ICT implementation and insecurity regarding the confidentiality of e-transactions (Narayanan 2004: 249).

TEXTILES AND GARMENTS (T AND G)

Textiles and garments, ranked third, account for 7.0 percent of total employment in the manufacturing sector in Penang (*SERI* December 2003). The local T and G industry had to face the challenges of liberalisation beginning January 2005. Among the challenges are the removal of the quota system and free trade agreements within the WTO and AFTA. The removal of the Multi-Fibre Agreement (MFA) and the Agreement on Textiles and Clothing (ATC), which imposed quota restrictions on exporting countries will give manufacturers in China a big boost. It also means that apparel manufactured in Malaysia and other developing countries that are exported to the United States and the European Union will no longer be limited by import quota restrictions. The end of quotas could also mean that Malaysian manufactures will be squeezed out of their key markets.

Reports show that for the first five months of 2004, textile and apparel exports amounted to RM3.75 billion, 16 percent higher than the previous year's figure of RM3.24 billion. The reason why Malaysia managed to retain a textile and apparel-manufacturing sector of this size was because the Multi Fibre Agreement (MFA) quotas artificially restricted exports from cheaper countries (*The Star* 2 August 2004). A study done by SERI in 2004 showed that many T and G companies in Penang were coping, albeit with the indirect help of the MFA which limited the amount of Chinese textile and garment exports (*SERI* May 2004).

At present, reduction of profit margins is one of the strategies adopted by my informants in T and G manufacturing to enhance their competitiveness and fight the incursion of China-made products into the local market. One of the informants interviewed is surviving on government contracts, for example, manufacture of uniforms for the army and police forces and the production of other lower end domestic products. The SERI report of May 2004 prepared for the Penang state government indicated the strong challenges that local SMEs in this sector are facing from China-based manufacturers in terms of cost. The report also indicated that local manufacturers in Penang are now focusing on higher end products generating higher value added. Other strategies taken up to battle for survival include research and development, product differentiation, customer-service orientation, strategic partnerships, quota manipulation and vertical integration.

PLASTICS INDUSTRY

The plastics industry in Penang has evolved over the years since its establishment in 1962, during which time it produced polyethylene bags and household wares only. Its development has been tied to the EE industries. As the EE sector began to develop in Penang in the early 1970s, the plastics industry sector started to transform and began producing consumer audio-visual electronics-related products. As new investment arrived in the 1990s, the plastics industry ventured into producing plastic parts and components for the PC (personal computer) and its peripherals as well as plastic parts for the telecommunications sector. This sector accounted for almost eight percent of the total number of manufacturing firms in Penang (*SERI* March 2003).

However, SERI's report to the Penang state government revealed that the total number of approved investment projects for this sector has fallen off. Three major reasons were identified. First, local plastics manufacturers do not plan to expand investments in their existing products except for new product development. Second, there are not many new plastics establishments. Third, very few plastics firms actually carry out innovations (*SERI* March 2003).

The reasons mentioned above could be related to the sub-sectors of the plastics industry they are involved in. First, the survey data collected during my research and SERI's survey of SMEs in Penang illustrate that plastics companies in Penang are mainly involved in injection moulding, extrusion, blow moulding of general plastic products or precision and engineering products in the EE sector. There is little innovation due to the nature of the plastics manufacturers in Penang who are basically downstream producers. The local SMEs in Penang are suppliers of plastic parts and components to the TNCs in the EE sector, and they are heavily dependent on the customers' continuous patronage. Second, not all SMEs can expand abroad. Only the financially well-endowed companies are able to expand overseas. Furthermore, business opportunities also shrank as a result of the relocation of TNCs and highly competitive local companies overseas.

My survey data demonstrate that plastic injection moulding and precision tooling enterprises are working hard to catch up with their competitors from Thailand and China. Findings based on nine companies interviewed in this sector indicate that their profit margins are getting narrower than years before. Enterprises such as these play an important role as supporting industry for the TNCs and therefore are very much dependent on the TNCs for contracts. According to an informant from a SME, one of his customers (SONY) invested in China and discovered that companies in China could offer lower prices for the same products that he manufactured in Penang. SONY requested him to reduce the price charged. Otherwise, he was informed that he might not get his contract renewed. He said that his company used to get RM18,000 for each mould produced for SONY. However, the price has been reduced to RM8,000 and he therefore found it difficult to continue producing for SONY. He decided to compete on producing higher value-added moulds, which needed higher accuracy, thus avoiding competition with the Chinese producers of lower-end moulds that require less precision. Reduced profit margins, therefore makes him unclear about what to do in the future.

Data from my survey also show some SMEs that are heavily dependent on the domestic market (such as the production of polyethylene bags) are facing stiff competition from Thailand and China. Some of these companies therefore decided not to further invest and upgrade their production plants but to import the goods and sell them in the local market instead. An informant interviewed in

Butterworth stated that, initially, he and his partner planned to set up a new plant in Butterworth but due to the more competitive market, decided to put their plan for expansion on hold. They visited Thai plastics manufacturers and discovered that certain Malaysian trading companies import huge volumes of plastics from Thailand and distribute these in Malaysia. As a result of their visit, they decided to temporarily import from Thailand and distribute the goods in Malaysia. This was because the quality of the Thai products is as good as or even better than the quality of their products. The Thai products also cost less.

However, three other medium sized plastics manufacturers that control more than 60 percent of the export market are more competitive in both the domestic and export markets. Their countries of export include various European countries, the United States, countries in the Middle East and Africa as well as Japan and Australia. Besides market orientation and company size, the type and quality of products also determine the company's competitiveness. Two companies that specialise in manufacturing plastic products that are related to security, water soluble bags, laundry bags for hospitals, surgical bags and medical products that need to meet special sterility and quality requirements are not affected by import competition from less sophisticated foreign-made products.

Thus, only companies that are involved in niche markets may be able to survive and succeed in the long run. Similarly, manufacturers that are more sophisticated and who are involved in precision and injection moulding may also continue to flourish (*SERI* March 2003).

WOOD-BASED PRODUCTS

The wood-based sector (including furniture) employed 1.2 percent of total manufacturing workers in 1993 in Penang (*SERI* December 2003). The wood-based products industry is also hard hit by cheap products from China. Based on an interview at a company in Kepala Batas in Province Wellesley, it was revealed that the company's export market has been reduced from 30 percent in the last three years to 0.5 percent at the time of the interview. The company's previous customers from Singapore, Hong Kong, Taiwan, Australia and Saudi Arabia turned to China for lower priced products of the same quality. At present, the company is relying for its survival on the domestic market. The company felt that it was difficult to compete with cheap products imported from China. To ensure its continuous presence in the industry, the company has been forced to reduce its profit margin from 20-22 percent in the past four years to just 6-8 percent in July 2003. The owner-industrialist suggested that a reduction in the corporate tax would be a good solution and would help to keep his company competitive in the global market.

FOOTWEAR INDUSTRY

In the shoe industry, two local shoe manufacturers were interviewed. One manufacturer's export market had shrunk from 80 percent in the past four years to only 15 percent in 2003 and its work force had also been reduced from 300 to 60 people. This informant complained that his company lost its competitiveness due to lack of skilled labour compounded by high labour turnover. Another local shoe manufacturer stopped producing the finished products in Penang and outsourced the manufacturing of shoes to Chinese OEMs.

OTHER INDUSTRIES

An interview with a company that assembles computer monitors also shows the same trend of replacement of production with the import of finished products from China. Other local industries such as tyre and spare parts manufacturers and dealers have also been hard hit by cheaper imports. It was reported that, "motor trades such as tyre and spare parts dealers nationwide have drastically cut down orders for local products following the influx of imported tyres and parts" (*The Star* 5 May 2002).

STRATEGIES ADOPTED BY SMEs TO FIGHT HE NEW CHALLENGES

Findings from my research as well as from research conducted by SERI indicate that SMEs have three possible ways to deal with the new challenges arising from trade liberalisation associated with AFTA and WTO.

RELOCATION

Many companies have considered relocating their manufacturing plants to countries such as Thailand, Vietnam and China. Amongst these countries, China is the preferred choice because of its market size, big pool of skilled labour, and good incentives provided by public authorities. They acknowledge that this strategy may be risky not only because of the capital involved, but also because of human resource, cultural, political and language barriers. In this respect, the SMEs strongly felt that the Malaysian government should help them to establish contacts, provide information and financial supports.

Certain large garment manufacturers such as Ramatex Bhd have already set up manufacturing plants in China. Overseas operations in China and Namibia already accounted for 38 percent of Ramatex Bhd's revenue in 2003, an increase of 30 percent over a year ago. Similarly, PCC Group has set up a subsidiary company, PCC Garments Ltd in 1998 in Cambodia while Jerasia Capital Bhd launched a manufacturing unit in Cambodia in 2004 (*The Star* 2 August 2004).

However, smaller companies may not have the ability to follow the paths taken by these companies.

EXPANDING MARKET SIZE BY EXPORTING OVERSEAS

Some of the SMEs realise that they cannot continue to produce solely for the small domestic market and that they need to broaden their market by exporting overseas. An informant from a rubber parts manufacturing company said that the tyre market in Malaysia is small and that local producers are facing stiff competition from tyres imported from Thailand and China. So, his company had to expand its marketing network to foreign countries. In fact, some SMEs are already exporting to non-traditional markets such as to the Middle East countries.

Going Up the Value Chain Only a few SMEs have chosen to restructure their operations so as to produce less labour-intensive goods and to move up the value chain through technology upgrading, product research and development, differentiation, new designs and so on. Very few SMEs focus on innovation as a way to compete in the market. Only two medium-sized SMEs amongst the forty companies surveyed have their own research and development (R&D) unit to come up with new products. This indicates that smaller companies either do not have a long-term perspective or lack the funds necessary for R&D work.

The strategy of moving up the value chain may seem to be a good idea. However, we have to keep in mind that companies in China are also moving up the value-chain. Who will move up faster? Is it too late for Malaysian SMEs to start now? Can Penang-based SMEs stay competitive? No doubt, this is a correct strategy but the Penang SMEs have to work much harder than their competitors from China. They cannot remain complacent. As the Chinese economy continues to grow, so will its capital stocks and technological ability. What this means is that there will be a gradual change in the comparative advantage of China and also in the mix of products exported by China. Evidence suggests that China is gaining comparative advantage with respect to skilled and high-technology products that compete directly with the exports of Malaysia, Taiwan and Singapore that are aimed at the world's richest nations (Wong 2003 and *Asian Labour News* 6 February 2004).

LOWERING PRODUCTION COSTS AND NARROWING PROFIT MARGINS

Some of the SMEs in the surveys are competing with cheaper imported goods by narrowing their profit margins and also by lowering their production costs through the use of foreign labour. However, this is only a makeshift measure. The smaller companies remain at risk and are becoming less competitive and losing their export as well as domestic markets to cheap China-made products. SERI's report also shows that even though company revenue is growing, profits are marginal to flat especially for the low-end mass manufacturers and subcontractors dependent on TNCs (*SERI* December 2003). A question that arises is how long can these firms sustain themselves and stay competitive in the years to come?

When respondents were asked about SMEs in their respective sectors that had ended operations in recent years and the reasons why, the feedback was that most of the SMEs ceased operations because of lack of competitiveness in pricing and not being able to meet the demands of the customers. Some companies that operated as subcontractors to TNCs had to close shop because of the relocation of these TNCs to China. This is especially true of small companies (those with less than ten workers) in the plastic injection moulding sector. Owners of companies that closed usually ventured into other types of business such as trading that require relatively less capital. Others even moved into the restaurant and hawker businesses.

MAJOR CHALLENGES AFFECTING THE COMPETITIVENESS AND DEVELOPMENT OF SMEs IN PENANG

After analysing the various sectors of the SMEs in Penang, my conclusion is that there are four major factors that can affect the competitiveness and development of the SMEs.

SHORTAGE OF SKILLED PRODUCTION WORKERS

As the market becomes more competitive with liberalisation, the lowering of manufacturing costs through the use of cheap foreign labour can help to maintain the competitiveness of Penang SMEs to some extent. However, research also shows that there is a negative impact of foreign labour on the struggle to increase the productivity of labour. Therefore, Malaysia should reduce its dependence on cheap, foreign unskilled labour. Tham and Liew (2004: 271) pointed out that "the prolonged reliance on foreign labour give wrong signals to industries that they can continue to rely on foreign labour without having to undertake strategic adjustments in moving towards labour-saving production."

The survey conducted for this study revealed that most companies in the labour-intensive sectors such as textiles and apparel, wood products, foot wear, and fabricated metals are facing a shortage of skilled production workers. This issue is not new in fact, it was brought to the attention of the Penang state government by SERI in February 2001.

Lack of skilled and knowledgeable workers is a challenge for Penang SMEs. It is essential to develop a competent workforce to keep Penang's SMEs competitive. Among the SMEs, problems identified include the attitude of entrepreneurs towards developing their employees' skills and knowledge. It is also recognized that most employers lack the willingness to send their workers for training though the government has provided various programmes for human resources development, for example, the Penang Skills Development Centre (PSDC). Generally, workers in the SME sector are lacking in more advanced skills and knowledge relevant to their industries. Because of this, MNCs may turn to other countries that can provide more highly skilled workers. For example, India has emerged as one of the new, favoured destinations for FDI, especially in the software industry. Therefore, continuous economic development will depend upon whether Penang's technological, educational and R&D infrastructure is able to provide increasingly sophisticated levels of support for local industry (Kahaner 1996).

THE GOVERNMENT'S FOREIGN LABOUR POLICY

The government's foreign labour policy has created problems for SMEs that are dependent on cheap foreign labour. The SMEs surveyed complained that the foreign labour policy is inflexible and should be liberalised. According to them, the seven years maximum for foreign labour to work in Malaysia is too short. When the labourers are trained and have gained experience, they are forced to leave Malaysia. Continuous training of new batches of labourers, as well as charges for permit renewals increase costs for manufacturers. The manufacturers claim that local workers lack discipline, e.g., irregular work attendance causes instability in production. Besides this, the high turnover of local workers is also a major problem in the footwear sector of the SMEs. Local workers, especially those who are university graduates, often leave the SMEs for TNCs since the latter tend to offer better career prospects, higher salaries and better work environments.

RED TAPE

Another complaint of the SMEs is the red tape problem. Penang SMEs find it difficult to get government approval for their business plans. The process takes a long time and also involves endorsements from a range of ministries and agencies. The two round tables with SMEs organised by SERI in Penang in the last quarter of 2003 indicated that SMEs are frustrated with red tape. This not only affects SMEs but also the TNCs: … this red tape creates uncertainties for businesses, which in turn add to unwanted market risks and acts as a disincentive to investment … (*The Star* 30 May 2004). Feedback received from my informants also indicated that the Penang state government has becomes too complacent and too slow in approving business plans and providing incentives. In fact, other regions in the country such as Malacca have become more aggressive in attracting foreign direct investment. Malacca's ranking in terms of investment changed from 10th position in 1997 to 2nd in 1999 while Penang improved from

7th position in 1997 to 1st in 1999. However, in terms of the total value of investment, Penang plunged from RM4.78 billion in 1999 to RM3.77 billion in 2001 while Malacca increased from RM2.87 billion in 1999 to RM3.44 billion in 2001 (*SERI* July 2000, December 2002).

LACK OF FINANCIAL SUPPORT

Many SMEs perceived the liberalization of AFTA and WTO as fair competition and an opportunity to expand their markets. However, they are facing financial challenges in that banks are only interested in lending to listed companies and companies that promise good returns. According to the SMEs, banks are too conservative and reluctant to lend even though the government had directed local banks to provide more loans to SMEs. It is hoped that the government would give special attention to SMEs as announced in the 2004 Budget. An additional RM1 billion provided under the micro credit scheme by Bank Pertanian Malaysia and Bank Simpanan Nasional (*The Star* 13 September 2003) would help to boost the SMEs. On top of that, the proposed threshold for the corporate tax of 20 percent was increased to RM500,000 from RM100,000 to encourage SMEs to step up their investments.

CONCLUDING REMARKS: PROSPECTS FOR PENANG SMEs

SMEs are likely to survive and prosper but the future of the smaller firms is not so bright if rigorous measures are not taken soon. The future of Penang SMEs lie in the hands of their entrepreneur-owners, nevertheless, there is a need to shift from individual and family-controlled companies to share-holding companies that will increase capitalisation and also make them more competitive. There is also a need to shift from the mentality of short-term gain, to move up the value chain and to invest in R&D.

Second, to be able to compete by moving up the value chain, local SMEs have to work harder than their competitors from China. Malaysia can become more of a value-added manufacturer and designer (*SERI*, February 2004). Penang SMEs, which are engaged in assembly-type operations in the EE sector should move away from being so dependent on cheap foreign labour (Tham and Liew 2004).

One of the strategies used in moving up the value chain is to invest more in R&D and to develop more Intellectual Property (IP) sensitive products. Local companies can protect their own niches in the global supply networks by raising production standards and shifting into high-tech products, thus avoiding "commodity overlap" with countries like China and Thailand. If Penang SMEs can develop more IP-sensitive products, this will enable SMEs to stay competitive in global markets and thus provide more jobs for local people. Also, the fight against piracy of intellectual property can be stepped up in order to make Malaysia more attractive as a place for FDI than other places such as China.

Third, as mentioned above, Penang SMEs can no longer compete on labour costs in the EE sector. More investments should be carried out in order to develop a K-economy (knowledge economy). Penang SMes need to increase their use of ICT and shift away from the "old labour-intensive production" economy to the "new tech-knowledge" economy. This means that both the government and the private sectors should invest more heavily in intangible capital such as human capital and knowledge production to enhance Malaysia's economic competitiveness (Tham and Liew 2004)

Finally, in relation to the development of the K-economy, the state government has to ensure that Penang has the needed infrastructure available. Thus, the future of Penang SMEs lies partly in the hands of the Penang state government. Penang is becoming less attractive to FDI within Malaysia, other regions that have been able to attract FDI are Malacca and the Kedah Kulim High Tech Park. If the Penang state government continues to be complacent, it will loose out to other states in attracting FDI and this will have great implications for the socio-economic well being of Penangites who make their living from the manufacturing sector of the TNCs and SMEs. Since the lack of skilled labour is an issue, the state has to work harder to develop human resources that match the needs of the SMEs in Penang. Besides this, the government has to continue to develop and upgrade its infrastructure, especially the high tech infrastructure, and to produce a large pool of skilled human capital. All these actions would help Penang SMEs to move up the value chain, remain competitive, and also attract more FDI.

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