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Abstract

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PENANG SMEs: STRUGGLE, ACCOMMODATION AND CHALLENGES

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Abstract

Penang's economy has gone through two major shifts in the past five decades. Before the 1960s, its economy was largely dependent on trade, its free port status had made Penang an important entrepot for trade and commerce for the northern region of Malaya, South Thailand, Indonesia, Brunei and India. However, the Korean War, economic nationalism in Thailand, Burma and Indonesia, the period of *Konfrontasi*, had caused a sharp fall of Penang's trading and commercial economy. with those countries. On top of that the progressive removal of the free-port status after the mid-1960s, and the development of other growth areas, particularly in the Klang Valley and the Federal Capital also contributed to the alteration of the whole economic scenario for Penang. To ensure future survival of the state, its leaders were forced to look for other alternatives 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 and it managed to increase productivity and employment but it wasn't sufficient to provide job for the mass labour force in Penang that was engaged primarily in trading activities. However, under the leadership of Dr. Lim Chong Eu as Chief Minister from 1969 till 1990, industrialization was identified as the major engine of growth and Penang was able to renew its dynamism into the economy. The post-1969 economic policies of industrialization, which has been promoted until this day has not only encouraged foreign direct investment (FDI) and created employment opportunities for Penangites but has also opened up opportunities for the development of local entrepreneurs especially the small and medium enterprises (SMEs) as support industries for foreign TNCs. Small and medium enterprises were mushrooming along with the establishment of TNCs in Penang.

However, the 1997 East Asian Financial Crisis had caused a major set back for the Malaysian economy. Almost every sector of the economy was affected. It is in this contact that this article discusses the 'third shift' of the economy in Penang, particularly by focusing on the SMEs on three aspects. First, the major factors affecting the business performance of the SMEs. Second, how the SMEs have accommodated to the prolonged regional economic crisis from 1997-2000. Third, the challenges now faced by Penang SMEs in the context of the liberalization of Asean Free Trade Area (AFTA) and the influx of low price products into the local market as part of the globalisation process.

PENANG SMEs: STRUGGLE, ACCOMMODATION AND CHALLENGES

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, its free port status had made Penang an important entrepot for trade and commerce for the northern region of Malaya, South Thailand, Indonesia, Brunei and India. However, some external and internal factors had caused a sharp fall of Penang's trading and commercial economy. The external factors such as the effect of the Korean War, economic nationalism in Thailand, Burma and Indonesia, 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 the 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 future survival of the state, its leaders were forced to look for other alternatives 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 in Mak Mandin and Prai by the Alliance government led by Wong Pow Nee, chief Minister from 1957 till 1969. It managed to increase productivity and employment but it wasn't sufficient to provide job for the mass labour force in 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 per cent, much higher than the national rate, which was only 7.3 per cent (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 renew dynamism into the economy. Industrialization 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. By 1972 the first electronic transnational corporation (TNC) was established in Penang (Ismail 1982).

The post-1969 economic policies of industrialization, which has been promoted until this day has not only encouraged foreign direct investment (FDI) and created employment opportunities for Penangites but has also opened up opportunities for the development of local entrepreneurs especially the small and medium enterprises (SMEs) as support industries for foreign TNCs. Small and medium enterprises were mushrooming along with the establishment of TNCs in Penang and the economy was at the peak in the mid 1990s. However, in the third quarter of 1997, the East Asian Financial Crisis started in Thailand and the effect spread over to the East Asian countries and amongst others caused a major set back for the Malaysian economy. Almost every sector of the economy was affected.

As the ASEAN Free Trade Area (AFTA) has come into full effect in Malaysia in January 2003 and the rapid process of globalisation forcing the opening up of national economy boundaries to abide to trade rules by the World Trade Organization (WTO), it raises questions on whether the local companies are able to face these new challenges? What will happen to the well being of the Penang people if the local manufacturers are not able to withstand this challenge? The manufacturing sector contributed 40% of the total employment in Penang. Will Penang suffer a slow death and turn back to the situation in the 1960s?

The highlight of this paper is to describe the Penang SMEs in meeting the challenges of AFTA and World Trade Organization (WTO). These SMEs are defined as companies with fewer than 150 full-time employees and RM25 million in annual turnover in sales. Sources used in this study are based on a personal interview with 30 SMEs in the Klang Valley in between 1996 and 2000, and with fourty SMEs in Penang in the third quarter of 2003. A survey of 100 companies on SMEs in Penang in the third quarter of 2003 by the Socio-Economic and Environmental Institute (SERI) is also used. Other sources used are from 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 SMEs performance in the manufacturing sector by the Small and Medium Industries Development Corporation (SMIDEC). Twenty per cent (59) respondents in the 1999, 27 per cent (91) respondents in 2000 and 29 per cent (73) in the 2001 ACCCIM surveys represent SMEs from the Northern region of the Peninsular of Malaysia. Since there is no research conducted specifically on Penang SMEs in the aftermath of the 1997 financial crisis, the ACCCIM and SMIDEC surveys are adequate to give a general representation of Penang SMEs. These surveys gave in depth descriptions on how the financial crisis affected the SMEs in Malaysia and how the SMEs accommodated to the aftermath of the protracted financial crisis.

The Financial Crisis, SMEs' Struggle and Accommodation

The financial crisis that spread through a large swathe of Asian from 1997 was a manifestation of the adverse impact of the globalisation process. Economically, Malaysia suffered the worse setback in development when its gross domestic product (GDP) plummeted by –6.7 per cent in 1998 after nine consecutive years of robust growth. The country was literally impoverished by the ferocity of the crisis. Between 2 July 1997 and 1 September 1998, the Malaysian ringgit depreciated by 45.2 per cent in exchange for the US dollar, and the Kuala Lumpur Stock Exchange (KLSE) lost 57.9 per cent or RM421.0 billion of its capitalization (Ong 1999: 159). Following this, Malaysia's GDP per capita fell 9.0 per cent from RM9,065 in 1997 to RM8,245 in 1998 (Ragayah & 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 Shari 1999, 2001). On the other hand, the crisis enabled foreign interests to enhance control of the nation's wealth most considerably from 27.7 per cent in 1995 to 31.8 per cent in 1998 and 32.7 per cent in 1999 (Malaysia 1999, 2001).

The regional financial crisis affected adversely 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 struggles faced by the local SMEs. Among others, 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 sank to 4.88 on January 7 1998. Many SMEs suffered severy from the use of foreign currencies in the purchase of raw materials, machinery, and equipment, acquisition of components and other requirements. A survey by SMIDEC in 1998 revealed that one of the immediate actions taken by SMEs companies was the retrenchment of workers as a response to the financial crisis in 1997. This was especially so in the electrical and electronic as well as the machinery and engineering sectors, while the transportation and equipment sector remained unaffected (see Chin, forthcoming).

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 sector, which are export-oriented SMEs, benefited from higher sales revenues from the depreciating ringgit and showed better performance than before (*SMIDEC* 1998).The shrinkage in foreign and domestic demand remained a lingering obstacle to improve business performance of 46 per cent of SMEs in 2000 and 50 per cent in 2001 (*ACCCIM* 2000, 2001)

The SMEs in general also face with increased domestic competition that arose in different forms. Local corporations and traders resorted to price-cutting to below cost in an effort to raise cash to survive through 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 local market to the detriment of local SMEs. To cope with the increasing competition and deliberate lowering of market prices and to avoid going out of business, a study of thirty Chinese SME entrepreneurs in 2003 show that survival was through adopting stringent measures such as dealing in cash and denying credit terms except long-time customers to minimize risks. Cash commitments to properties were avoided and investment was made in machineries to increase productivity (Chin 2003a). Among ways to enhance competitiveness included attempts to expand market share (36%), maintain existing size of operations and wait for better times (20%) and some nine per cent were forced to scale down their productions as demand shrank. All these remained the major measures taken by the SMEs by up to the first half of 2000 (*ACCCIM* 2000). At latter stage, it was found that increased competition facing SMEs (in 2001) was caused by increasing consumer selectivity in purchases, price-cutting by competitors to generate cash in expectation of further worsening in the economy, and the influx of cheap basic consumer items resulting from trade liberalization with the implementation of AFTA and WTO agreements. Hence 37 per cent of SMEs in the 2001 ACCCIM study sample confirmed the adverse effect of increased competition in the domestic market. In a survey of 100 SMEs in Penang by SERI indicated that this trend persisted into 2003.

Other struggle that local SMEs have to overcome was the severe cash flow problems arising from the ringgit depreciation and the need to tolerate credit terms on purchases stretching in excess of 100 days, as reported by 30 per cent of the respondents in the 1998 SMIDEC survey. Hence many had to resort to borrowing from banks to overcome shortage of internal financial resources. The ability of SMEs to adjust to the financial crisis was hampered by the dependence on foreign sources of supply of necessary raw materials and equipment.

Much affected were manufacturers who relied on imported raw materials whose prices escalated in tandem with the depreciation of the ringgit. Finished goods that comprised 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. The pegging of the ringgit US dollar at a fixed rate of RM3.80 in late 1998 sustained the increase in the costs of imported raw materials and components (*ACCCIM* 2000).

Regarding the cash flow problem, no clues were revealed by official or local business reports on how the business community received help from other sources such as the family or loan syndicates. Some of the Chinese SMEs had suffered heavily from the crisis. The badly affected who had no 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 loan. However there were enterprises that survived through moderate loans of RM100,000 or so extended by the family or relatives. A few enterprises that failed to secure loans from the government were forced to seek the easily available loans from local loan syndicates. Many of these operate outside the law levy exorbitant interest rates of 12-16 per cent per annum. Notorious in the use of threat in the recovery of their loans and interests, these syndicates have become a menace and the indebted had often paid heavy prices for their indiscretion (see, for example, *The Star*, 24 March 2002).

Other factors that dented business performance included management style, government policies and domestic political situation. The Chinese business community is also generally more conservative and prudent in doing business. Low rates of borrowing enable Chinese businessmen a degree of flexibility in making quick adjustments to tide through an economic crisis. It is also alleged that the moderate scale of operation of SMEs makes it easier to adjust management and production in response to changing circumstances.

Overall, the Malaysian SMEs weather the protracted financial crisis with the help from the state and the SMEs' own immediate response (see Chin 2003b). The storm had over but the bigger waves of economic challenges that are difficult to resist are sweeping into the shore of our domestic economy which could slowly destroy what we had build in the pass decades if proper and stringent measures are not quickly implemented.

New Challenges for Penang SMEs : AFTA and WTO

Though the crisis had put a set back to the SMEs in Malaysia, but on the other hand many SMEs emerged stronger after the crisis, despite the fact that a number of them ceased operation. However, SMEs are facing the challenges imminent with the globalisation and trade liberalization. This section will further discuss the state of affairs of SMEs in Penang in relation to the liberalization of the AFTA and WTO. Based on a most recent study of forty over Chinese SMEs in Penang from June to September 2003 that spread across Butterworth, Prai, Mak Mandin, Bukit Mertajam, Bukit Tengah, Bukit Minyak, and Bayan Lepas give an idea that the SMEs are now facing stiff competition from the ASEAN member countries. From the SMEs interviewed in Penang give a picture that most of the sectors covered in this study are facing great impact with the relocation of their TNCs customers and the influx of China made products into the local market.

Electrical and Electronics (EE): The electrical and electronic sector accounting for 56.0% of total manufacturing workers in Penang, the largest employer in the manufacturing field following by the second largest employer, fabricated metal sector hiring 8.0% of total manufacturing workers (*SERI*, December 2003).

Classified as the international cluster, SMEs driven by FDI such as those in the EE and fabricated metal sectors had created vast jobs opportunities and entrepreneurial or technopreneurial opening 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. Till 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). However, the challenge now face by Penang is the China factor (and not mentioning the rising India in recent years), especially after its ascension into the World Trade Orgnization in 2001 which offers a large pool of skilled, semi-skilled and unskilled workforce with low wedges.

As compared with local workforce in Penang, it is facing with shortage of skilled workers that could operate in the up-ward value-change that includes Research and Development (R&D). From my recent interview in July 2003 with a home-grown TNC in the EE sector shows that there is lack of local human resource that could contribute in the R&D of his company and this give an idea that Penang lack of skilled workers. From another interview in July 2003 with a SME in the EE sector specified that there is a lack of skilled workers in this sector in Penang. The availability of skilled workers could be a major factor that may determine the TNCs to either stay or to relocate their manufacturing plants to lower cost manufacturing base. A question arises is whether Penang will continue to be the favourable destination for FDI in the EE sector and contribute job opportunity to the locals? Research shows that, 68 per cent of Japanese TNCs listed China as one of the top 10 locations in 1996, 65 per cent did so in 2000 and 82 per cent in 2001. These responses made China the most frequently identified promising location for FDI. China was ranked first in the list of 10 locations (McKibbin & Wang 2003: 5).

The suggestion received from the SMEs interviewed in this sector is as long as the local SMEs can maintain the manufacturing and operating cost then they could continue to stay on. Local SMEs in these sectors are still competitive in term of product quality that satisfy most TNCs requirements compare to other Asean countries. To be more competitive, local SMEs in this sector capitalize on the maximization of cheap foreign labours to cut down manufacturing and operating cost. However, the rising cost of production and declining productivity will continuously prompt more TNCs as well as local companies to relocate to lower production cost locations such as China and Thailand. For example, the labour cost was 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 production (*The Star*, 16 April 2004).

If Penang SMEs could no longer compete on labour cost in the EE sector, they should shift their focus to other area of competency such as develop the use of Information and Communication Technology (ICT). However, sad to say that Penang SMEs gave very little emphasis on the use of ICT. In a recent study of SMEs in the EE cluster in Penang, How (2001) examined 50 SMEs between March-April 2001 in Penang in relation to their ability to participate in e-commerce, especially their ICT infrastructure in place. The analyses showed that 73 per cent 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 Network (LAN) and their workers had little or no access to computers. On top of that, most of the company management staff has very little knowledge about ICT facilities. In term of training, only 14 per cent of the firms provided formal training to equip their staff with the knowledge of ICT. This show that SMEs in the EE cluster in Penang are not ready for the challenge 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 lap the full benefits of ICT implementation and insecurity regarding the confidentiality of e-transactions" (Suresh 2004; 249).

Textile and Garments (T&G): Textile and garments, ranked third, account for 7.0% the total employment in the manufacturing sector in Penang (*SERI*, December 2003). The local T&G industry is all set to face the liberalisation beginning January 2005. Among the challenges are the removal of quota system, free trade agreements within the WTO and AFTA. The removal of the Multi-Fibre Arrangement (MFA) and the Agreement on Textiles and Clothing (ATC) next year which imposed quota restrictions on exporting countries of T&G that is highly labour intensive will give

China the extra advantages not only to the attraction of FDI but also the much cheaper products that is expected to flood the international markets once their export quota is lifted. A research by SERI shows that many T&G companies in Penang are coping, albeit with the indirect help of the MFA which currently limits the amounts of Chinese textile and garment exports (*SERI*, May 2004).

At present, reducing of profit margin is one of the strategy adopted by my informants in the T&G manufacturing to enhance their competitiveness and continuous presence in the market to fight the incursion of China products into our local market. One of the informants interviewed is surviving on government contracts, for example manufacture of uniforms for the army and police forces and other lower end domestic products. From the SERI report in May 2004 to the Penang State government also revealed the challenges that local SMEs in this sector are facing difficulties to compete with China manufacturers in terms of cost. The report also gave an idea that local manufacturers in Penang are now focusing on higher end products generating higher added value. Other strategies taken up to battle for survival are research and development, differentiation, high services-orientation, strategic partnerships, quota manipulation and vertical integration.

Plastic industry: The plastic industry in Penang had evolved over the years since its establishment in 1962, producing polyethylene bags and house hold wares. Its development has strong relationship with the EE industries. As the EE sector began to developed in Penang in the early 1970s, the plastic industry sector started to transform into producing consumer audio-visual electronic products. As new investment arrived in the 1990s, the plastic industry take a new look and ventured into producing plastic parts and components for the PC & peripherals as well as plastic parts for telecommunications sector. This sector accounted for almost eight per cent of the total number of manufacturing firms in Penang (*SERI*, March 2003).

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

The reasons mentioned above could be related to the types of plastic industry they involved. First, from the survey data in my research and SERI's survey on SMEs in Penang last year illustrate that plastic companies in Penang are mainly involved in injection moulding, extrusion, blow moulding of general plastic products or precision & engineering products in the EE sector. There is little innovation needed due to the nature of the plastic manufacturers in Penang that are downstream producers. Basically 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 support. Second, reason for the decline of total number of new plastic firms establishment could be related to the relocation of TNCs to lower cost production site and some capable local plastic companies that could fulfilled the standard required by their customers, expanded overseas. However, not all SMEs could expand abroad, only the financially competent companies are able to expand their investment overseas. In a way, business opportunity also shrank due to the relocation of TNCs and highly competitive local companies.

From my survey data demonstrates that plastic injection moulding and precision tooling enterprises are working hard to catch up with their competitors from Thailand and China. 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 very much dependent on the TNCs for contracts. According to the information received from the survey interview illustrated by one of the SMEs said that one of his customer, SONY invested in China and discovered that local companies in China offer lower prices for the same products that he produced in Penang. SONY requested him to reduce the price, if not, he may not get the contract. He said that his company used to get RM18,000 for a mould he produced but now the price is as low as RM8,000 and he find it is difficult to do this business. He decided to compete on producing higher value-added moulds which needed higher accuracy and avoiding competing with the Chinese producers at the lower-end moulds that require less precision. At present his company surviving by reducing profit margin and he is not clear what to do in the future.

Third, based on the information received from the survey shows that some SMEs that depended heavily on the domestic market faced with unbend able competitions of imported polyethylene bags from Thailand and China. Such companies decided not to further invest to upgrade their production plant but to import and sell in the local market. Some local small plastic bag and frame exclusion plastic manufacturers find it difficult to compete with the same products imported from Thailand, which is cheaper by 30 per cent. From an informant interviewed in Butterworth stated that initially he and his partner plan to set up a new plant in Malaysia but due to the much more competitive market and decided to hold their plan for expansion. They visited Thai plastic manufacturers and discovered that some Malaysian trading companies imported huge volume of plastics from Thailand and distribute in Malaysia. From their visit, they decided to temporary import from Thailand and distribute in Malaysia because the quality is good, better than their products and with lower price. It will be very costly and high risk for them to set up a new plant that will cost them million of ringgit to invest in heavy machineries and the prospect is uncertain.

However, three other medium size plastic manufacturers that have more than 60 per cent of export market are more competitive in both domestic and export markets. Their countries of export are not dependent in the region but to European countries, United States, the Middle East and African countries, Japan and Australia. Beside market orientation and company size, the type and products quality also determine the company's competitiveness. Two companies that specialise in manufacturing plastic products that related to security and water soluble bags, laundry bags for hospitals and surgical bags and medical products that need to meet certain special cleanliness requirements and quality are not affected by other commonly used imported products.

Base on the finding from my research and SERI's, give an idea about the situation of local companies in this sector that the smaller plastic companies might not be able to survive. Only companies that involved in niche markets have the opportunity to survive and succeed. Conversely, the plastic makers that are already involved in precision and injection moulding and are already supporting the export markets or even have an investment abroad will continue to flourish (*SERI*, March 2003).

Wood based products: The wood based sector (including furniture) accounting for 1.2% of total manufacturing workers in 1993 in Penang (*SERI*, December 2003). The wood based products industries are hard hit by cheap products from China. Based on an interview of a company at Kepala Batas in the Province shows that the company's export market has been reduced from 30 per cent in the last three years to 0.5 per cent 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 price products of the same quality. At present the company is surviving on the domestic market. The company felt difficult to compete with cheap products imported from China. To ensure its continuous present in the industry, the company is forced to reduced its profit margin from 20-22 per cent in the past four years to just 6-8 percent in July 2003. The industrialist suggested that a reduce in corporate tax will be a good solution to keep his company to be more competitive in the global market.

Shoe industry: In the shoe industry, two local brand shoe manufacturers were interviewed, one facing with reduced export, its export market had shrank from 80 per cent in the past four years to only 15 per cent in 2003 and its work force has been reduced from 300 to 60 people. This informant complained that his company loses its competitiveness due to lack of skilled labour and at the same time facing high labour turnover. Another local shoe manufacturer stop producing the finished products in Penang instead he contracted out to China manufacturer and then import from China and put up his own brand name and packing in Penang.

Other industries: From an interview with a company that assemble computer monitor also shows the same trend of replacing production with finished imported products from China and only do some qualitative control locally and create their own brand name. This tells that little job is done in some of the local SMEs Other local industries such as tyres and spare parts manufacturers and dealers are also 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 the New Challenges

The SMEs from both my research and SERI's suggested three possible ways to deal with the new challenges in the continuous liberalisation of the AFTA and WTO.

Relocation: Most companies, especially the medium size and more competent companies considered to relocate their manufacturing plants to a more competitive manufacturing base to seek for cheaper and larger skilled labour force. The destinations of countries suggested are Thailand, Vietnam and China. Amongst these countries, China is the most preferred country for relocation due to its market size, big pool of skilled labour force, and good incentives. They acknowledge that this strategy is very risky, it involved not only big capital but also to deal with human resource, cultural, political and language barriers. In this respect, the SMEs strongly felt that the government should help them to establish contacts, provide information and financial supports.

Expand market base abroad: Some of the SMEs realised that they cannot continue to compete in the small domestic market that trying to outdo one another but to broaden their export market to overseas. An informant from a rubber parts manufacturing company said that the tyre market in Malaysia is small and that local producers are not able to compete with imported cheap tyres from Thailand and China. So, his company need to expand its marketing network to back-up the industry. In fact, some SMEs are already doing well in exporting to non-traditional market, such as to the Middle East countries.

Upward value chain: Only few SMEs chose to restructure their operations to produce less labour intensive and moving up the value Chain such as technology upgrading, products development, differentiation, designs and R&D. Very few SMEs focus on innovation as a way to compete in the market. Only two medium size SMEs amongst the forty companies surveyed have their own research and development (R&D) unit to invent new products. This tells that smaller companies are either do not have long-term prospective or lack of financial support for R&D work.

The upward value chain strategy is an excellent idea. However, we also have to keep mind that China is also moving up the value-chain. Who will move up faster? Is it too late for some SMEs to start now? Can Penang SMEs stay competitive? No doubt, this is a right strategy but the Penang SMEs have to work double harder than their competitors from China and cannot continue to be complacent.

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

When asked about SMEs in their respective sector that had ended operation in recent years, the feedback from the survey interview informed that most of the SMEs that had ceased operation was due to lack of competitiveness in pricing, not able to meet the demand of the customers. Some companies that operate as subcontractors to TNCs have to close shop for the reason that they lack of contract (due to their customer's relocation to China) and with high overhead. This is especially in the relatively small companies of less than ten workers in the plastic injection moulding companies. Some of these entrepreneurs left their previous businesses and ventured into other types of business, mostly trading that require relatively smaller capital and can be handled personally. Some of the previous small company employers are now into restaurant and hawker businesses.

Major Struggles Affecting the Competitiveness and Development of SMEs in Penang

After analysing the various sectors in the SMEs in Penang as mentioned above, it shows that there are four major factors affecting the competitiveness and development of the SMEs.

Shortage of Skilled Production Workers: As the market become freer and trading environment become more liberalized and with the unimpeded new competitors getting into the traditional market, cheap foreign labour become the major competitive factor to lower manufacturing cost. The competitiveness of Penang SMEs are very much dependent on cheap foreign labour. The survey interview revealed that most companies in the labour intensive sectors such as textile and apparel, wood products, food wear, and fabricated metals are facing with shortage of skilled production workers. This issue is not new, in fact, it had been reported by SERI to the Penang State Government in February 2001.

The government's foreign labour policy: The government's foreign policy created problem for SMEs that dependent cheap foreign labour. The SMEs surveyed complained The foreign labour policy is inflexible and should be liberalised. The maximum year for foreign labour to work in the country is too short, the maximum years are seven. When the labourers are trained and gain experience, they were about to leave and this add to the cost to train a new batch of labourers, every renew of charges for every foreign labour is a cost to the manufacturers. The manufacturers need close cooperation with the government to consistently supply them with enough skilled labour. Though they are local workers but they lack of discipline, such as low in work attendance and caused instability in production. Besides that, local workers' turnover is also a major problem in the indigenous cluster such as the food wear sector and other SMEs. Local workers especially graduate trained in the SMEs left to join TNCs which offer better career prospect, higher salary and better work environment. This not only causes inconsistency in production but also hinder company growth in a long run.

Red tape: Another set back for the SMEs is the red tape problem. Penang SMEs find it difficult to get approval for their business plan. The process takes a long time, it involves endorsement from a range of ministries and agencies. In the two round tables with SMEs organised by SERI in Penang in the last quarter of 2003 gave an illustration that SMEs are frustrated with the red tape. This not only affecting the 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). A feedback received from my informants exemplified that the Penang State government has becomes too complacent and too slow in approving business plans and incentives. In fact other region in the country such as Malacca has become more aggressive in attracting FDI, its ranking in term of investment moved up from 10th position in 1997 to 2nd in 1999 and Penang improved from 7th position in 1997 to 1st in 1999. However, in term of total value of investment, Penang plunged from RM4.78 billion in 1999 to RM3.77 billion in 2001 and 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 a fair competition, opportunity to expand their market but they are facing with financial difficulty to expand their company. A number of SMEs interviewed in the survey complained that the banks only interested in the listed companies and companies that promised good return. They criticized the Malaysian banks for not really encourage business development. In this case SMEs face with difficulties to compete with other countries. Cash flow is an all time major problem for small companies to expand and therefore, remain small. Banks are too conservative even though the government had directed local banks to provide loan for SMEs. It is hope that the special attention given by the government to SMEs as announced in the 2004 budget to provide an additional RM1 billion to the micro credit scheme under Bank Pertanian Malaysia and Bank Simpanan Nasional (*The Star* 13 September 2003) will help to boost up the SMEs. On top of that the proposed threshold for chargeable income with corporate tax of 20% be increased to RM500,000 from RM100,000 will encourage SMEs to increase investments in the country.

Future Prospects of Penang SMEs and Penangites

The present finding of the research shows that large and competent SMEs will survive and prosper but the future of the smaller firms is not so bright if rigorous measures is not taken in the near future. The future prospect of Penang SMEs lay in the hands of the entrepreneurs, there is need to shift from the individual and family control companies to a share holding companies that will enable the company to restructure in a shorter period to develop the company to be more competitive. There is also a need to shift from the mentality of short-term gain to a long-term investment to move up the value chain and to invest in R&D. In such ways local SMEs will improve themselves from the traditional productions that repeating what others do, the "limited" technical and engineering resources to innovations, and product development.

Second, the future of the Penang SMEs also rests in the hand of the Penang State government. Penang is becoming less attractive to FDI within Malaysia, other region of growth in Malaysia that has been able to attract FDI are Malacca and the Kedah Kulim High Tech Park. If the Penang state government continue to be complacent, it will loose out to other states in attracting FDI and this will have great implication for the socio-economic well being of the Penangite that make their income from the manufacturing sector in the TNCs and the 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. Beside this the government have to continue to develop and upgrade it infrastructure, especially the high tech infrastructure that will give advantage for its investors in the state to compete with their competitors from other countries. It will not be the end route for Penang, if it could develop and produce a pool of strong human assets, it could continue to ensure its competitiveness by moving up the value chain and continue to attract FDI.

Third, to be able to compete by moving up the value chain, local SMEs have to work double harder than their competitors from China. One of the strategic way is to invest in more R&D and develop more Intellectual Property (IP) sensitive products. In fighting piracy, Malaysia gives confidence to TNCs and local large-scale companies to continue to invest in Malaysia and this is one of the advantage over China. If Penang SMEs could develop more IP sensitive products it will be an extra incentive for TNCs to invest in Penang and the SMEs could continue to stay competitive in the market and providing jobs for the local.

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