



## **Economic Briefing To the Penang State Government**

### **Coping with China: How Penang Firms are Faring**

#### **Inside this issue:**

**Coping with China:  
How Penang Firms are  
Faring** 1

**Schooling and Educa-  
tion Do Not Mean the  
Same Thing** 8

The China threat has almost become a cliché, however, instead of being paralysed by fear into inactivity, many local companies have come up with strategies to cope with the challenges and seek business opportunities in China itself. Based on research conducted by SERI, this article seeks to share the experiences of these companies, with the objective of initiating a discussion as to how local industries can individually and collectively improvise and strategise to rise to the threat of China eroding their market share both domestically and globally, and most of all to also ride on China's growth to their own advantage. The focus here is on the Textile and Garment (T&G) and Electronics and Electrical (E&E) sectors.

#### **The Textile and Garment Sector**

This market is currently dominated by a few large players which contribute significantly to the state's economic growth and employment. Massive challenges lay ahead for these players as globalisation takes its toll on labour markets and the cost and availability of raw materials. The fact that the T&G industry is highly labour intensive links its fate to the rise of China as the much-favoured FDI centre. Many believe that this is a sunset industry in Penang. China's key attraction is the availability of a large skilled labour force at significantly lower costs. At present, many T&G companies in Penang are coping, albeit with the indirect help of the Multi-Fibre Arrangement which currently limits the amount of Chinese T&G exports. Come 2005, the Agreement on Textiles and Clothing takes effect and China is expected to flood international markets with their products once their export quota is lifted.

#### **Business implication of the Multi-Fibre Arrangement (MFA) and the Agreement on Textiles and Clothing (ATC)**

The year 2005 will see the complete removal of the MFA which imposed quota restrictions on exporting countries of T&G. Malaysia currently benefits from this arrangement as we are allowed a larger export quota than China. With its removal however, Malaysian exporters will face heightened competition in international markets. The basic aim of the ATC is to secure the removal of restrictions currently applied by some developed countries to imports of textiles and clothing. The implementation of the ATC is supposed to level the playing field for all T&G manufacturers although it may not necessarily work out that way in reality. It is unlikely that the benefits of the removal of these restrictions will be evenly distributed. Businesses that have used this temporary period of protection within the MFA to modernise, rationalise and invest in research and development will be the ones to emerge victorious.

Socio-economic &  
Environmental Research  
Institute (SERI)  
10 Brown Road,  
10350 Penang, Malaysia

Phone: 604-2283306  
Fax: 604-2267042  
Email: [seripg@tm.net.my](mailto:seripg@tm.net.my)  
Website: <http://www.seri.com.my>

## **The fight for survival**

Just how are our companies facing this impending threat? Many have agreed that they cannot compete with China in terms of cost. One domestic manufacturer has stated that China's selling price equal his cost price! At best, Penang can be classified as a medium-cost manufacturing and assembly centre. How can we measure up to China, a nation with a population of 1 billion and significantly lower production and labour costs? The key to survival lies in differentiation. We need to differentiate ourselves from China. Local manufacturers need to justify the higher costs with higher quality goods and services. Research and development, differentiation, high service-orientation, strategic partnerships, quota manipulation and vertical integration are some of the strategies Penang firms have embraced in this fight. Some, however, have chosen to set up operations in China itself, to neutralize the competition from Chinese companies.

### ***Strategy One: Investing in China***

The sheer logic of supply and demand is behind the outflow investment from Penang into China. As a vastly populous nation, the cost of labour in China is significantly lower and cost of capital is much cheaper. Penang manufacturers have also discovered a vast untapped market in China compared to the highly saturated domestic Malaysian market. These factors increase profit prospects and hence prove attractive to businesses.

Achieving economies of scale is another reason for investing in China as an increase in the scale of production leads to a lower cost per unit of output. Penang manufacturers are able to achieve this by joint ventures with Chinese companies. This involves focusing most production facilities in China and exporting the final product for worldwide sales.

### ***Strategy Two: Research and Development***

Many local plants of transnational companies are now investing heavily into research and development in the need to differentiate their products from generic products. This is essential for survival as China is able to churn out generic products at an alarming rate and price. The investment in R&D has paid off as our local firms have successfully produced breathable fabrics, wrinkle free fabrics, dirt and water repellent fabrics and are currently working on producing more of such fabrics. By justifying themselves on the basis of higher technology and higher value products, they are able to retain their operations in Penang.

China lacks the confidence of many investors in bringing in expertise and technology due to its poor Intellectual Property (IP) protection. The weak IP protection has seen many successful products duplicated, repackaged and sold at a much lower price. Success has a lot of followers, therefore the more profitable the product, the greater the competition. The higher level of IP protection afforded in Malaysia is used to draw foreign talent and technology. Moreover, by investing heavily in R&D, companies are able to be a step ahead of competition and to ultimately create a niche for themselves as innovators.

### ***Strategy Three: Formation of strategic partnerships***

These firms also foresee a shift in consumer expectations towards technologically enhanced textiles. As such, the formation of strategic partnerships with chemical companies such as DuPont and 3M to carry out R&D is becoming more common. Successful partnerships have led to the development of technologically enhanced textiles such as the performance knit shirt, which essentially contains anti-bacterial properties.

### ***Strategy Four: Shift in product focus***

Especially in the garment industry, many players are focusing on customer expectations and customization. Bulk production is too competitive and as such, the focus has been shifted to meeting the specific needs of the international buyers. The aim is to compete based on the quality of the products, not the price. Across the industry, many players are focusing on higher end products generating higher added value. This includes special arrangements such as producing shirts with unequal sleeve lengths and other specification details.

**Strategy Five: Quota manipulation**

This strategy seems short-lived with the impending ATC in 2005. However, many companies have used this window of opportunity to manipulate their production figures by using different operations based in different countries to "add-value" to a particular piece of garment, and finally exporting it from the country with the most beneficial quota arrangements. Take for example the fact that China has a smaller export quota than Malaysia. This has resulted in China being used as an operational base where subcomponents such as buttons, pockets and collars are sewn on. Malaysia then becomes the export base for the final value added product.

Some local firms have had to resort to Outward Processing Arrangements (OPA) to remain competitive. OPAs are arrangements whereby cutting and minor sub-assembly processes are undertaken in places outside Penang where costs are much lower. Sufficient sewing and assembly work is then done in Penang to satisfy rules of origin and is finally exported.

**Strategy Six: Vertical Integration**

Vertical integration has helped some companies control the costs of their materials and production. Vertical integration is the process whereby firms within the same industry but in different stages of production merge. This merger gives the group direct control of its resources and facilitates efficiency in its distribution process. The basic raw material in this industry would be cotton. As a commodity, the price of cotton is bound to fluctuate. Owning cotton farms by way of vertical integration however, lessens fluctuations whilst at the same time allow producers to ensure its quality. Resources can also be specifically tailored, for example instructing the textile factory to produce a specifically blended mix of polyester and cotton to meet the stringent requirements of the foreign buyer. Having direct control over the distribution and delivery process will ensure on-time delivery which is a critical factor for foreign buyers in awarding contracts to garment manufacturers. As such large international buyers are more confident in dealing with integrated textiles and garment producers.

**Have these strategies paid-off?**

In terms of production, most T&G manufacturers are producing close to full capacity for the year 2004. With regards to quality, our firms have earned themselves a name as good suppliers who assure quality and commit to delivery. This is supported by the fact that garment manufacturers are continuing to see orders come in from international buyers such as Tommy Hilfiger, Hugo Boss, LL Bean and Nordstrom to name a few. Clear distinctions have been made as far as our Chinese competitors are concerned. Penang based companies have a good track record and hence garner more investor confidence.

2005 will be the beginning of a new phase with the complete removal of the MFA. It is inevitable that some smaller players may close due to the tough competition from low-cost countries. However, the focus shift of the larger players towards quality and efficiency may see this sector undergo a change where it is dominated by a handful of formidable and successful key players in the international arena.

**The Electrical and Electronics Sector and Its Fight for Survival**

The more enterprising of our local firms have responded to the threat of China by setting up a working relationship with their China counterparts. Most firms have leveraged on China's strengths by restructuring their operations to take advantage of China's low cost of production. Upon realizing that China is not always an enemy but potential also an ally, many are able to find a working structure which enables the local and Chinese companies to complement each other in the value chain of production. China in itself has many weaknesses that it needs to overcome to gain investor confidence. It is without a doubt that they currently possess more skilled workers at a lower cost than Penang. However, that cost is rapidly escalating and in time may overshoot. Inland logistics are a far cry from that of Penang and most important to the E&E sector, the issue of its underdeveloped Intellectual Property Rights (IPR).

***Strategy One: Jumping on the Bandwagon and heading to China***

Many local firms did not want to lose their existing customers and hence followed them into China. Whilst confident of a captive market in terms of their existing customers, they used the opportunity to look for new Chinese customers i.e. expanding their market share. Other firms who ventured into China decided that it was impossible to compete with Chinese companies and therefore chose not to export to China but to manufacture in China for international sales.

***Strategy Two: Making China an important trading partner***

For those who are unwilling to succumb to the herd effect and hitch a ride to China, partnerships were formed whereby they imported intermediate goods from China at a much cheaper price and focused on value adding to complete the final product. Contracts are awarded to Chinese companies based on cost efficiency and productivity. This helps to lower the overall cost for our local manufacturers.

***Strategy Three: Brand Building***

Brand loyalty is the only key to survival in the competitive consumer market today. Some local firms have stepped up marketing efforts to emphasize on the quality aspect of their goods and hence justifying the higher costs of their products.

***Strategy Four: Moving up the Value Chain***

Penang can no longer compete as a low cost manufacturing and assembly hub. We need to refocus on our core competencies and move up the value chain. What Penang possesses in terms of infrastructure and facilities, China lacks. Hence Penang companies need to capitalize on that and focus on design and development and research and development. Local companies that have moved up the value chain have found a niche market in China and have proven successful in the areas of value added services in the hi-tech industry such as sub-con, tooling and equipment development to name a few.

***Strategy Five: Outsourcing***

As part of the measure to lower cost, some local companies have outsourced non-key business functions to the most efficient supplier. For example, Penang based operations now cater to high value added, high technology and low labour content business divisions while high volume and high labour content business divisions are outsourced to the lowest cost provider. These low cost providers are normally found in third countries.

**Surviving or Thriving?**

Firms which have ventured into China are indeed benefiting from the lower cost of production especially if they use China as an export base for international sales. Many have reported that penetration into the Chinese market is a different story altogether as they face stiff competition from domestic Chinese producers. There is also the fear of a wage-inflation spiral in China in the very near future. This is expected to wipe out the cost advantage of China.

The push towards branding as a differentiation tool has resulted in a conscious effort in our local E&E firms to continuously invest in R&D to improve the quality of goods produced. With sufficient encouragement and investment capital, this move should see us a notch further up the value chain.

Regardless of whether China is being used a low cost manufacturing centre or a market for Malaysian exports, the fact remains that China is a large market in terms of E&E. There is huge potential for trade between China and ourselves in this aspect, especially if we can differentiate our local E&E products from theirs.

Of the local E&E firms that have invested in China, some have set up warehousing facilities in China to take advantage of the lower costs, some use Chinese agents to distribute their goods to the Chinese market while others have

set up plants in China to handle production of high volume, low technology goods. Finally there are the firms with no capital investments in China, but export 100% Malaysian products for sale in the Chinese market. These are the firms already have or are currently building up brand awareness. Pensonic is one brand name that is penetrating the Chinese market.

## Help from within?

Whilst key players of the abovementioned sectors are apparently doing the best they can to keep competitive and most importantly maintain market share and profit margins, many are still reluctant to embrace change. The mindset of the smaller players has to change in terms of venturing into new areas of business growth. The Penang corporate sector is characterized by a fair number of family-run companies which have been successfully listed on the KLSE. The success of these family-run publicly listed entities are attributable to two main factors. Firstly, the strong business acumen which they possess and secondly, the strong sense of loyalty that runs through the veins of these businesses. However, it is also this loyalty that stands in the way of change. Determined that the same business which saw them through the last 20 years will see them through the next 20, most refuse to look into new areas of growth and business opportunities. Most of these businesses adopt a reactive approach rather than a proactive approach in their business strategies. Unfortunately, most expect the government to cushion their operating environment from external threats. The government would be most unsuccessful if it works alone. A collaborative effort between the private sector and the government is needed if success is desired. The government can only influence the external operating environment. It is up to the firms themselves to reorganize and restructure to benefit from the current market situation.

## Government Intervention to the rescue

The government plays a pivotal role to ensure that the manufacturing industry continues to compete in global markets and contribute to the growth of Penang.

As R&D has been identified as the key to differentiation, encouraging collaborative efforts between key business industries and academia would accelerate the rate of product development within the larger key players in these industries. This would also facilitate the transfer of technology to our local workforce. Another avenue of such technology transfer is through the MNCs.

SMEs however, are reluctant to venture in to R&D for two main reasons. Firstly, it is their low risk tolerance, Secondly, the lack of capital. Apart from partial State funding, these SMEs would also benefit from State assistance in the export of capital and expertise through matching, development grants or joint ventures. The need to export local talent and expertise is important, especially if the Penang economy were to reduce its reliance on MNCs.

Industry sources acknowledge that the working trips organized by the Chinese Chamber of Commerce and the Malaysian China Business Council have been most helpful as it increases their exposure to the Chinese business environment and matches them up with appropriate partners. However, more in-depth information and evaluation is needed for serious investors. Due to their inability to afford overseas survey missions, smaller players would benefit from an updated database with information regarding high risk and high return areas of investment in China.

Opportunities have been identified in the high value-added sector of the manufacturing chain. However these business windows of opportunities are very small and disappear quickly. Hence, assistance in setting up the proper channels to support our local businesses in securing these opportunities would be beneficial.

In order to attract foreign investors and at the same time encourage domestic investors to invest overseas we need to be able to draw the funds and build the technology. Both domestic and foreign investors should have confidence in the State Government that they work with. Many investors have identified government bureaucracy as one of their greatest challenges. Perhaps the government can help by providing more competitive tax incentives, by loosening foreign labour policies and decreasing the turnaround time in documentation procedures.

## Conclusion

China should not be viewed as just our cost competitor but as a vast market for us to benefit from trade relations. If Penang is successful in marketing its strategy of *China+1* to both foreign and domestic investors, we should benefit from the symbiotic relationship. Change is inevitable and to succeed, we must change. We will stand to lose if we continue our reactive approach to threats and challenges. The period of adjustment is painful but if we embrace it and adopt proactivity in terms of keeping Penang one-step ahead of our Chinese competitors in terms of quality, technology and efficiency, this relationship will bear fruit in time to come. *By Poh Heem Heem*

## Schooling and Education Do Not Mean the Same Thing

In this day of the march towards the much trumpeted “knowledge society” and “knowledge economy”, it is imperative to get our thinking straight on the difference between “schooling” and “education”.

Fay and Michael Kanin were very perceptive about what education really means when they wrote the screenplay to the 1958 Hollywood movie, *Teacher's Pet*. Clark Gable played Jim Ganon, who never attended college, but is a well-known city editor of the local newspaper. Meanwhile, Doris Day played, Erika Stone, an instructor who teaches journalism at the university. As would be expected, the two have opposing views about what makes a good journalist. Stone claims that the likes of Ganon thinks that journalism is a trade, and not a profession, to be learnt only on the job like artisans and argues, on the contrary that, “the basic fundamentals can be taught just like in medicine.” Their impasse might not have been broken if not for Hugo Pine, played by Gig Young, a published psychology professor, Erika's colleague, at the university. Pine helped to clarify the common confusion between education and schooling. He says that, “if you care to look it up, you will find that education is the acquisition of knowledge and the definition of knowledge is knowing – familiarity gained by experience. You will also find that wisdom is defined as the presence of experience and knowledge.” Therefore pointing at Ganon, he says, “now being experienced, you therefore have education, you have knowledge and you have wisdom.”

Schooling is about education, but it is possible to receive education without attending school. Society wants education for its members by setting up schools but the main concern is education, specifically the acquisition of knowledge, not qualification. Schooling provides a means for knowledge to be acquired but nevertheless it is only a means. It would be better, at teaching institutions, to place emphasis on learning rather than on earning a qualification in the education process. For instance, although I teach finance, I often remind my students that a purpose of this course, but by no means its main purpose, is so that when the semester is over, we would know something about finance. That is secondary. Instead, the main aim is to learn how to go about acquiring knowledge, in this case, about finance. By pursuing the main aim, the secondary aim will naturally fall into place. If successful, then the same learning can be applied to virtually anything else: be it pursuing knowledge in music or religion or philosophy or even languages. When that happens, the ability to learn on one's own becomes the key that would open the door to boundless knowledge.

In fact this is the method by which universities reproduce knowledge over the centuries. There is an important distinction between education and training, and the university is a place for education, not training. If we opt to only train our students, the level of knowledge would only increase up to the extent of what the teacher knows. This places a tragic limit to learning. It becomes knowledge put in a box. More so if the teacher's knowledge is out-of-date, becoming as well, knowledge standing still. Worse still if students end up learning only 90 percent, or less, of what the teacher knows, and pass on 90 percent to their students when they themselves become teachers and after that their students passing on 90 percent. The level of knowledge in the society will deteriorate with the passing generations.

In contrast, education emphasizes how students learn to learn and challenge what is taught, bringing in new insights and perspectives and constantly apply them to changes being observed in society. Students make a start at contributing their own ideas, writing them down. Over the years, once-upon-a-time students replace part of what they were taught, putting old knowledge in the store and replacing these with new ideas of their own. Society and knowledge evolves in the process. Knowledge is built. Today we might use multi-media presentations and computer interactive software in the classroom as part of the so-called “e-learning” education technology but such gizmos must not be allowed to seduce us from what is really needed during classes, which is brain-power. Teaching technology might have come a long ways but learning has not at all changed from the way knowledge was passed and built upon from Socrates to Plato then to Aristotle, or even long before that time.

The pay-off comes in the problem-solving skills that education provides, via the ability to apply knowledge. On the other hand, the level of training normally sets the limit to a trained person's ability to solve problems. School days or college days then mark only a brief passage in a continuous lifetime of unceasing learning. Attending classes will end but the few years of school cannot substitute for a lifelong quest of knowledge acquisition by gathering experience and accumulating wisdom. Employment recruiters, i.e., human resource managers or personnel officers might do well by turning their attention away from paper qualifications and find alternative ways to evaluate the education level of their prospective staff members. In these days of dubious means to earn a degree or even a masters or doctorate, complete with transcripts and all, judging by the many Internet offers, surely recruiters would prefer people who can do what is needed of them at work than the decorative papers that job seekers might have brought with them.

In this regard, the private sector has done better. It is common in factory environments, for instance, to find supervisors and even managers, who rose, through experience, rank-and-file, overseeing fresh university graduates just recruited at the job-entry level. In the public service this has never been the practice. Non-graduates who join the public service are doomed to a career lifetime at the subordinate position, unless they acquire some form of paper qualification during their tenure. Meanwhile, graduates entering the public service will achieve officer level status their first day at work.

The problem has become even more acute. Last year, the Public Service Department introduced the skill level achievement or *pencapaian tahap kemahiran* (PTK) as a condition for job promotions across the entire civil service adding therefore yet another piece of qualification to make a government employee eligible. Instead of introducing a more holistic evaluation of worker performance the assumption appears to be that the PTK assessment process is sufficiently comprehensive. Still, the newspaper reports that in a recent PTK test sat by some 130,000 mid-level ranked teachers, only 0.9 percent managed to pass. The passing grade was 80 marks out of 100. However, statistically speaking with a normally distributed population, which is definitely achieved with a sample size of 130,000, a properly designed test should be able to pass at least 20 percent of the candidates, given a 80/100-point passing grade. A test in which virtually everybody passes or everybody fails is either too easy or too harsh and does not perform the task of what testing is supposed to do.

Malaysians today are caught in a paper chase, scrambling for basic degrees and beyond. I discovered one opportunity for a doctorate in business administration advertised on a lamppost beneath another advertisement offering plumbing services - a strange place to look by one wishing to pursue learning. A visit to most bookstores will see people searching through the shelves. The government's personal income tax relief of up to RM500 per year for purchases of reading materials forms a positive incentive. If pursuing a degree means reading many books, then why bother looking it up on a lamppost? It appears that those people reading books purchased from bookstores are not the ones signing up for high-level degrees. The first group of people acquires knowledge, the other, acquires qualifications. When job-recruiters start asking for knowledge rather than paper qualifications, then pursuit of knowledge, as a society, will increase. Then putting whimsical decorations of quaint alphabets besides ones' names will become less of a preoccupation, and class attendance will rightfully be for the purpose of learning, not to qualify for a piece of documentation. *By Dr Chan Huan Chiang*



**Socio-Economic & Environmental Research Institute (SERI)**

**10, Brown Road**

**10350 Penang, MALAYSIA**

**Tel: 604-228 3306**

**Fax: 604-226 7042**

**E-mail: [seripg@tm.net.my](mailto:seripg@tm.net.my)**

**URL: <http://www.seri.com.my>**