

Introduction

Background

- 1.1 Australia's resources sector is experiencing its most prosperous economic cycle in over a century. Consequently the terms of trade are the strongest since the 1950s, which has led to the Australian dollar's rapid appreciation since 2003. Such rapid sectoral and economic changes affect all sectors of the economy, some more than others. In tandem with this, and the reason behind these shifts, the dynamic industrialisation of a handful of developing countries, in particular China, is driving world production and trade strategies.
- 1.2 These global changes are affecting not only the Australian manufacturing sector, but those of all Western economies. However, Australia is experiencing the dual impact of China's industrialisation given it is resource rich and with an established manufacturing sector.
- 1.3 The Australian manufacturing sector now confronts further challenges and yet is being exposed to new opportunities. The very nature of manufacturing is transforming. In view of this, on 3 May 2006 the Treasurer, the Hon. Peter Costello MP, asked the House of Representatives Standing Committee on Economics, Finance and Public Administration to inquire into and report on the state of Australia's manufactured export and import competing base now and beyond the resources boom.

Conduct of the inquiry

- 1.4 The inquiry was advertised nationally on 31 May 2006 and subsequently received 50 submissions from a broad cross section of interested parties. The inquiry was conducted concurrently with an inquiry into the current and future directions of Australia's service industries and much evidence received applied to both inquiries.
- 1.5 Between July and November 2006 the committee conducted manufacturing site visits in Melbourne, the Gold Coast, and Newcastle and Hunter regions. In February 2007 a site visit was held in Perth. A total of 13 public hearings were held in Canberra, Sydney and Melbourne between August 2006 and March 2007.
- 1.6 A list of submissions, exhibits and public hearing witnesses can be found at Appendices A, B and C respectively.
- 1.7 Submissions received and transcripts of hearings can be found at the committee's website:
<http://www.aph.gov.au/house/committee/efpa/manufacturing/index.htm>

Impact of the resources boom on manufacturing

- 1.8 The rapid expansion of the Chinese manufacturing sector in the last twenty years has led to unprecedented global demand for raw materials and a consequent increase in the price of these; most notably in the last three years when the rest of the global economy was also growing strongly. Australia, being a resources rich nation, has experienced an increase in its terms of trade and a significant increase in the value of the Australian dollar.
- 1.9 Flowing from this, as the mining sector's profitability has surged, it has attracted employment from Australia's manufacturing sector. The impact of this has been skills shortages especially for skill-sets common to both sectors.
- 1.10 China has caused the Australian resources boom. China's industrialisation started in the low-value, high-volume manufacturing sector where they could manufacture at very low per unit cost as they transferred surplus labour from agriculture to manufacturing.

- 1.11 What is happening in China is the ‘industrial transition phenomena’ whereby developing countries’ economic focus shifts over time from agricultural, to manufacturing production, and finally to providing services. In Western economies this change spanned the 19th and 20th centuries. China is now undergoing this transition – at a much later stage, but on a massive scale¹ and at a much faster pace.² Essentially, the boom we are experiencing is a result of a 21st century industrial revolution.
- 1.12 The Committee heard repeatedly that the appreciated exchange rate has undoubtedly hurt the manufacturing sector. Most thought the resources boom has been a significant contributor to this appreciation.
- 1.13 Apart from the impacts on the exchange rate the other impact of Chinese industrialisation on Australian manufacturers has been competition from cheaper imports. This has either led to the rise of ‘off-shoring’³ of low-value production or the replacement of domestically produced component parts with imported component parts from developing countries.
- 1.14 However, evidence to the inquiry indicates that irrespective of a resources boom, manufacturing would have grown less than services, and so its share of the economy would have declined. Manufacturing’s long run trend of losing employment to the services sector would have continued.⁴ But, even if the sector accounts for a decreasing share of employment, it may still contribute to increased Australian prosperity.

Does Australia need a manufacturing sector?

- 1.15 The evidence received by the inquiry to date shows that no industrialised country has a magic formula to ensure a country grows or maintains a specific sector or sectors. It appears that free-market developed countries naturally gravitate towards those sectors in which they have a comparative or competitive advantage, although a number of countries have

1 The population of China is around 1.3 billion; during the United Kingdom’s industrial revolution the UK population was 21 million (in 1820). Sourced from Angus Madison, *The World Economy – A Millennial Perspective*, OECD 2001.

2 It took the UK about 35 years to double its output due to the industrial revolution (1820-1855) but it has only taken China 12 years (1987-1999).

3 Off-shoring refers to manufacturing production being relocated in a lower cost country (usually where low-cost labour is plentiful).

4 Manufacturing has seen rationalisations and improvements in labour productivity that the services sector has not.

‘artificially’ created these advantages.⁵ Whether these countries’ strategies will ensure long-term prosperity is unproven.

- 1.16 Presently the manufacturing, services and agricultural sectors each contribute around 20 per cent to total Australian exports, with the booming resources sector contributing around 40 per cent. This is a sectoral mix that has changed markedly over recent times; in particular the current ‘level pegging’ of services, manufacturing and agriculture. Services have increased their share of exports, with a further expansion of this sector expected in the future (although some services are not easily globally traded).⁶ The Treasury indicated this trend is worldwide:

Typically, an economy will start off being largely agricultural. Then, over time, manufacturing—secondary industry—develops, and then later on the tertiary sector develops.⁷

- 1.17 Some countries are still ‘industrialising’ and so their manufacturing sector is significantly larger than their other sectors—Korea is an example. There are also other countries revitalising their manufacturing sectors, like Ireland. These types of countries may have explicitly interventionist programmes to achieve the rapid growth in the sector. Often such government policies are justified as policies of economic necessity, where there are no other succeeding or alternative sectors.⁸
- 1.18 The big difference between countries like Ireland and Korea and most of the established industrialised nations is the focus of their manufacturing growth. The former’s manufacturing sectors are concentrated in high value-added or advanced manufactures.⁹ In many cases, policy programmes have been targeted to support these manufactures.
- 1.19 In established manufacturing centres with less interventionist governments, market mechanisms are relied upon to move the sector into more competitive areas. These areas tend to be the high-end, specialty, and science and technology sectors. As a consequence, many old-style manufacturers lose their competitive edge as their products can no longer

5 Through attractive corporate tax levels, lucrative grants, subsidy programmes and highly directive public sector policy. Ireland, Singapore and Taiwan were mentioned as examples of countries that set out to build up specific manufacturing industries. Refer Appendix F.

6 Child care and aged care are two good examples of services that will increase significantly in the domestic market but are not easily globally tradeable.

7 Mr J Hawkins, the Treasury, *Transcript*, 1 December 2006, p. 9.

8 Ireland, for example, was in an economic recession when the Irish Government instituted a manufacturing revival strategy and, unlike Australia, had no resources sector.

9 Some established countries like Finland and Germany do concentrate manufacturing in the high-end market.

compete on price with industrialising *and developing* trading partners, like China and India.¹⁰ The developing and rapidly industrialising countries operate under protectionist and interventionist regimes but their biggest asset in world trade is a steady supply of low-cost labour and weaker regulatory frameworks (be they socially desirable or not).

- 1.20 There will, therefore, be a natural resource shift intra-sector (although skills transfers from low-value to hi-tech manufacturing are not as smooth) and inter-sector from manufacturing to services or resources. The shift within the sector is likely to be limited as the niche high-end sector will be lean, highly automated and demanding different skill-sets.
- 1.21 If the manufacturing sector is to remain it will be because it is globally competitive and the goods produced are globally in demand. Australia will have a manufacturing sector if it contributes to higher living standards for Australians. To achieve this, firms will need to be innovative in not only their end-product but also in their production and the delivery of their end-product (including integrating supply chains and after sales relationships).
- 1.22 The committee heard evidence of many examples of innovative Australian manufacturing activity, including during committee site-visits. These manufacturers were succeeding in the global arena.
- 1.23 Participants in the inquiry process, including the Treasury, noted that the biggest risk an economy faces when it allows resources to move from manufacturing to their most efficient use at a point in time is the difficulty in returning appropriate resources to the diminished sector when the global market demands:
- And once a factory is shifted overseas, or a contract lost, it may be difficult to expand manufactures or other non-resource exports again even if, after the resources boom fades, the exchange rate appreciation is reversed.¹¹
- 1.24 Resources move from manufacturing into the mining, services or agricultural sectors with relative ease. It is, however, more difficult for resources to move freely from the other sectors back to manufacturing; particularly if the sector lapses for more than one locally trained and

10 Others include Brazil and Russia – the so called ‘BRIC’ countries.

11 The Treasury, *Submission no. 21*, p. 13.

sourced skill generation.¹² The market would finally restructure but it would be a lengthy and costly process.

- 1.25 There was, therefore, almost universal agreement amongst participants that there is a pro-active but not protective role for government in manufacturing.
- 1.26 The Australian Government's future role in the sector will be to provide a sound macroeconomic framework; assist adjustments to structural and sectoral change; provide public infrastructure to support the development and utilisation by industry of advanced science and technological platforms; facilitate research and innovation transfers between the public and private sector; and ensure the business environment, including transport systems and regulation, are uniform and stable across the nation.

What is the outlook for Australian manufacturing?

- 1.27 The future composition of the sector will be different from what it is now. Based on evidence received by the inquiry, with limited government intervention, the sector will select its own winners and ultimately cull its losers.
 - 1.28 The industries that will survive are likely to be those at the technological frontier; those manufacturing industries that embrace these new technologies; and some naturally protected by high transport costs for their type of good.
 - 1.29 It must be borne in mind that the industrialising nations will not produce only low-value high volume products indefinitely. China is already investing in science and technology expertise through its strategy of 'endogenous innovation' ('zi-zhu-chuang-xin'). These countries are increasingly competing in markets for sophisticated manufactures and their ability to reach quality standards should not be underestimated. Western world manufacturers will need to be vigilant to ensure they retain a market edge in sophisticated or niche products.
 - 1.30 The other aspect of Chinese industrialisation is that it will be a very long time before the Chinese 'run out of cheap labour' to produce low-end products. There is a much touted 'barbeque view' that as China industrialises and its standard of living increases, so too will its wage
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12 Along with the loss of direct skills is the loss of specialist training skills. Ireland was able to reinvigorate its manufacturing sector because it could still capture the skills needed for the sector from a willing expatriate labour force.

structure and consequently its input costs will rise to meet those of industrialised nations. This argument is flawed (even with the political regime aside); because even if this is happening in some parts of the Eastern seaboard like Shanghai, China's immense agricultural-based population will supply low-cost labour for many generations.

- 1.31 Despite the bad press manufacturing often receives because of the changing fabric of the sector, that very change brings with it vibrant opportunities and as such it is an exciting arena for Australians to operate in. This was succinctly expressed by the National Manufacturing Forum in its October 2006 report:

Australia should generate a feeling of excitement and confidence about its manufacturing prospects in the global economy. This involves thinking, engaging and competing locally and capturing all the opportunities that flow from there.¹³

- 1.32 Challenged as it may be, given the right tools, the Australian manufacturing sector has many opportunities to seize.

13 National Manufacturing Forum, *Strategic actions to boost Australian manufacturing—a report by the National Manufacturing Forum to State and Territory Ministers responsible for manufacturing*, Melbourne, October 2006, p. 14.

