



Balancing the Risks: Ensuring our Prosperity Survives the Boom

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Introduction

It is a pleasure to be here today. The Press Club has a special significance for Ai Group. The Australian Industry Group was launched at the National Press Club on 11 August 1998 when we announced the merger of the former Metal Trades Industry Association and the Australian Chamber of Manufactures.

That was a defining point in our history of over 130 years. In 1873 the issues driving the formation of our earliest predecessor organisations were collective Vs individual bargaining and free trade Vs protectionism.

Ironically these debates remain with us today and I suspect we have not seen the last of them.

But of course things do change and today I would like to take this opportunity to explore some critical directions for Australian industry, the economy and Australian society at what is a time of very significant and I suspect under-appreciated change. Naturally, these changes are very much appreciated by those most directly involved.

The directions I would like to talk about sit in a broad global context. This includes the ongoing threats to global security; the accumulation of demographic pressures - particularly in the developed world; growing environmental concerns; the rapid emergence of new economic powers led by, but certainly not limited to, China; and a distinct tide internationally of reactive protectionist sentiment.

As a nation, we are clearly benefiting from the surge in non-rural commodity prices fuelled in no small part by the phenomenal rise of China as an economic powerhouse.

We would be very foolish, however, merely to sit back and pocket our winnings.

In particular, we should not be blind to the forces underlying what some commentators have labelled our “two-speed economy” and to the significant shifts that are occurring outside the booming mining and non-residential construction sectors.

These issues lie at the heart of the *Manufacturing Futures* report that our organisation is releasing today.

This report is the culmination of an extensive engagement with Australian manufacturers of all sizes and from all around the country.

Manufacturing Futures reports on the profound shifts that are occurring in a sector that accounts for around 13% of GDP; that employs over a million Australians; that in 2004-05 accounted for 43.9% of exports of goods and services; and that generates around half of all business expenditure on research and development.

The Report advocates a strategy to ensure that Australian businesses equip themselves to continue to build national prosperity beyond the current commodity boom.

I can think of no organisation whose members are closer to the “two-speed economy” than Ai Group. It is a striking message that comes through at our Council Meetings and at the many business forums we conduct.

Among our members and the many other businesses for which we provide services both sides of the two-speed economy are apparent.

- Many businesses report very strong sales and buoyant conditions. These include our constructors, our manufacturers of mining equipment and related products, our logistics companies and our labour service providers.
- However, the majority of manufacturing businesses and sub-sectors are facing deep-seated challenges and upheaval. This is broader than the more familiar areas of automotive components and clothing, footwear and textiles but is extending across a broad spectrum of manufacturing.

The current business environment

Let me begin by looking at the current business environment.

There are extensive benefits for Australia from the closely associated booms in China and in the domestic minerals sector.

As already discussed these are not confined to the minerals sector. They also include a very timely boost to incomes and wealth: a flow-on that is being enjoyed by the Federal Government which finds itself flush with cash as income tax revenues, including company tax revenues, cascade into Canberra.

While the cash and the good news roll in, we must not be blind to some important undercurrents and risks inherent in the contemporary environment.

Some commentators are alert to some of the danger signs:

- While there are now some indications of a reversal in fortunes, over the past few years we have seen a very poor export performance and high current account deficits.
- Even though we have the tremendous windfall of a once-in-a-generation peak in our terms of trade, Gross Domestic Product has not been able to break through an annualised rate of 3% for five successive quarters. We have to go back to the recession of the early 1990s to find a longer period of lower-than-3% growth.
- There are murmurings about the resilience of domestic conditions. Most fundamentally, there is a slowdown in productivity growth:
 - as the positive effects of earlier reforms subside;
 - as we test the capacity of important areas of our infrastructure; and,
 - as lesser-skilled labour is absorbed into the system.

Competitive Challenges

These question marks over domestic economic resilience come at a time of profound global developments that have been compared with the earlier Industrial Revolutions in Britain and the United States.

A recently released Boston Consulting Report notes what it calls “a massive shift ... in the world’s economic center of gravity” as the Rapidly Developing Economies of China, India, Central and Eastern Europe and Latin America are set to provide about 40% of the world’s GDP growth over the next decade.¹

These rapidly developing economies – among which China is the dominant player - are reshaping the established order.

SLIDE 1 (see below)

Last December Ai Group published a study² showing Australia’s distinctly sub-par export performance relative to the rest of the OECD.

- As the slide indicates, the study showed that the OECD as a whole has lost considerable global export share of goods and services as China has surged.
- Australia’s loss of market share since 2000 is three times that of the OECD as a whole.
- The study indicated that, in Australia’s case, the global competitive challenge has been turbo-charged by the strength of our exchange rate.

While it is symptomatic of our favourable terms of trade, the higher exchange rate constricts the non-booming sectors.³

The intense pressures stemming from the twin forces of China and the currency are not felt any more acutely than in the Australian manufacturing sector.

As I will discuss in more detail below, the manufacturing sector is reacting very actively to these forces and is undergoing a distinct restructuring in the face of China. These changes are behind the emergence of more productive manufacturers who are taking advantage of domestic and global opportunities to forge new growth paths.

At the same time, the extent of this restructuring is fuelling significant fears that there will be loss of capability or a “hollowing out” of the sector.

Once lost, capabilities can be very difficult to regain.

This threat of “hollowing out” is an imposing question mark over the ability of the economy to respond to the challenges and the opportunities presented by China and other rapidly developing economies and to play its role in rebalancing the domestic economy as the steam goes out of the commodity boom.

¹ The Boston Consulting Group, *Organizing for Global Advantage in China, India, and other Rapidly Developing Economies*, March 2006.

² Ai Group, *Balancing the Risks; Building Australia’s economic resilience*, December 2005.

³ See David Gruen, *A tale of two terms-of-trade booms*, address to Ai Group’s Economy 2006 Forum. Reproduced in *Economic Roundup*, Summer 2006.

Generating prosperity and rebalancing the economy

If history and logic are any guides, our terms of trade will not remain at their current levels indefinitely. Different commentators will quibble over the timing and the extent of the correction but few will argue with the proposition that we will see a reduction in current prices as miners increase supply – not the least from within Australia.

As minerals prices fall, the economy will be required to rebalance and sectors that are currently not booming will be called on to lift their contribution to aggregate performance.

The theorists among us may suggest that any correction in minerals prices will - sooner or later - be mirrored in a lower exchange rate. In some sort of automatic or mechanistic process, they may postulate that areas of activity such as manufacturing, tourism and the rural sector will expand - sooner or later - in compensation for the loss of income in the minerals sector.

However, even at the best of times such a rebalancing is very much easier to conceptualise than it is to actually bring about. Some may recall the commodity boom of the early 1980s - a boom that ended in a protracted slump. Adjustments are rarely rapid: they are never automatic and they are never easy.

Moreover, in the current circumstances, there are two further difficulties:

The current restructuring of the manufacturing sector under the twin pressures of China and the currency are putting at risk some manufacturing capabilities. If these are permanent and if they are not replaced with new capabilities, it will be all the more difficult for this sector to play a role in meeting competitive challenges and in rebalancing the economy.

This sits alongside the second additional area of difficulty - the weaknesses in the supply of skilled labour.

SLIDE 2 (see below)

- An indication of our vulnerability on skills was recently made starkly apparent in a Queensland Government Report⁴ showing sharp disparities between the proportions of the population with different levels of qualifications and the proportions of jobs requiring those qualifications.
- Compared with about 84% of jobs that require a VET or university level qualification less than half of the population have qualifications at these levels. The disparity is most pronounced for VET-level jobs and qualifications.
- The flip side is the mismatch between the over supply of less-skilled labour chasing declining numbers of unskilled jobs.

These are formidable forces. They are challenging not only for the manufacturing sector but also other non-booming sectors. Ultimately they are challenges for the whole economy.

⁴ Queensland Department of Employment and Training, *Queensland Skills Plan*, 2006.

Business is not standing still in the face of these pressures

As mentioned at the outset, *Manufacturing Futures* is the culmination of an extended period of very close engagement with Australian manufacturers at a time when the sector is acutely aware of the competitive forces around them.

Around 80% of manufacturers report that they are concerned about the future prospects for the sector: 30% are very concerned. Over 60% identify competition from low-cost countries as a source of their concerns.

The majority of manufacturers are responding actively in this new environment. Although there are common themes, the nature of these responses varies considerably across the sector.

As *Manufacturing Futures* shows, manufacturers are taking a variety of steps in rethinking, restructuring and reinvigorating their businesses. For example,

- Two thirds of manufacturers are seeking to introduce new products;
- Sixty percent anticipate increased spending on skills acquisition; and,
- About half expect to increase their spending on R&D.

Internationalisation

Critically, the intensity with which manufacturers are engaging in global strategies is distinctly higher than ever before. This marks a new phase in the industry's development.

- About a half are looking to increase their use of global supply chains;
- About one third are looking to increase their reliance on exporting; and,
- Roughly a third anticipate greater use of offshore outsourcing.

This greater global engagement comes at a time when for every two dollars of domestic sales there is one dollar worth of imports. This is up from a level of one in five a decade ago.

SLIDE 3 (see below)

It also comes at a time when offshore investment has grown exceptionally strongly to the point where we have become a net exporter of direct investment in manufacturing.

The increased emphasis on international engagement is a critical development and one that requires us to re-evaluate our thinking about manufacturing and about what it means to be a successful Australian manufacturer.

Traditionally we have gauged the success or failure of Australian manufacturing with measures such as:

- manufacturing's share of GDP;
- export of manufactured goods from Australia; and,
- the share of manufacturing employment in total employment.

However, as the internationalisation of Australian manufacturing gathers pace, these measures, while still important, will not reflect the full range of benefits. Many new successes will be reflected in benefits of a different nature. These include:

- inward income flows to domestic parent companies and domestic shareholders; and,
- outward flows of services related to manufacturing such as industrial research, design and marketing.

These developments have far-reaching implications - including for our international tax regime; for our approaches to international collaborations in Research and Development and our agenda in relation to Free Trade Agreements.

The internationalisation of the industry also challenges our preconceptions about what manufacturing is. Critically, production is production while manufacturing is much more than production.

SLIDE 4 (see below)

- Many Australian manufacturers are considering the location of their production activities.
- For these businesses, Australia may instead provide manufacturing-related services - such as in research and design - to production facilities located offshore.

These strategies will form part the future of Australian manufacturing. They will complement strategies with which we have greater familiarity such as expanding exports from Australia base; developing a more skilled domestic workforce and investing in new products and processes.

The extent and vigour with which manufacturers are re-thinking and reconfiguring their businesses is evidence of the much-vaunted responsiveness of Australia's globalised economy.

These businesses are developing products and services with a high value-added content so that squeezes on margins in lean periods do not imperil survival. Examples include the successful medicinal and pharmaceutical industries where technological innovation affords first-mover margins that can provide a buffer against adverse currency movements.

While Australia clearly has many successful mass-market manufacturers – often with significant natural advantages - for most, success rests more on their innovation, creativity and flexibility. *Manufacturing Futures* shows that as part of the current wave of restructuring, many manufacturers are pursuing these positive directions.

These positive developments do not suggest that the changes the industry is going through are painless. On the contrary, jobs are being lost and facilities are being closed.

The key message of *Manufacturing Futures* is that business is very aware that success and, often, survival depends on a willingness to take tough decisions and to see them through.

Particular vulnerabilities for a large slice of manufacturing industry

In addition to these active strategies, *Manufacturing Futures* also identifies a significant segment of the manufacturing sector that is not re-thinking its operations.

Our research suggests that, regrettably, as many as 30% of all manufacturers may not be actively reinvigorating their businesses. We have identified this set of manufacturers in particular as an important area of vulnerability.

Section 3: Policy

In this last section I want to turn to some questions revolving around policy – particularly Industry Policy.

Clearly there *is* an important role for policy.

Two areas on which there is very broad agreement is the importance of solid macroeconomic policy and of the need for a reinvigoration of microeconomic reform.

Microeconomic Reform

While these are areas of broad agreement, it is becoming clearer that, notwithstanding the current changes to the industrial relations system, there remains a lot that can and should be done.

The areas ripe for reform include:

- Further, reducing regulatory burdens;
- Financing and planning of infrastructure;
- Ensuring appropriate investment and pricing of energy and water;
- Driving efficiency in our education and training systems;
- Generating better value from our extensive investments in public sector research;
- Improving the way our federal structure operates; and,
- Tackling our heavy burden of income taxation and our high effective marginal tax rates.

I am not going to go into the detail of these measures today. There are areas of reform that cannot be addressed by tinkering: real inroads will require strong and determined leadership.

Industry Policy

The major policy area I would like to address is that of Industry Policy.

The question over the appropriate role for Government in the face of the global pressures such as I have been discussing is one that is taxing the minds of Government and industry leaders around the developed world.

Witness the Schumer-Graham Bill in the US Congress that would impose a 27.5% tariff on Chinese goods if China does not revalue its currency. Also, there is the power the French Government has acquired to block foreign investment in allegedly

“strategic” industries – including the French lottery and horse racing. These are clearly not the responses that are required in those countries - nor here in Australia.

The dominant ideology from Canberra over the past couple of decades has been strongly against the idea of interventionist Industry Policy.

I would acknowledge that in a globally-connected economy – and Australia is one of the most open economies in the OECD - the choices we have are much more limited than in the past and the options are less straightforward. However we do not accept that there is **no** role for Industry Policy.

There is for example, widespread acceptance for an active role in building and maintaining defence industry capabilities.

More generally Industry Policy in a global economy should be about building capacity. In launching *Manufacturing Futures* today, we are calling for a renewed manufacturing strategy that:

- is an assault on barriers inhibiting business responsiveness; and,
- adds to our knowledge base – that is our skills, our business capabilities and our innovativeness – and makes business more competitive and more responsive.

Manufacturing Futures puts forward a strategy that includes some 29 recommendations across six broad objectives:

- Building strength through capital investment;
- Further globalising Australian industry;
- Building world class capabilities;
- Being a more skilful global competitor;
- Loosening the shackles of government red tape; and
- Being a more innovative competitor.

The recommendations are set out in full in *Manufacturing Futures* itself. They include:

- Phasing the company tax rate down to 25% - although priority should first be given to personal tax reform.
- Reducing business regulation in a sustained and ongoing way. For manufacturers, as for businesses in other sectors, regulation continues to grow by stealth – whether it be related to taxation; to environmental controls; local government planning or to the complexity of grant applications.
- Giving a new emphasis to the development of workforce skills – particularly by supplementing current entry-based qualifications with an increased focus on continuing education and adding to the skills of the existing workforce.
- Building business capabilities by introducing a new approach to the co-ordination and delivery of business development programs across jurisdictions. The new approach would be modelled on strategies forged in the UK, the US and Ireland. This would include the important areas of the development of export skills and the protection and enforcement of intellectual property to equip companies of all sizes but particularly SMEs.

- Improving the effectiveness of our support to innovation by removing biases against international collaboration; by making the R&D tax concession more effective and by improving the effectiveness of the links between the private sector and our public sector research capabilities.
- Mechanisms to remove barriers to the development of offshore markets and to ensure a robust WTO-consistent anti-dumping system here in Australia.

Conclusion

- In our open economy we must strive for a dynamic economy and a flexible and adaptable industrial structure that allows us to maintain competitiveness.
- We cannot rely on permanently high prices for our commodities.
- At the moment we are lucky but experience and logic should tell us that there are dangers in thinking our good fortune will last indefinitely.
- Instead we need to pave the way and build capacity for the inevitable adjustments that will need to occur as periods of good luck subside.
- These adjustments will have to overcome the setbacks to capability development that have occurred due to the constraining conditions such as we are currently experiencing.
- We agree that picking winners is not the best solution.
- However, we need also to make sure we continue to grow winners across business sectors and among individual businesses.

As we have seen, manufacturers are themselves responding actively by embarking on a renewed phase of restructuring. They are putting in place a range of strategies both to improve domestic productivity and to increase their global engagement.

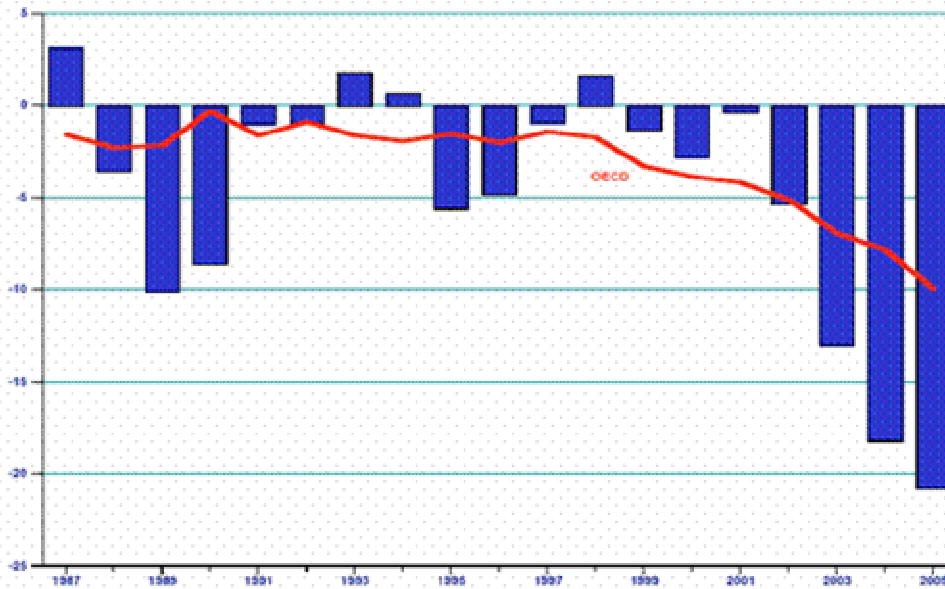
Companies make their own decisions about their futures. If the positive policies such as those put forward in *Manufacturing Futures* are implemented effectively, there will be a much greater chance that these company decisions will be aligned with the interests of Australia and with favourable benefits in terms of growth; jobs; exports; and successful Australian investments abroad.

SLIDES

Slide 1

GOODS AND SERVICES EXPORT PERFORMANCE

Cumulative % change in market share since 1986: Australia and the OECD



Source: OECD Economic Outlook, June 2005, Annex Table 44.

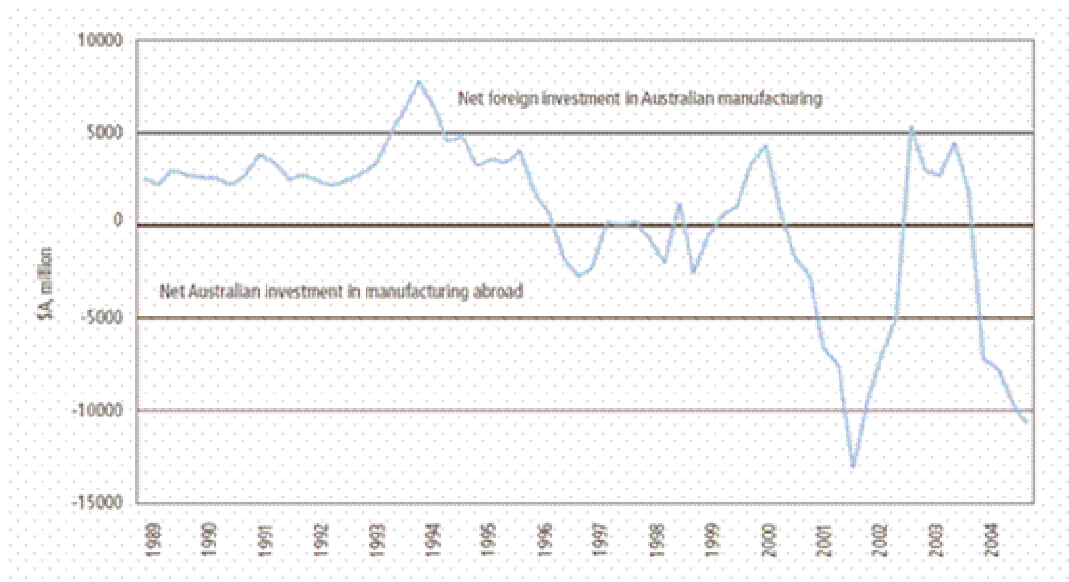
Slide 2

Jobs : Skills Mismatch

	Qualification Profile of Working Age Population (%)	Job Qualification Requirements (%)
University Level	16.4	21.7
VET Level	30.0	62.8
Non-Tertiary	53.7	15.5

Slide 3

Australia - a net exporter of direct investment in manufacturing



Slide 4

Manufacturing is more than production

