Where to for Australian Manufacturing?

Mrs Heather Ridout, Chief Executive Ai Group

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Mobilising the Industry

Outline

- Introduction
- Recovering from shock of GFC
    - While economy is recovering tentatively, manufacturing has been hit hard by the economic downturn and is not in a strong position
- The Challenges for Manufacturing
    - Challenges ahead are substantial for the sector and for the economy as a whole
- Elements of a vibrant ongoing contribution from manufacturing
    - Not protection but anti-dumping
    - Export facilitation/broader global engagement
    - Capability development ; workforce, management, innovation

Introduction

SLIDE 1

Thank you. It is pleasure to speak at your Convention.

The steel industry has a proud tradition at the centre of the Australian manufacturing industry.

It is probably the leading sector in terms of the advances it has made in the management of workplace safety – and I know there is, quite rightly, considerable pride in the industry about these achievements.

The steel industry, like the sector as a whole, has been through major upheavals over the past thirty or so years - reshaping its roles in the domestic and global economies. It's not a story without casualties but it's a story of ongoing adaptation and searching for - and finding - new sources of strength.

Today I would like to make some comments about the future of manufacturing in Australia. What are the prospects and what are the elements in manufacturing making a vibrant, ongoing contribution to the Australian economy?

The outlook is anything but benign and anyone expecting an easy ride is likely to he disappointed. The next decade or two looks set to be every bit as testing as the past few decades and in many respects more so. It also will not be without its causalities. However, I am confident that manufacturing will again show that it can adapt, build on existing strengths and develop new ones.

Recovering from the Shock of the GFC

Before casting an eye to the future, I would like to make a few comments about the current situation.

The economy has begun a tentative recovery from the shock of the Global Financial Crisis.

Ai Group monitors economy through PCI, PMI and PSI.

SLIDE 2

We noticed a distinct downwards drift from early in 2008, well before the Lehmann Brother's collapse that heralded the GFC proper. A good part of this early drift down was the deliberate impact of the Reserve Bank's moves to raise interest rates and slow the economy.

While the picture is certainly more encouraging in recent months, the detail in our releases point to the patchy nature of the recovery.

In our most recent releases – for October – a number of sub-sectors were still contracting.

- 2 out of 4 construction sub-sectors
- 5 out of 12 manufacturing sub-sectors; and
- 2 out of 9 service sub-sectors

Some good news for the steel industry in October was firmer construction materials and basic metals sub-sectors. The metals fabrication sub-sector held on to gains made in the previous month.

We have seen a gradual broadening of recovery in recent months. This however is coming from a low base.

It still reflects strong contributions from stimulatory fiscal and monetary policies.

Both are being withdrawn.

- The fiscal stimulus was designed to be temporary and its removal will detract from GDP growth from the end of this year.

- Over the past couple of months we have seen the Reserve Bank begin to wind in the emergency low interest rates.

Of course it is entirely appropriate that these stimulatory measures are withdrawn as private sector momentum recovers in its own right and makes up for the receding stimulus spending.

Our reading is that we do not need to further accelerate the withdrawal of fiscal stimulus and that we should be very wary of moving too fast and too far on interest rates.

Of course these are matters of delicate judgment and an opportunity to reconfigure in the May budget.

Of course the story of recovery, tentative though it may be, is a long way better than most would have anticipated one year ago.

Manufacturing was particularly hard hit over the past year and a half.

SLIDE 3

This chart taken from national accounts data to the end of June, shows manufacturing fell much more sharply than for the economy as a whole.

SLIDE 4

This chart adds in the mining and construction sectors as a further basis of comparison – highlighting again the more severe impact on manufacturing.

Further cause for concern comes from expectations about investment in the manufacturing sector.

We have recently done some work looking at the investment outlook facing businesses in the services, construction and manufacturing sectors.

SLIDE 5

The current year is far from a good one with businesses feeling the shock of the GFC. Still, a more businesses are expecting to increase in investment over last year's levels than are expecting to decrease investment.

In the following year, 2010-11 fewer are expecting to increase investment and more are expecting to reduce investment.

The slump in value add is a large part of this.

Also businesses across the board, but also in manufacturing, have avoided wholesale sackings and have instead tended to hold on to their workforces as much as possible.

They have cut costs of course and this has included reducing hours worked but not by enough to stem the bleeding of profits.

SLIDE 6

Even though there was a refreshing kick-up in profits in the June quarter, this was not sufficient to make up for lost ground and in many cases there is not much left in the war chest to finance the next phase of investment.

Further, another result of our investment study, about 1 in 4 manufacturers who had gone to the market in seeking finance reported difficulties in obtaining funds.

The Challenges for Manufacturing

This is a good point of departure to look at the more fundamental challenges that are emerging for manufacturers.

SLIDE 7

The "two-speed" economy

Many of you will be familiar with the "two-speed economy" phenomenon that was a topic of discussion before the GFC stole the headlines.

The broad thrust was that the increased demand for our mineral resources from China and the increased investment in minerals development and various related infrastructure projects, investment and labour was being diverted to Western Australia, the Northern Territory and Queensland and away from industries such as manufacturing in the south east corner.

This together with the lift in the value of the domestic currency puts tremendous pressures on sectors such as manufacturing which are competing against imports and in export markets.

With mineral exports figuring prominently in expectations for the next couple of decades, these pressures are resurfacing.

As the Governor of the Reserve Bank recently observed the "'two-speed economy' debate of a few years ago was really only a preview of what we could see if the [expected] resources sector build-up goes ahead."

The Secretary of the Treasury has also made similar comments in recent weeks.

Both anticipate major structural pressures and restructuring as a result of the anticipated boost to the surge in the mining sector.

These pressures could make it all the more difficult to attract investment to the sector.

It's not all one way

Of course these points to some extent overlook a number of positive elements for manufacturing from the boom in minerals exports.

Manufacturing is a major supplier to the mining industry and to the associated construction projects. Whether it is construction and building materials, mining and construction equipment or a wide range of other inputs, a lot of our manufacturers certainly saw the upside of the two-speed economy of a few years ago. And many are anticipating further benefits in the period ahead.

There are additional flow-on benefits that come from the high population growth that we can expect to see in the years ahead. Benefits from a growing domestic market and in particular in the housing construction sector and all the manufactured goods associated with housing and household formation.

While there is some encouragement that can be taken from these points, they are very much a consolation prize with the balance, as far as manufacturing is concerned, firmly on the downside.

These challenges have economy-wide implications

These challenges faced by manufacturing are relevant not only for the sector itself but for the economy more broadly.

The demand for capital to finance the development of our mineral projects presents as a major issue.

Where is this capital going to come from and, particularly in the light of some long lead times before export income kicks in, how will we accommodate the surge in our current account deficit that would be associated with further inflow of capital from abroad?

This raises questions about our national savings effort, our ability to export and most fundamentally, our productivity performance which in recent times has been anything but noteworthy.

The supply of labour across the economy is a further issue. We will need labour both for the expanding mining sector but also for the rest of the economy.

Further, there are concerns about the balance of our economy. What risks are we exposing ourselves to with such a large reliance on a narrow range of commodities and possibly a narrow range of trading partners?

If the economy simply restructures to accommodate this particular growth path and places a range of other industries on the scrap heap, how well equipped will we be to adjust if, or when, commodity demand falls or if economic conditions in China or other large customers take a turn for the worse?

Competition from emerging economies

Of course these are not the only challenges for Australian manufacturers arising from the rise and rise of China, India and other emerging economies.

A core part of these countries' rapid development is, and is likely to continue to be, the growth of their industrial sectors and the flooding of the world market with cheaper and increasingly high-quality manufactured goods.

This is a problem made worse by the undervaluation of the Chinese currency which, in addition to contributing to major global imbalances at the macro level, is lowering the price of exports from China and reducing access to that market from abroad.

Of course the implications of this are world-wide and not specifically related to the Australian scene.

Similar competitive pressures are felt around the entire OECD in all industrial sectors including the high technology areas that have previously been seen to be the preserve of the major manufacturing centres of the US, Japan and Germany. Only yesterday in the *Financial Times* Carlos Gnosen CEO of Renault and Nissan was quoted as warning of the loss of manufacturing from Europe.

Climate change

Another challenge that is prominent in our minds at the moment is the challenges presented by climate change policies.

I know it is a challenge that is particularly relevant to the steel industry.

This is not only because of the risks from the proposed Carbon Pollution Reduction Scheme that face our large steel producers.

Of course these risks are substantial notwithstanding the progress that has been made over the past year or so in expanding the allocation of permits for the large producers.

We hope that, over the next week, further progress will be unveiled that will ameliorate the competitive pressures associated with the imposition of costs in Australia that are not faced by competitors located in other countries.

While competitive pressures will mean that steel producers will be severely constrained from passing their costs on in the domestic market, the CPRS and the challenges its presents are relevant all along the value chain and indeed across the manufacturing sector.

The price of steel may not rise, but costs of electricity, or gas and transport, along with a wide range of other inputs will rise from 2011 and will continue to rise.

Until there is substantial progress in developing an international agreement, these issues will pose significant challenges for manufacturers and the economy more generally.

Ai Group has been very active with both the Government and the Opposition to have strong measures put in place that will assist businesses of all sizes adapt to the new costs while maintaining competitiveness. We also hope that that next week some further progress announced.

Demography

No coverage of challenges can be complete without mentioning the demographic “time bomb” of the ageing population. It is not something that is specific to manufacturing but its impacts are nonetheless very real.

The pressures on tax revenues as the population ages will pose significant questions in the period ahead. The Henry Review is set to focus our minds on the longer-term implications for our patterns of taxation not only because of demography but very significantly shaped by the ageing of the population.

Perhaps more directly, demographic pressures are already exerting their influences on the supply of labour across a wide variety of skilled areas not the least of these are a range of trades very important to the manufacturing sectors.

Elements of a vibrant ongoing contribution from manufacturing

I think you will agree with me that the challenges facing the manufacturing sector are substantial.

They are challenges that come on top of a long-run decline of the share of manufacturing in the total economy.

SLIDE 8

Nevertheless, this is not a predicament that is a cause for despair. Not that despair would do any good anyway. But the thing about challenges is that they are there to be overcome.

So that is the question: what can be done. I think there are points that are relevant for both governments and for businesses themselves.

Anti Dumping

While we want to keep our economy as open as possible, we shouldn't be so naïve as to leave ourselves open to the unfair and unprincipled practice of dumping goods at low prices.

The Australian Industry Group, through its leadership of the Trade Remedies Taskforce, is a key advocate in the battle against dumping into the Australian market. The allegations of dumping, be it from China, Indonesia, Korea or even the United States, in the metals area among others are something that we take very seriously because these dumping actions are a real threat and genuine to Australian business survival and profitability.

The Productivity Commission is currently reviewing the operation of Australia's anti-dumping regime as the result of an inquiry promised in far better economic times. Australian industry are not big users of the system – it is, after all, very costly and time-consuming to run an action. The Commission fortunately seems to have recognized that there is a need for a serious anti-dumping regime to be maintained in Australia but is now finalizing its recommendations on the exact shape of that regime. That report is due by the end of the year.

Australian industry needs to be very forthright in the defence of its interests against the dumping of artificially cheap and often inferior products –including steel products – into our economy. Fair competition is fair enough but that playing field needs to be level.

Facilitation of exports and global engagement

With a trade deficit in manufacturing has been estimated at over $110 billion for 2008, the importance of raising export performance in the sector has perhaps never been as important.

This is a task that falls largely on businesses themselves of course but it one with significant national benefits and one deserving national recognition and support.

I would point to the important role of the Export Market Development Grant (EMDG) as an important way to help potential exporters overcome the significant barriers to developing new markets.

At Ai Group we also work through the Commonwealth Government's Global Opportunities program to facilitate global engagement between members and companies in other countries. For example we have helped put together an Australian-Taiwan ICT cluster that is building global opportunities for Australian businesses – particularly in the area of e-health.

These are examples of programs where government and industry can work in partnership to increase the sectors' global engagement and to help reap the benefits of looking beyond our own borders for opportunities.

Capabilities

<u>Workforce skills</u>

Investing more in our workforce skills is a key element in driving better performance in our industries.

This is an extensive agenda ranging from basic literacy and numeracy skills, to more flexible and up to date VET and university programs.

It is an agenda that relates both to new entrants and to the training of the existing workforce.

In many ways workforce skills is the lynchpin of building a stronger and more adaptable contribution from the manufacturing sector. It is an area where responsibilities rest with government, with employers and with employees themselves.

<u>Business capabilities</u>

Investing in workforce skills needs to be complemented by investments in management capabilities.

There was a very interesting international report released earlier this month *Management Matters in Australia* suggesting that whereas Australian businesses perform well in operational management, we are compare less favourably in people and strategic management.

This is an area of very strong potential and one that can usefully be fostered by Governments. The very successful though small scale Enterprise Connect Program is an example of the way that businesses can lift productivity substantially with some professional guidance.

<u>Innovation</u>

Much more can be done. Mainly by companies themselves but also by governments and public sector research organisations.

R&D is not the be all and end all of innovation but an important element in the success of many businesses.

Welcome a number of the changes announced in the Budget:

- Increased focus on smaller and medium sized businesses
- Increase in the basic rate
- Decoupling from the company tax rate
- Available irrespective of location of IP

However there are a number of negatives particularly associated with the Governments discussion paper released in September.

- The removal of the 175% incremental concession
- The proposal to narrow the range of eligible expenditure and to provide a lower level of incentive for “supporting” expenditure.

These changes taken as a whole will result in large reduction in support for business spending on R&D, and will reduce expenditure and the broader economy-wide benefits that flow from it.

Winding up

These are all elements that we should be building on if we are to drive additional investment and growth in manufacturing.

They are elements in a broad strategy that will benefit both the manufacturing sector and the broader economy by =improving our ability to manage the risks we face of imbalances in the structure of the economy if we rely too much on commodities to the detriment of manufacturing and other sectors.

I mentioned a bit earlier that the period ahead will be as challenging as the period we faced before the GFC.

While they were difficult times for the sector, there was still plenty to be encouraged by.

Even many of our businesses supplying the automotive sector: a sector that has found it particularly hard going in recent times, found ways to adapt and thrive in the changed environment.

Automotive suppliers diversified and found new avenues for sales and growth – many finding opportunities in mining equipment and other transport equipment for example.

These businesses are innovative: they responded to changed incentives; they were flexible and they adjusted their capabilities to take advantage of new opportunities.

Another point of encouragement that I take from the past ten or so years is the export performance of the manufacturing sector. This might surprise some but I think this tells an important story.

If we separate out the volumes and values of exports as in this table we see that manufacturers did quite well in the years 2001/2 to 2008/9 and they grew the quantity of their sales by almost as much as the booming minerals sector and of course they did so in much more difficult market conditions.

The difference of course was that the minerals sector had the good fortune to see their prices skyrocket whereas for manufactures, prices actually fell over this period.

So while there is plenty of work to do and I think that government has a role to play as well as businesses themselves, there is plenty of reason to have confidence in our ability to overcome the substantial challenges and to continue to see manufacturing play a very important and vibrant role in the national economy.

It is not something that will happen automatically. I think we need our industrial leaders and champions and we need advocates for the industry. People who can point to the strong opportunities and possibilities that lie, often hidden, among these challenges.