The Future Of Manufacturing

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Much anxiety about our economy turns on whether we need manufacturing, and whether it deserves protection. If the sector is to survive, some new ideas need to come off the production line first, writes Ian McAuley.

Next month the Gillard Government will release its industry and innovation statement. In anticipation, the debate on industry policy is following traditional lines, with arguments that go back to pre-Federation days.

Should we focus our economy on minerals and food, a view articulated by The Australian's David Uren last week, or should we sustain a more diversified economy, particularly in manufacturing, a view unsurprisingly supported by Paul Howes of the Australian Workers' Union?

Both views, however, are rooted in ideas that are past their use-by dates.

The idea that we should stick to what we do best goes back 200 years, to David Ricardo's concept of "comparative advantage". In an example drilled into every student who has endured a first year economics course, Ricardo compared the economies of Portugal and England and their capacity to produce wine and cloth. Portugal was able to produce both wine and cloth more cheaply than England, but England was far better at producing cloth than wine.

Therefore, counter to the intuitive notion that Portugal should produce both wine and cloth, Ricardo demonstrated that both countries would be better off if they specialised — Portugal in wine, England in cloth.

It's a robust theory, but only so long as the economies concerned are static. In fact, economies are dynamic, and some industries develop faster than others. Wine-making developed only slowly, and Portugal's economy remained primarily focussed on agriculture, while England industrialised, building up tremendous wealth as it developed a broad manufacturing base.

In the nineteenth century, and well into the twentieth century, a country's manufacturing strength was a measure of its level of development and was closely related to its prosperity.

Australia followed the path of developing a strong manufacturing sector, assisted by high tariffs and related protection. While agriculture and minerals provided our export income, manufacturing provided well paid and meaningful employment.

In the years following the Second World War, a huge flow of immigration provided both labour and a domestic market. Australia's manufacturing industries expanded rapidly. At one stage we had seven vertically-integrated car manufacturing firms, and shipbuilding, aircraft, clothing and footwear industries.

The model worked; had we gone the free trade route at the time of Federation our present economy would now look something like Argentina's. But it had a limited life. Tariff protection was costly, with those costs falling disproportionately on the poor. Without competition driving modernisation, complacency set in.

The car plant which had been state-of-the-art in 1950 was obsolete by 1980. While firms in other countries were installing new equipment our factories remained labour intensive. And we sustained industries such as clothing only by virtually prohibiting imports.

The assumption that all manufacturing jobs are good jobs had been tested and found wanting. In fact many short-cycle specialised manufacturing jobs — operating a press, winding electric motor coils, assembling components — are soul-destroying, and, unless they can be replaced by capital intensive technologies, can never be sustained in a country that aspires to pay decent wages.

Yet the idea persists that there is something special about manufacturing. Kevin Rudd said that he wanted Australia to remain a country that actually makes things. When the financial crisis of 2008 hit, one of President Obama's priorities was to shore up what was left of America's auto industry. And the closure of a manufacturing plant looms much larger in our consciousness than the day-to-day turnover in employment. (Every working day about 4000 Australians shuffle between employment and unemployment.)

We are constrained by the way we think about industries. We tend to overrate the economic importance of the physical processes of transforming materials into finished products, and underrate the set of services which go along with such processes.

But some services associated with manufacturing are technologically sophisticated high value operations — services such as plant engineering, production control, logistics and product design — and they don't have to be performed in the same establishments as the actual manufacturing. Manufacturing is simply a part, and often a very small part, of a long chain of activities delivering customer value.

More basically, we tend to classify industries by what is produced, rather than what people do in those industries. For example, 27 000 Australians are still employed in the industry classified as "textile, clothing, leather and footwear manufacture", but that classification covers everything from basic sewing operations of mass produced shirts and underwear through to one-off design and fabrication of high fashion gowns, and bespoke manufacturing of specialised safety clothing.

Rather than thinking about whether we should have a "manufacturing" sector, we would do better by thinking about what activities we can sustain in a world where we need to compete on the basis of our use of human capital.

Some of those activities will be in what we once called "manufacturing", but that classification should not be of concern — it is merely a statistical artifact that has largely lost its relevance. We need those activities if we are to sustain our prosperity when this resource boom runs its course.

That is not to disparage our agricultural and mining sectors. The notion that we simply allow plants and animals to grow and that we dig up a few minerals is a false one. They are skill- and capital-intensive sectors. But they provide only 600,000 jobs out of our workforce of 12 million, and, more basically, their fortunes, and therefore our exchange rate, are linked to volatile world commodity markets.

We cannot insulate ourselves fully from exchange rate volatility — a point stressed by Greg Combet when he played down hopes that a lower exchange rate would revive manufacturing. But we can broaden our industrial base to become less dependent on the fortunes of commodity exporters. That's why activities such as manufacturing are important.

This is hardly a radical idea, and many on the left and right of the political spectrum would endorse it. But its realisation into a practical industry policy requires a change in our thinking — not only to get away from the obsession with "manufacturing", but also in how we think about competition.

Our commodity industries have conditioned us to believe that competition is simply about cost competitiveness. That's why the productivity debate, for example, is so focussed on cost factors, particularly labour costs.

Industries which compete on the basis of quality, innovation and customer responsiveness, and which integrate manufacturing and service operations, operate on a different basis and can ride out exchange rate fluctuations. We should note that earlier this century, when the €/$A exchange rate was high, European firms like Miele, Renault and Siemens stayed in the Australian market.

Most economists and business commentators, apart from those who wish to see the mining sector privileged (see, for example the Liberal Party's promise "to deliver a more positive environment for mining") would like to see our industrial base broadened, and no doubt so too would unionists like Paul Howes. But a prerequisite is to break from some entrenched ways of thinking.