# Chapter 6

# Trade in manufactured goods

6.1 This chapter looks at Australia–China trade in manufactured goods. In contrast to the trade relationship in agricultural products, China's economic strength is in the production and export of a wide range of cheap, high-quality and increasingly high-tech manufactures. Forty per cent of China's GDP is from exports of manufactures. This chapter considers the concerns of Australian manufacturers competing with low cost, high volume Chinese imports. It also examines the strategic opportunities for Australian manufacturing companies both to export and to invest directly in China.

6.2 The chapter is divided into five parts:

- the first looks at recent developments in China's manufacturing sector, particularly the changing composition of its exports;
- the second part gives an overview of Australia–China trade in manufactured products;
- the third part provides survey-based evidence of Australian manufacturers' attitudes to China, and widely held perceptions of China's unfair competitive advantage in manufacturing;
- the fourth part presents survey-based evidence on how Australian manufacturers have responded to China's export manufacturing sector, and committee witnesses' views on the best strategy for Australian manufacturers to capitalise on China's supply chains and growing consumer demand; and
- the chapter concludes with the committee's options and recommendations for the Australian manufacturing sector to respond to China's challenge.

## Recent developments in China's manufacturing sector

6.3 The story of China's rise as an industrial power makes prominent reference to its economy's manufacturing prowess. Cheap labour and imported manufacturing equipment have provided the basis for a phenomenal export performance.

6.4 Table 6.1 shows that in the 20 years from 1980 to 2000, exports from China increased in value from $US18.1 billion to $US249.2 billion.[1] In the 2004 calendar year, the value of China's exports was $US593.4 billion.[2] The table shows that in the

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1 J. Wong and S. Chan, 'China's emergence as a global manufacturing centre: Implications for ASEAN', *Asia Pacific Business Review*, Vol. 9, No. 1, Autumn 2002, p. 80.

2 'Brief on China's imports and exports', Ministry of Commerce of the People's Republic of China, http://english.mofcom.gov.cn/aarticle/statistic/ie/200503/20050300025384.html (accessed 7 September 2005).

decade since 1995, the value of China's exports has increased by more than 400 per cent.

## Table 6.1: China's exports, 1980–2000

| | 1980 | 1990 | 1995 | 2000 | 2004* |
|---|---|---|---|---|---|
| **Total exports ($US 'billion)** | 18.1 | 62.1 | 148.8 | 249.2 | 593.4 |
| **Primary products (%)** | 53.4 | 25.6 | 14.4 | 10.2 | 6.5 |
| **Manufactured goods (%)** | 46.6 | 74.4 | 85.6 | 89.8 | 93.5 |
| *TCF (%)* | 22.9 | 24.9 | 28.6 | 24.9 | 14.6 |
| *Machinery and electronics (%)* | n.a. | 17.9 | 29.5 | 42.3 | 55.7 |

*Source: J. Wong and S. Chan, 'China's emergence as a global manufacturing centre: Implications for ASEAN', Asia Pacific Business Review, Vol. 9, No. 1, Autumn 2002, p. 83. * 2004 figures are based on China Customs data, http://english.china-customs.com/customs-statistic/ (accessed 7 September 2005).*

6.5 The basis for this performance was a marked increase in the volume of manufactured exports. In 1980, manufactured exports accounted for 47 per cent of all China's exports: primary products accounted for 53 per cent. In 2000, manufactured exports had increased their share of total Chinese exports to 90 per cent while the share of agricultural exports had fallen to 10 per cent.[3]

6.6 Table 6.2 shows the composition of China's exports for selected months between January 2002 and October 2004. The total value of China's exports more than doubled between these months. The ratio of manufactures to primary product exports (as a percentage of total exports) for each of the four months was in excess of 9 to 1. The value of manufactured exports increased from around $US20 billion for January 2002 to over $US49 billion for October 2004. The value of primary products as a percentage of total exports fell slightly from 8.2 per cent for January 2002 to 6.5 per cent for October 2004.

3 J. Wong and S. Chan, 'China's emergence as a global manufacturing centre: Implications for ASEAN', *Asia Pacific Business Review*, Vol. 9, No. 1, Autumn 2002, p. 83.

## Table 6.2: China's export performance for selected months ($US '000)

| Commodity | Jan 2002 | Oct 2002 | Oct 2003 | Oct 2004 |
|---|---|---|---|---|
| **Total** | 21,703,291 | 29,946,376 | 40,925,906 | 52,523,879 |
| **Primary products** | 1,786,843 (8.2%) | 2,480,600 (8.3%) | 2,926,423 (7.2%) | 3,437,572 (6.5%) |
| **Manufactures** | 19,916,448 (91.8%) | 27,465,776 (91.7%) | 37,999,483 (92.8%) | 49,086,306 (93.5%) |
| *Chemicals* | 1,099,593 | 1,282,678 | 1,657,216 | 2,377,504 |
| *Machinery and transport equipment* | 7,904,931 | 11,889,336 | 18,192,336 | 23,750,262 |
| *Manufactured goods classified as raw materials* | 3,599,177 | 4,673,600 | 5,941,384 | 8,833,998 |

*Source: General Administration of Customs, People's Republic of China. Figures in brackets denote proportion of primary products and manufactures which account for total exports. http://www.iwep.org.cn (accessed 7 September 2005).*

### *The changing composition of China's manufactured exports*

6.7 The surge in China's manufactured exports has been driven by a significant shift in the composition of these exports. Professor John Wong and Ms Sarah Chan, from the National University of Singapore, explained that:

> [B]efore 1995, traditional labour-intensive manufactures like textiles, clothing and footwear (TCF) used to dominate China's export structure. More recently, China's manufactured exports experienced a radical change in composition, marked by the rise of non-traditional items like machinery, electronics and other high-technology products. Few economies have ever achieved such remarkable export diversification within such a short span of time…rapidly gaining comparative advantage in capital-intensive manufactures even before it begins to lose comparative advantage in labour-intensive activities.[4]

6.8 In 1995, China's TCF exports and machinery and electronics exports accounted for 28.6 per cent and 29.5 per cent of total exports respectively. In 2000, the share of TCF exports had fallen to 24.9 per cent while machinery and electronics exports had increased to 42.3 per cent of total Chinese exports. China's customs figures for the 2004 calendar year show that the proportion of TCF exports had fallen to 14.6 per cent of the value of total Chinese exports. The value of China's machinery and electronics exports had increased to 55.7 per cent of total exports (see Table 6.1).

6.9 Table 6.3 shows China's major export manufactures for 2004. The highest value exports were of data processing machines ($US60 billion), textile garments

4 J. Wong and S. Chan, 'China's emergence as a global manufacturing centre: Implications for ASEAN', *Asia Pacific Business Review*, Vol. 9, No. 1, Autumn 2002, p. 81.

($US50.1 billion) and footwear ($US15.2 billion). The highest year-on-year growth rates for 2004 exports were for steel products (168 per cent), motor vehicles (82 per cent), radios (65 per cent) and televisions (58 per cent).

**Table 6.3: China's major manufactured exports (2002, 2003, 2004, 2005)**

| | Jan–Dec 2002 ($US billion) | Jan–Dec 2003 ($US billion) | Jan–Dec 2004 ($US billion) | Jan–Jun 2005 ($US billion) |
|---|---|---|---|---|
| Data processing machines | 20.1 | 41 | 60 | 33.5 |
| Textile garments | 33.9 | 42.2 | 50.1 | 26 |
| Footwear | 11.1 | 13 | 15.2 | 8.8 |
| Radios | 5.3 | 7.4 | 14.2 | 8.2 |
| Steel products | 2.2 | 3.1 | 8.4 | 7.3 |
| Toys | 5.6 | 6 | 6.4 | 2.5 |
| Televisions | 2.4 | 3.5 | 5.5 | 3.3 |
| Electric motors | 2.2 | 2.4 | 2.9 | 1.6 |
| Motor vehicles | .26 | .43 | .78 | .74 |

*Source: China Customs Information Network, http://english.china-customs.com/customs-statistic/ (accessed 7 September 2005).*

6.10 Table 6.1 shows that in 2004, China's TCF exports accounted for only 15 per cent of total Chinese exports. Their contribution to China's overall export performance has more than halved since 1995.[5] Table 6.3 shows that the rate of recent increase in TCF exports is moderate compared with the export boom in data processing machines, steel products, televisions and motor vehicles. In the six months from January to June 2005, the value of China's steel product and motor vehicle exports was approaching the value of these exports for the entire 2004 calendar year.[6] The January to June 2005 value of TCF exports was roughly half their total 2004 value.

6.11 Still, Table 6.3 does show that the value of China's TCF exports progressively increased over the period. The value of textile exports for recent calendar year is significantly higher than for most manufactures. The TCF sector remains crucial to China's export performance and is the exemplar of China's comparative advantage in low cost, low-tech production. To certain markets and for certain items, the volume of

5 The 1996 Senate Committee report into Australia–China relations noted that 'in recent years', TCFs had declined as a share of total Chinese imports to Australia from 60 per cent to 40 per cent. 'Australia China relations', *Senate Foreign Affairs, Defence and Trade References Committee*, June 1996, p. 129.

6 China Customs Information Network, 'China's 20 major export products and top 5 trade countries', http://english.china-customs.com/customs-statistic/ (accessed 13 September 2005).

China's TCF exports has increased exponentially since the World Trade Organization's abolition of clothing import quotas on 1 January 2005.

### *The growth and impact of China's machinery and electronics exports*

6.12 China's rising comparative advantage in the production and export of non-traditional manufactures, such as electronics, is attributable to increased foreign direct investment (FDI) in Dongguan and Shenzhen in Guangdong province and in Shanghai (see map on page xxxi).[7] Total FDI in China has increased from $US44.2 billion in 2001 to $US54.9 billion in 2004.[8] In 2003, the volume of FDI in China was comparable to inward investment in the US economy ($US67 million).[9] A 2005 OECD paper on recent trends and developments in FDI noted:

> Inward FDI into the Chinese economy keeps hitting new records…There is little doubt that Hong Kong-based investors account for much of the direct investment into the mainland, but it would be too simplistic to ascribe the boom in Chinese FDI simply to 'round-tripping' of investment…[10]

6.13 Another explanation for China's growing high-tech manufacturing sector is the large-scale import of components from East Asian economies. From the 1980s to early 1990s, Japan exported electronic components to the Republic of South Korea and Hong Kong for assembly into finished products. Since the mid-1990s, Japan, the Republic of South Korea and Taiwan have produced components and shipped them to China for assembly.[11] Unlike China's TCF sector, its growing manufacturing prowess is built on labour-intensive specialisation in regional production chains.[12]

6.14 Undoubtedly, China's rise as a global manufacturing centre has impacted on regional East Asian economies. Writing in 2000, Professor Wong and Ms Chan argued that the development of a high-tech Chinese manufacturing sector has:

> …apparently resulted in most ASEAN economies experiencing a severe hollowing-out of their industries. China's manufacturing prowess, manifested in its ability to produce an unprecedented range of products, has

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7 J. Wong and S. Chan, 'China's emergence as a global manufacturing centre: Implications for ASEAN', *Asia Pacific Business Review*, Vol. 9, No. 1, Autumn 2002, p. 85.

8 OECD, *Recent trends and developments in foreign direct investment*, 1995, p. 10, http://www.oecd.org/dataoecd/13/62/35032229.pdf (accessed 13 September 2005).

9 OECD, *Recent trends and developments in foreign direct investment*, 1995, p. 3, http://www.oecd.org/dataoecd/13/62/35032229.pdf (accessed 13 September 2005).

10 OECD, *Recent trends and developments in foreign direct investment*, 1995, http://www.oecd.org/dataoecd/13/62/35032229.pdf (accessed 13 September 2005). 'Round-tripping' refers to capital flight out of a country, and then foreign direct investment back in.

11 Australian Chief Executive, 'China's industrial rise: East Asia's challenge', *CEDA*, November 2003, p. 36.

12 Department of Foreign Affairs and Trade, *China's Industrial Rise: East Asia's Challenge*, Economic Analytical Unit, Canberra, October 2003, p. x.

> alarmed ASEAN countries whose markets are now swarming with China's high-quality but inexpensive goods...China's economic resurgence underscores the need for ASEAN to accelerate structural domestic reform and will compel ASEAN economies to base their future economic growth on their true comparative advantage.[13]

6.15 However, in 2003, a DFAT report titled *China's Industrial Rise: East Asia's Challenge* found that:

> [O]nce trade flows associated with…integrated production chains are factored in to analyses of regional net trade flows, no overall trend emerges of Chinese exports encroaching on its neighbours' export markets.[14]

The report notes that many economies in the region are changing their production mix to compete less directly with China.

- Singapore has moved out of labour intensive sectors and is focussing on higher-technology exports, where it has a comparative advantage. Half of Singapore's net exports compete with China's.
- Japan has also been shifting its production from labour intensive industries—such as assembled computers—and into products such as video and digital cameras.[15] The report estimates that only 18 per cent of Japan's net exports compete with China's—the lowest of the major East Asian economies.
- The Republic of South Korea competes with China in roughly half of its export sectors 'but continues to expand exports of these products regardless, at a similar rate as China'.[16] South Korea does benefit from the export of high-technology components to China for assembly.
- Indonesia competes with China in almost half of its net export markets while almost two-thirds of Malaysia's net exports are in competition with China's. However, the report found that both countries had been able to increase their net exports in these sectors. Both countries' main trading partner is the United States.

6.16 The DFAT report highlights the complementarity of the China–Australia trading relationship. It therefore sees China's growing capacity for assembling high-

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13 J. Wong and S. Chan, 'China's emergence as a global manufacturing centre: Implications for ASEAN', *Asia Pacific Business Review*, Vol. 9, No. 1, Autumn 2002, p. 91.

14 Department of Foreign Affairs and Trade, *China's Industrial Rise: East Asia's Challenge*, Economic Analytical Unit, Canberra, October 2003, p. x.

15 Department of Foreign Affairs and Trade, *China's Industrial Rise: East Asia's Challenge*, Economic Analytical Unit, Canberra, October 2003, p. xi.

16 Department of Foreign Affairs and Trade, *China's Industrial Rise: East Asia's Challenge*, Economic Analytical Unit, Canberra, October 2003, p. xi.

tech articles and processing raw materials as an advantage for Australian exporters.[17] Chapter 2 of this report made the same observation.

6.17 However, the 'big picture' trade relationship overlooks the challenges facing import-competing Australian producers in certain industries. An April 2004 *ANZ Industry Brief* explains that:

> …the range of Chinese merchandise available on the local market provides competition across a wide range of Australian manufacturing. Those industries will be most adversely affected through price competition. The only manufacturing sectors likely to be largely unaffected by the growth in imports from China are those with relatively low import penetration rates…Those industry sectors having the highest import penetration rates are most likely to be significantly adversely affected…[18]

6.18 The next section looks at the trends and composition of Australia–China trade in manufactured products, and identifies the Australian manufacturing industries facing fiercest competition from Chinese imports.

## Australia–China trade in manufactures

### *The deficit with China in elaborately transformed manufactures (ETMs)*

6.19 The most prominent feature of Australia–China trade in manufactures is Australia's large and growing deficit in elaborately transformed manufactures (ETMs). Put simply, Australia's imports of ETMs from China far exceed its exports of ETMs to China. In 2004, Australia imported $A15.9 billion of ETMs from China and exported $A1.0 billion of ETMs to China.[19]

6.20 The main reason for the growth in this deficit with China is the recent surge in Australia's imports of China's ETMs. In 2004, ETM imports from China increased 27.7 per cent on the previous calendar year: ETM imports from the US fell 0.5 per cent and increased from Japan by three per cent. In 2004, Australia's exports of ETMs to China increased four per cent on the previous calendar year: ETM exports to the US rose 2 per cent and fell to Japan by 11 per cent.[20]

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17 Department of Foreign Affairs and Trade, *China's Industrial Rise: East Asia's Challenge*, Economic Analytical Unit, Canberra, October 2003, p. xiv.

18 ANZ Industry Brief, 'Australia–China Trade: Realizing the potential', 23 April 2004, p. 4, http://www.anz.com/Business/info_centre/economic_commentary/Australia-China_Trade_Brief.pdf (accessed 21 September 2005).

19 Department of Foreign Affairs and Trade, 'Export of Primary and Manufactured Products, Australia 2004', Market Information and Analysis Section, June 2005, p. 9.

20 Department of Foreign Affairs and Trade, 'Export of Primary and Manufactured Products, Australia 2004', Market Information and Analysis Section, June 2005, p. 9.

6.21 It is Australia's poor overall ETM exporting performance that is of most concern to the manufacturing sector. In 2004, Australia's trade deficit in ETMs widened to a record $86.3 billion, an increase of 9.5 per cent on the previous financial year. ETM imports increased in value from $96.9 billion in 2003 to $105.1 billion in 2004.[21] ETM exports increased slightly in value from $18.5 billion in 2003 to $18.8 billion in 2004.[22] The need and opportunities for Australia to increase its exports of these manufactures is considered later in the chapter.

### *Australia's imports from China*

6.22 Table 6.4 shows that in the eleven years from 1994 to 2004, the value of Australia's imports of Chinese manufactured products increased from $A3,191 million to $A17,084 million. In 1994, imported manufactures from China accounted for 5.4 per cent of all Australian imported manufactures. China ranked fifth behind the US (23.2 per cent), Japan (20 per cent), Germany (6.7 per cent) and the United Kingdom (6.4 per cent). In 2004, imported manufactures from China accounted for 14.6 per cent of all imported manufactures, second only to the US (16.3 per cent).[23]

**Table 6.4: Australia's imports of manufactured products by principal markets**

| | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *US* | 13,699 | 15,345 | 16,738 | 16,856 | 19,255 | 19,210 | 29,749 | 19,749 | 21,617 | 19,157 | 19,093 |
| *China* | 3,191 | 3,665 | 3,891 | 4,515 | 5,545 | 6,319 | 8,615 | 9,828 | 12,046 | 13,387 | 17,084 |
| *Japan* | 11,804 | 11,629 | 9,916 | 11,171 | 12,988 | 13,296 | 14,817 | 14,639 | 15,201 | 15,805 | 16,326 |

*Source: Department of Foreign Affairs and Trade, Exports of Primary and Manufactured Products 2004, June 2005, Table 29. http://www.dfat.gov.au/publications/stats-pubs/pmp_2004_analysis.pdf (accessed 21 September 2005).*

6.23 Table 6.5 shows that in the China–Australia bilateral trade relationship, China's competitive advantage lies in manufacturing. Between 2001 and 2004, Australia's top 10 merchandise imports from China were all manufactures. Recall that Table 5.2 showed that China's top 10 merchandise imports from Australia between 2001 and 2004 were either minerals or agricultural products.

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21 Department of Foreign Affairs and Trade, 'Export of Primary and Manufactured Products, Australia 2004', Market Information and Analysis Section, June 2005, p. 89.

22 Department of Foreign Affairs and Trade, 'Export of Primary and Manufactured Products, Australia 2004', Market Information and Analysis Section, June 2005, p. 17, http://www.dfat.gov.au/publications/stats-pubs/pmp_2004_analysis.pdf (accessed 21 September 2005).

23 Department of Foreign Affairs and Trade, 'Export of Primary and Manufactured Products, Australia 2004', Market Information and Analysis Section, June 2005, p. 100, http://www.dfat.gov.au/publications/stats-pubs/pmp_2004_analysis.pdf (accessed 21 September 2005).

## Table 6.5: Australia's top 10 manufactured imports from China ($US million)

| | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|
| ADP machines | 303 | 476 | 735 | 1,273 |
| Videos, cameras | 67 | 104 | 250 | 501 |
| Women's suits | 191 | 212 | 272 | 324 |
| Office machines | 100 | 169 | 229 | 298 |
| Toys | 177 | 205 | 246 | 297 |
| TV/videos | 47 | 74 | 122 | 280 |
| Footwear | 141 | 183 | 210 | 265 |
| Travel goods | 144 | 157 | 191 | 252 |
| Furniture | 69 | 102 | 156 | 245 |
| T-shirts | 119 | 123 | 163 | 219 |

*Source: 'Australia–China Free Trade Agreement Joint Feasibility Study', Department of Foreign Affairs and Trade, Canberra, and Ministry of Commerce, Beijing, March 2005, p. 14. Note: Ranking is based on 2004 outcomes.*

6.24 The other feature of Table 6.5 is the extent of Australia's recent import increases of China's traditional and non-traditional manufactures. Between 2001 and 2004, Australian imports of China-made women's suits, T-shirts and footwear increased by 70 per cent, 84 per cent and 88 per cent and respectively. The growth in Australian imports from China's emerging machinery and electronics industries is even steeper. Imports of China-made video cameras increased by 748 per cent, televisions and videos by 596 per cent and ADP machines by 420 per cent. These figures support the earlier observation of the continuing export significance of China's TCF sector, in the context of a rapidly developing and export-oriented high-tech manufacturing sector.

### *Australia's exports to China*

6.25 Table 6.6 shows Australian export values for selected ETMs. Among Australia's largest exports of ETMs are passenger cars, professional and scientific instruments, car parts, office machines and telecommunications equipment. In 2004, passenger cars accounted for 12.6 per cent of Australia's ETM exports, televisions and radios accounted for 7.8 per cent and TCF exports for only 1.2 per cent.

6.26 China is Australia's third-largest export market for ETMs with 4.6 per cent of total exports, behind New Zealand (21.9 per cent) and the US (14.5 per cent). In 1995,

China was Australia's 12th largest export market for ETMs with 2.8 of total ETM exports.[24]

**Table 6.6: Australia's ETM (elaborately transformed manufactures) exports**

| | 2001 ($Am) | 2002 ($Am) | 2003 ($Am) | 2004 ($Am) |
|---|---|---|---|---|
| Passenger cars* | 2,966,506 | 2,810,296 | 2,600,935 | 2,366,147 |
| Professional & scientific instruments | 1,207,945 | 1,072,934 | 938,531 | 1,134,229 |
| Car parts | 971,123 | 1,018,384 | 920,798 | 725,655 |
| Office machines | 586,615 | 439,005 | 304,526 | 323,627 |
| Telecommunications equipment | 536,750 | 336,445 | 375,948 | 443,159 |
| TV's, radios | 174,952 | 129,081 | 150,118 | 145,113 |
| Apparel and clothing | 283,855 | 241,379 | 239,764 | 196,021 |
| Footwear | 39,093 | 34,052 | 24,910 | 23,338 |
| Total exports of ETMs | 20,832,193 | 19,543,677 | 18,462,049 | 18,747,027 |
| Total exports of ETMs to China | 778 (3%) | 908 (3.5%) | 1,049 (4.5%) | 1,110 (4.6%) |

** unassembled, assembled new and assembled second-hand*

### *Australia's car and TCF industries*

6.27 Over the past two decades, the challenge of restructuring and opening up Australia's manufacturing sector has tended to focus on two industries: cars and TCF. China's entry into the WTO, its rising competitiveness in high-tech production and continuing reductions in Australia's tariffs has intensified import-competition for these local industries. Still, Australia's car and TCF industries also stand to benefit from export opportunities in China.

6.28 Table 6.7 compares Australian exports of auto components to China with China's imports of these products to Australia. It shows a ten-fold (1,000 per cent) increase in Australian auto product exports to China between 2000 and 2003. China increased its exports of these products to Australia by 41 per cent during this period.

24 'Australia–China Free Trade Agreement Joint Feasibility Study', Department of Foreign Affairs and Trade, Australia, Ministry of Commerce, Beijing, March 2005, p. 66, http://www.dfat.gov.au/publications/stats-pubs/pmp_2004_analysis.pdf (accessed 1 October 2005).

## Table 6.7: Australia–China trade in auto products

| | 2000 ($Am) | 2001 ($Am) | 2002 ($Am) | 2003 ($Am) |
|---|---|---|---|---|
| Australia's auto product exports to China | 5,263 | 14,204 | 16,793 | 56,478 |
| Australia's auto product imports from China | 173,794 | 197,938 | 166,328 | 246,529 |

*Sources: Federation of Automotive Products Manufacturers, Submission to DFAT's 'Australia–China Free Trade Agreement Joint Feasibility Study' June 2004, p. 10.*

6.29 The main reason for the growing market for auto products in China is the sharp increase in domestic consumer demand for vehicles. China's car exports are low. In 1995, China sold 1.43 million cars: in 2002, it sold 3.26 million.[25] Imports of car products from countries like Australia have been crucial to the rapid recent growth in China's car production capacity. In 2005, China was ranked the world's fourth largest car producer, behind the US, Japan and Germany. In 2004, it produced 5.1 million cars compared with Germany's 5.5 million. In March 2005, Mr Zhu Yanfeng, the General Manager of China First Automobile Group, announced that 2005 production would increase to 6 million units, making China the world's third largest car manufacturer.[26] In September 2005, the *Economist* argued that 'within a few years China will replace Japan as the second-largest national [car] market after America'.[27] It is further projected that by 2020, China will overtake the US as the world's largest-selling car market.[28]

6.30 The Department of Industry, Tourism and Resources (DITR) noted that 'China has designated the automotive sector as a pillar of the national economy'. It added:

> Currently there is limited auto trade between the two countries [Australia and China]. China does not rank in the top 20 as either an import source or export destination for vehicles. This may change in the medium term, as an expected over-capacity in vehicle production may lead to Australia becoming an export destination for passenger vehicles.[29]

6.31 Although Australia has benefited from China's demand for car components, it faces increasing competition from China's growing production capacity in these

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25 Federation of Automotive Products Manufacturers, *Submission* to the Department of Foreign Affairs and Trade 'Australia–China Free Trade Agreement Joint Feasibility Study', June 2004, p. 7, http://www.dfat.gov.au/geo/china/fta/submissions/cfta_submission_4ma09.pdf.

26 China.org.cn, 'China to be the world's third largest car maker', 14 March 2005, http://www.china.org.cn/english/BAT/122783.htm (accessed 13 September 2005).

27 'Extinction of the predator', the *Economist*, 8 September 2005.

28 See H. McDonald, 'Giant awakes', *Sydney Morning Herald*, 8 July 2005.

29 Australian Department of Industry, Tourism and Resources, *Committee Hansard*, 21 June 2005, p. 33.

components. There is also greater competition from cheap car component imports. In the first nine months of 2005, the Australian automotive sector lost 3300 jobs and half a dozen major components-supply contracts.[30]

6.32 The *Australian Financial Review* has argued that China's car components industry still has some way to go to meet foreign manufacturers' demands:

> Half a dozen contracts lost is simply not evidence that we are seeing a major shift of the industry to low-cost countries such as China. Though China is a formidable competitor, its automotive components sector is generally not yet capable of producing at the levels of quality and price that the manufacturers demand.[31]

6.33 However, the federal government has identified China as a major challenge for the Australian car components industry. In September 2005, the Industry Minister, the Hon. Ian McFarlane, MP, argued that Australia's big four car producers—Ford, Holden, Mitsubishi and Toyota—had an obligation to use Australian-made components in return for the generous taxpayer subsidies they have received. He argued that the government believed the industry was 'pretty well set' with the release of the 10 year car plan in 2003:

> But the new issue is China, and we can't afford to lose contracts in local cars to overseas components and that's what the emphasis is at the moment, the turn that around. It's quite a task.[32]

6.34 Table 6.8 shows a comparison of Australia's TCF exports to China and TCF imports from China. Notably, Australian TCF exports to China have increased since 2002–03. In 2004–05, Australian TCF exports to China were valued at $A40.8 million, an increase of 28.4 per cent on 2002–03. China's TCF imports to Australia grew by only 13.7 per cent over the same period.

## Table 6.8: Australia–China trade in TCF products

| | 2002–03 ($Am) | 2003–04 ($Am) | 2004–05 ($Am) |
|---|---|---|---|
| Australia's TCF exports to China | 31,809 | 37,051 | 40,844 |
| Australia's TCF imports from China | 3,686,552 | 3,613,061 | 4,192,262 |

*L. Caddy, Council of Textile and Fashion Industries of Australia Limited, 15 September 2005.*

6.35 Still, in 2004–05, the value of Australia's TCF imports from China was nearly 103 times that of Australian TCF exports to China. Clearly, the Australian TCF sector

30 J. Gordon, 'Car industry hits 'low-water' mark', the *Age*, 22 September 2005, p. 1.

31 Editorial, 'Car industry is finely tuned', *Australian Financial Review*, 22 September 2005, p. 62.

32 J. Gordon, 'Car industry hits 'low-water' mark', the *Age*, 22 September 2005, p. 1.

faces immense competition from low-cost, high quality Chinese imports. Although successive federal governments have assisted the local industry to restructure, they have also reduced levels of tariff protection. DITR told the committee that since Australia abolished its TCF quotas in 1993:

> there has been a relatively free trade environment between Australia and China for textiles and clothing. In recent years Chinese clothing and knits have accounted for around a third of all clothing and knits consumed in Australia, whilst imported Chinese textiles are around one-quarter of all textiles imported into Australia. The drop in Australia's textile and clothing tariffs in January this year [2005] is expected to facilitate further trade with China.[33]

## Table 6.9: Australian TCF tariffs, 2005–2015 (Current government policy)

| | 1 Jan 2005 | 1 Jan 2010 | 1 Jan 2015 |
|---|---|---|---|
| Clothing and some finished textiles | 17.5% | 10% | 5% |
| Woven fabrics, carpets and footwear | 10% | 5% | 5% |
| Sleeping bags, table linen | 7.5% | 5% | 5% |
| Textiles, yarns | 5% | 5% | 5% |

*Council of Textile and Fashion Industries of Australia, Submission to the Department of Foreign Affairs and Trade 2004, p. 6, http://www.dfat.gov.au/geo/china/fta/submissions/cfta_submission_4ma18.pdf (accessed 12 October 2005).*

6.36 Table 6.9 shows that current federal government policy will cut Australia's TCF tariffs to five per cent by 2015. However, the committee notes that non-tariff barriers in China pose a considerable problem for Australian TCF exporters. A survey by the Council of Textile and Fashion Industries of Australia (TFIA) identified several non-tariff barriers of concern to Australian TCF producers in dealing with China. These include:

- a lack of transparency in pricing;
- a lack of intellectual property protection;
- a myriad of officials, agencies and rules required to gain access to the Chinese market, and difficulty in obtaining the correct licence to sell;
- a high number of sellers in China requiring intense promotional activity;
- the requirement that foreign companies must open at least two commercial offices in Beijing and Shanghai;

33 Australian Department of Industry, Tourism and Resources, *Committee Hansard*, 21 June 2005, p. 34.

- the disallowance of second-hand machinery used in China, thereby increasing costs for foreign companies; and
- frequent late payments from export debtors.[34]

6.37 Chapter 12 notes the attitude of Australia's TCF sector to a free trade agreement (FTA) with China and the committee's view on the appropriate rate of tariff reduction within this agreement. The last part of this chapter looks at the form that federal government assistance for the TCF industry might take. The following section notes that Australian TCF companies' attitude to expanding trade ties with China is quite positive, despite the China's low-cost imports and non-tariff barriers.

## Attitudes of Australian manufacturers to China

6.38 In August 2004, the Australian Industry Group (AiG) published a research report titled 'Australian Manufacturing and China'. The report was based on a survey of 848 Australian manufacturers, asking their opinion of the impact and opportunities that China presented to their industry. Table 6.10 shows some of the key findings.

## Table 6.10: Australian manufacturers' attitudes to China

| | China as a potential export market | China as a competitive threat in the domestic market | China as a source of low cost inputs | China as a destination for foreign investment |
|---|---|---|---|---|
| Industry average | 19.7 | 54.8 | 43.9 | 15.7 |
| **Variation from industry average by sector** | | | | |
| Food and beverages | 7.3 | -30.5 | -8.8 | 3.3 |
| Textiles | 22.2 | 29.5 | 15.5 | 10.1 |
| Clothing and footwear | 1.1 | 33.6 | 14.5 | 0.3 |
| Wood, furniture | 1.2 | 6.5 | -3.0 | -4.3 |
| Paper | -9.5 | -8.8 | -13.9 | -1.7 |
| Chemicals | 10.5 | -15.2 | -1.6 | .02 |
| Construction materials | -8.3 | 1.7 | -9.1 | -7.0 |
| Basic metals | 6.1 | 20.6 | 11.9 | -2.3 |
| Fabricated metals | -7.5 | 1.5 | -1.1 | 3.0 |
| Transport equipment | -9.6 | 0.2 | 6.8 | -2.4 |

34 Council of Textile and Fashion Industries of Australia, *Submission* to the Department of Foreign Affairs and Trade 'Australia–China Free Trade Agreement Joint Feasibility Study' 2004, pp. 6–7, http://www.dfat.gov.au/geo/china/fta/submissions/cfta_submission_4ma18.pdf (accessed 12 October 2005).

| | China as a potential export market | China as a competitive threat in the domestic market | China as a source of low cost inputs | China as a destination for foreign investment |
|---|---|---|---|---|
| Industry average | 19.7 | 54.8 | 43.9 | 15.7 |
| **Variation from industry average by sector** | | | | |
| Machinery | 0.9 | -1.7 | 2.1 | 1.3 |
| Miscellaneous manuf.'s | 2.1 | 2.8 | -3.5 | -2.9 |

*Source: Australian Industry Group, Australian Manufacturing and China—Opportunities and Challenges, p. 22.*

6.39 The AiG surmised that 'China's influence among the 12 key industry sectors is not even, largely reflecting varying trade exposures'.[35] The most obvious feature of the data is the far greater proportion of firms across all manufacturing industry sectors that view China as a threat, rather than an export or investment opportunity. An average of only 19.7 per cent of respondents viewed China as a potential export market, and only 15.7 per cent as a destination for foreign investment. In contrast, an average of 54.8 per cent of respondents believed China is a competitive threat in the domestic market, while 43.9 per cent viewed China as a source of low cost inputs.

6.40 Interestingly, Table 6.10 shows that firms in the textile industry were most positive about China as an export market (41.9 per cent), as a destination for foreign investment (25.8 per cent), and as a source of low cost inputs (59.4 per cent). Recent export data supports this optimism. From 2003–04 to 2004–05, Australian textile exports to China increased by 14.6 per cent.[36] Australian exports of woven textile fabrics increased 484 per cent over this period.[37]

6.41 However, textile firms also recorded highest agreement that China poses a competitive threat in the domestic market (85 per cent). The contrast is the response of firms in the food and beverages sector (24 per cent). A January 2005 ANZ Industry Brief concluded from the survey that:

> The most significant adverse impact of China trade for local manufacturers relates to the effect of China on competition in the domestic market. The main sectors affected are textiles (especially carpets and other finished products), clothing and footwear; basic metals (basic steel products) and

35 Australian Industry Group, 'Australian Manufacturing and China—Opportunities and Challenges', August 2004, p. 22.

36 Data supplied to the committee by Mr Lachlan Caddy, Economist, Council of Textile and Fashion Industries of Australia Limited, 12 September 2005.

37 Data supplied to the committee by Mr Lachlan Caddy, Economist, Council of Textile and Fashion Industries Australia Limited, 12 September 2005.

> wood, wood products and furniture...Overwhelmingly, the impact on local selling prices was to depress prices.[38]

### *Fair and unfair advantages*

6.42 The committee received submissions and heard from a range of witnesses on the reasons for, and the appropriate Australian response to, China's competitive advantage in manufacturing. As this chapter has mentioned, the strength of China's manufacturing sector reflects the high level of foreign direct investment in China, the import of leading manufacturing technologies, China's ability to tap into regional production chains and the productivity of its labour force.

6.43 However, the committee also notes widespread concern that China's exceptional export manufacturing performance has been based on unfair advantages. These include: a low-wage and in some cases an exploitative labour market; the absence of enforceable intellectual property rights; and 'dumping' of below cost-price excess production on export markets. These issues are significant not only in the context of the challenges facing Australia's manufacturing sector, but to the broader economic and political relationship. For this reason they are flagged below and considered in greater depth in chapters 14 and 18.

6.44 Clearly, the huge supply of labour in China puts natural downward pressure on wage levels. Average per hourly wages across all sectors are estimated at $US0.80.[39] In the textile industry, labour costs represent 5 to 10 per cent of total manufacturing costs in China, but between 30 and 55 per cent in the US.[40] However, there is also evidence that China's low wages and high levels of manufacturing productivity are based on systemic abuses of workers' rights. There is a ban on the formation of trade unions and strikes have led to imprisonment. Workers have few if any entitlements by way of overtime payments, superannuation payments or occupational health and safety provisions. Even wages are often unpaid. In the state-regulated construction sector, the value of unpaid wages has recently exceeded $US40 billion annually.[41]

6.45 The committee acknowledges the concerns of many within the Australian manufacturing sector and the Australian union movement that poor labour standards

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38 ANZ Industry Brief, 'China trade—Impact on Australian manufacturing', 10 January 2005, p. 3.

39 See the *Economist*, Country Briefings, www.economist.com/countries/ (accessed 19 September 2005).

40 TFIA, *Submission* to the Department of Foreign Affairs and Trade, 'Australia–China Free Trade Agreement Joint Feasibility Study', http://www.dfat.gov.au/geo/china/fta/submissions/cfta_submission_4ma18.pdf (accessed 19 September 2005).

41 'A firm battle to clean up wages in arrears is beginning to see results, Clearing up wages in arrears is not 'blowing up at storm'', *New China Net*, 21 January 2004, www.sina.com.au (accessed 11 October 2005).

underpin China's competitiveness. It is important that the international community continue to pressure China to conform to the standards of the International Labour Organization (see recommendation 20). These standards have sufficient breadth to enable China to pursue its own labour laws. The committee also believes that foreign-run enterprises operating in China have an important role to play in implementing corporate codes of conduct and pressuring others to adopt minimum labour standards (see recommendation 21).

6.46 Chapter 4 discussed the issue of intellectual property rights. It noted that counterfeiting in China remains extensive, despite China's obligations to implement the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement. Regulators' efforts to curb piracy and counterfeiting activity in China have proved grossly inadequate given the strength of consumer demand for status goods and a consumer culture more interested in good value than authenticity.

6.47 Perhaps the most significant trend in counterfeiting manufactured goods in China is in the automotive industry. For example, Honda has identified 11 Chinese car makers building copies of the Honda CR–V, some even selling purchase kits to install CR–V badges.[42] Red Flag, which once supplied limousines for the elite of the Communist Party, has recently released a limousine with 'strong styling similarities' to the Rolls–Royce Phantom.[43] Great Wall Motors produces low-cost utility vehicles and sports utility vehicles (SUVs) which look 'remarkably like more expensive vehicles from Toyota and Nissan'.[44] There have also been claims that small imported vehicles submitted to the Chinese authorities for certification have come back showing signs of disassembly. Chapter 11 on the proposed Australia–China FTA reiterates the committee's concern that China improve its enforcement of intellectual property rights (see recommendation 13).

6.48 The issue of 'dumping' is discussed in Chapter 11 with reference to the proposed Australia–China FTA. The term—'dumping'—refers to the export sale of a product at a price below that offered for the sale of a like product in the exporting country.[45] The WTO's Anti-Dumping Agreement—based on Article 6 of the GATT—allows countries to take action against dumping where it is shown to have caused material injury to domestic producers.[46] In the decade from 1994–95 to 2003–04,

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42 R. Wilson, 'China's cheap fakes driving West up the wall', the *Australian*, 15 June 2005, p. 17.

43 R. Wilson, 'China's cheap fakes driving West up the wall', the *Australian*, 15 June 2005, p. 17.

44 R. Wilson, 'China's cheap fakes driving West up the wall', the *Australian*, 15 June 2005, p. 17.

45 M. Priestley, 'Anti-dumping rules and the Australia–China Free Trade Agreement', *Research Note No. 38*, Parliamentary Library, 14 March 2005, p. 1.

46 World Trade Organization, 'Understanding the WTO', September 2003, p. 44.

Australian industry has initiated 18 anti-dumping actions against imports from China.[47] The corresponding number for the period 1984–85 to 1993–94 was 26.

6.49 However, China's capacity to export at below cost remains of concern to Australian manufacturers. In May 2005, following months of negotiations with the AiG and Australian manufacturers, the federal government amended the Customs Manual to allow Australian officials to investigate the effect of foreign governments' influence on the price of any goods coming into Australia from China, to determine whether they have been dumped.[48] Chapter 11 explains the context for manufacturers' lobbying on this issue.

## Responding to China's manufacturing sector

6.50 The August 2004 AiG survey reported that nearly 90 per cent of Australian firms affected by China in either customer or supplier markets 'have formally implemented some change to company strategy'.[49] The main responses to its survey of companies' strategic responses to China were:

- accelerate the pursuit of production efficiencies (38.9 per cent);
- import more from Chinese suppliers (31.5 per cent);
- accelerate the adoption of new technologies (30 per cent);
- move up the supply chain (23 per cent);
- decrease domestic productive capacity (20.5 per cent);
- increase domestic productive capacity (17.5 per cent);
- move down the supply chain (16.9 per cent); and
- relocate to China (4.2 per cent).[50]

6.51 The AiG noted that 39.9 per cent of firms have moved either up or down their supply chain. This indicates that 'firms are seeking to lessen direct competition through greater differentiation of products and services'.[51] Within the TCF sector, the two most common responses were 'import more from China' and 'decrease domestic capacity'. TCF firms were also most likely to opt for a strategy relocating productive capacity offshore. Most other industry sectors nominated 'accelerate pursuit of

47 M. Priestley, 'Anti-dumping rules and the Australia–China Free Trade Agreement', *Research Note No. 38*, Parliamentary Library, 14 March 2005, p. 1.

48 F. Brenchley and T. Sutherland, 'Win in dumping fight', *Australian Financial Review*, 13 May 2005, p. 23.

49 Australian Industry Group, 'Australian manufacturing and China—Opportunities and challenges', August 2004, p. 19.

50 Australian Industry Group, 'Australian manufacturing and China—Opportunities and challenges', August 2004, pp. 19–20.

51 Australian Industry Group, 'Australian manufacturing and China—Opportunities and challenges', August 2004, p. 20.

production efficiencies' and 'accelerate adoption of new technologies' as their leading strategies.[52]

6.52 There are notable examples of Australian manufacturers' success in China. Some multi-national companies have used Australian manufacturers as a base to serve China and the Asia–Pacific. McLanahan Corporation, the American equipment manufacturer, is using Australian manufacturers for its export of crushing and sizing machines to China. Apart from cheaper shipping costs, McLanahan cites the benefits of Australia's various fabrication facilities and its high quality manufacturing capacity.[53]

6.53 In other cases, Australian companies have themselves established a manufacturing niche in China as part of a wider Asian presence. For example, BlueScope Steel, formerly BHP Steel, has established over the past decade a prominent foothold in China for coated and painted steel and prefabricated buildings.[54] Notably, the company opted to use a country manager for China rather than multiple managers for the various production lines.

6.54 In 2005, Smorgon Steel announced plans to spend up to $60 million to buy a mid-range business in the scrap metal industry in China. This decision is part of a strategy to reduce the company's reliance on steelmaking and capitalise on the scrap generated by China's rapidly expanding manufacturing sector.[55]

6.55 There have also been examples of small manufacturers supplying the China market through advanced and highly specialised technology. For example, the Sydney-based Bishop Technology Group exports rack and pinion power-steering machines to car steering plants in China. The Group has succeeded by ensuring its intellectual property '…offers them [buyers] something they can't get from anyone else…'.[56] The committee notes that in September 2005, the federal government announced a new $108 million round of grants aimed at increasing expenditure on research and development among the main car makers in Australia.[57] Successful bidders are given 45 cents for every dollar spent on R&D.

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52 Australian Industry Group, 'Australian manufacturing and China—Opportunities and challenges', August 2004, p. 21.

53 See Invest Australia, 'McLanahan sizes up the Asia–Pacific from Australia', http://www.investaustralia.gov.au/media/CS_MA_McLanahan.pdf (accessed 21 September 2005).

54 See D. James, 'Strategy in Steel', *Business Review Weekly*, 22–28 September 2005, p. 44.

55 I. Porter, 'Smorgon sets sights on Asia', the *Age*, 27 October 2005, p. 2.

56 P. Roberts, 'Bright idea puts local minnow in the driving seat', *Australian Financial Review*, 8 October 2005, p. 18.

57 J. Gordon, 'Car industry hits 'low-water' mark', the *Age*, 22 September 2005, p. 1.

6.56 Several expert witnesses commented to the committee about the need for Australian manufacturing industries to refine continually their 'China strategy'. There can be no doubt that the intensity of competition from China can only be expected to increase. On this matter a January 2005 ANZ Industry Brief concluded:

> …the outlook for Australian manufacturing to this increased competition rests on the response of local manufacturers' to stem further erosion of market share and profitability. Manufacturers are expected to adopt a positive approach, rather than try to preclude this competition through calls for the erection of trade barriers. Nonetheless, some form of assistance is likely to be sought…[58]

6.57 Dr Robert Davis, Director of the Trade and International Affairs Branch of ACCI, emphasised the need for a value-added approach. Dr Davis identified:

> …a view amongst Australian manufacturers that they do have to move up the simply transformed manufactures route…the more innovative and astute of them moved up the chain so that Australian apparel manufacturing and textiles now is no longer just $3 T-shirts at the market stuff; it is Australian designed Australian motifs and it is moving right up the value-add chain…I think Australian manufacturing is exiting the areas where China is the most competitive, and that is a logical move. The future will be that we will focus more on higher intellectual property component manufacturing, where there is still that reticence to divest to China...[T]here is a tendency to allow the generation 4 level technology into China while the Australian manufacturers are at generation 7. I think Australian manufacturing will go into niche products. We will never be making eight billion biros a year, but we will move into the higher value-add, more technologically advanced area.[59]

6.58 This argument is common in the developed world. The capacity of rich economies to maintain their competitive advantage rests on a flexible, value-added economy, a highly educated labour force, and leading technology and infrastructure.[60]

6.59 However, the committee heard from several witnesses that China's development challenges this assumption. For example, Mr William Apple, an Industry and Investment Policy Adviser with the Australian Council of Trade Unions (ACTU), emphasised that China's growing competitive advantage is not confined to the labour intensive TCF sector. He argued that China had very successfully brought its many overseas educated engineers back to work for multi-national companies. The combination of high levels of foreign investment in China, a large returning supply of

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58 ANZ Industry Brief, 'China trade—Impact on Australian manufacturing', 10 January 2005, p. 5.

59 R. Davis, *Committee Hansard*, 29 June 2005, p. 27. His reference to generation level 4 and 7 is explained in the quotation contained in Chapter 4, paragraph 4.67.

60 See J. Bhagwati, *Free Trade Today*, Princeton University Press, 2002.

foreign-educated engineers, and the support of cheap semi-skilled labour was enabling China to move rapidly up the value-added chain.[61]

6.60 Mr Edward Murphy, an International Committee Member of the ACTU, elaborated on this point for the committee:

> Every year there are 550,000 engineering graduates from the Chinese higher education system. Sony used to virtually dominate the mobile phone battery sector as a global supplier. There is a Chinese company, I think it is called BMD, which has taken around 40 per cent of the market share for that particular product. This is the way BMD did it: it acquired one of the industrial robots used in Japan to make the mobile phone batteries, took it to China, disassembled it, worked out how it worked and substituted human labour for the robots. BMD also had five times as many engineers in its factory as Sony had in its factory in Japan. So you have low-cost labour—in part due to economic circumstances and in part due to the absence of proper labour standards—combining with a significant supply of highly skilled, tertiary educated labour to produce a technologically sophisticated product. It is the combination that is important in the case of China. It is not simply low-cost, relatively unskilled labour in TCF type areas where China's competitive advantage is important. It is a lot broader.[62]

6.61 Mr Doug Cameron, the National Secretary of the Australian Manufacturing Workers' Union (AMWU), told the committee that trade with China exposed the fundamental need for Australia to develop an industry policy for manufacturing. He argued:

> We currently have a national trade deficit in manufacturing of $83 billion. We have a deficit in elaborately transformed manufactures of $75.4 billion. We have structural problems in the economy. As I understand it, if you look at some of the arguments put forward by the employers this morning, we are importing low-value-added goods from China. If you look at our submission, you will see that the major imports from China are high-value-added elaborately transformed manufactures—goods like sound and video recorders, telecommunications equipment, computers, televisions and computer parts; anything but low-value-added components. We need an industry policy in this country to be able to compete globally. The approach of the federal government at the moment to simply rely on the market to determine the future of our manufacturing industry is not an appropriate way to go.[63]

6.62 The AMWU's submission to the committee argued that Australian policy makers have not yet realised that 'Chinese manufacturing represents a significant

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61 W. Apple, *Committee Hansard*, 27 June 2005, p. 69.

62 E. Murphy, *Committee Hansard*, 27 June 2005, p. 71.

63 D. Cameron, Australian Manufacturing Workers' Union, *Committee Hansard*, 29 June 2005, p. 75.

threat to Australia's manufacturing industries at all levels'.[64] The submission noted that the maintenance of high value-added manufacturing industries is important for the maintenance of a high standard of living. The AMWU claimed that:

> …in 2003 prices for every plasma television Australia imported, Australia had to export in the vicinity of 150 tonnes of iron ore. If Australia is to maintain and improve its standard of living, a trade and industry policy built on the 19th and early 20th century view of Australia as an agricultural and mineral supplier for the rest of the world is clearly neither economically nor environmentally viable.[65]

6.63 Similarly, Mr Martin Feil, a past director of the Industries Assistance Commission, referred to a 'China paradox':

> [T]he more we trade with China the more we will undermine the economic foundations of Australian society. We will basically export natural resources and raw materials to China and import manufactured goods from China. We add virtually no value to natural resources and raw material exports other than extraction and some logistics services. Imports of manufactured goods embody a great deal of value added in the manufacturing process.[66]

6.64 Mr Feil argued that employment growth in Australia depends on value-adding exports and manufacturing products that substitute for imports. Trade with China limits these opportunities. He claimed that the 'winners' from trade with China will spend on Chinese imports, and further deplete Australia's manufacturing industry. Accordingly, Mr Feil wondered how those 'who lack the education, experience and aptitude to be gainfully engaged in the services industry' will find work.[67]

6.65 More optimistically, others argued that Australian manufacturing can survive through securing strategic export niches in Asia. Mr Tim Harcourt, a senior economist with Austrade, told the committee that Australia has been 'quite successful in niche manufacturing'. He argued that '…the issue is really: have we got capacity and does it relate to things such as the scale of plant, appropriate infrastructure, labour issues and so on? Certainly the demand is there'.[68] Mr Apple of the ACTU told the committee that Australia needed a more aggressive approach to exporting ETMs to China's supply chains in East Asia. Although aggregate export figures suggest that China has been a lucrative market for Australia's ETM exporters (Table 6.6), Australia's share of China's ETM imports has fallen 'quite sharply'.[69] The reason, he argued, was that

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64 A. Kentish, Australian Manufacturing Workers' Union, *Submission P36*, p. 9.

65 A. Kentish, Australian Manufacturing Workers' Union, *Submission P36*, p. 11.

66 M. Feil, 'Australian entrée on Chinese menu', the *Age*, 5 September 2005, p. 6.

67 M. Feil, 'Australian entrée on Chinese menu', the *Age*, 5 September 2005, p. 6.

68 T. Harcourt, Austrade, *Estimates Hansard*, 3 November 2005, p. 74.

69 W. Apple, *Committee Hansard*, 27 June 2005, p. 69.

Australia has failed to tap into the East Asian supply chain that services China's production. Australian exports of ETM's to East Asia have not increased since the mid-1990s.[70]

6.66 Others preferred to emphasise the opportunities for Australian companies to invest directly in manufacturing in China. In this context, a 2004 Business Issues Paper from the Australian Chamber of Commerce (AustCham) Beijing argued the need for reform of non-tariff or 'beyond the border' measures facing Australia's export manufacturers.[71] AustCham recommended that the Chinese government:

- remove VAT on imported goods;
- make operating hours at inbound ports more flexible to coincide with inbound shipments;
- eliminate import duties on all capital equipment used in production; and
- ban all provincial protectionism (see recommendation 5).[72]

## The committee view on prospects and options for Australian manufacturing

6.67 The committee believes that the Australian manufacturing sector can meet the challenge posed by growing and freer trade with China. It rejects the notion that continued trade with China will render Australia nothing more than 'a quarry, a farm and a nice place to visit'.[73] The sector currently employs nearly 1.1 million Australians and is the largest spender on research and development.[74] Although its contribution to total production has declined over the past two decades, the sector's share of exports has doubled.[75]

6.68 The tariff reductions of the past twenty have exposed Australian manufacturing to international competition and demonstrated that, in most cases, these industries can respond and adapt. It is true that the volume, range and quality of China's export manufactures will force many Australian companies to restructure or phase-down production.[76] On cost alone, Australian manufacturers will struggle to compete with China. Their key opportunities are in using advanced technologies to encourage inward investment and to find a niche in overseas supply chains.

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70 W. Apple, *Committee Hansard*, 27 June 2005, p. 69.

71 AustCham Beijing, *2004 Business Issues Paper*, August 2004, p. 8.

72 AustCham Beijing, *2004 Business Issues Paper*, August 2004, p. 8.

73 D. Cameron, *Committee Hansard*, 29 June 2005, p. 48.

74 *ABS Yearbook 2005*, Australian Bureau of Statistics, Canberra, ABS Catalogue 1301.0, p. 543.

75 K. Henry, 'Australia–China economic directions—Long term trends in the Australian economy', *Australia–China free trade agreement Conference*, Sydney, 12 August 2004, p. 3.

76 See K. Phillips, 'It's now or never for manufacturing', the *Age*, 27 May 2005, p. 10.

6.69 Leaving the merit of an FTA to one side, the committee believes that the schedule of progressive tariff reductions in manufacturing should continue. Direct subsidies are expensive and would not alter the long-term competitiveness of the Australian sector.[77] The strong international pressure that Australian manufacturers now face does not invalidate the Australian government's decision to open manufacturing to global competition. However, the committee does stress the importance of continuing government promotion and targeted assistance for the local manufacturing sector.

### *Policy recommendations*

6.70 The committee did not explore fully the options that Australia should adopt to meet the challenge posed by the likely influx of cheaper manufactured goods into Australia from China. Many academics and organisations have varying viewpoints and suggestions on how the Australian government and the manufacturing sector should respond to these continuing pressures.

#### *A national manufacturing policy: R&D and skills development*

6.71 There is a strong body of opinion calling for the Australian government to have an overarching national policy on manufacturing to address China's challenge.[78] This was recommended by both the Australia–China Business Council (ACBC) and the AMWU in their submissions to the committee. The committee supports this proposal. It believes that two key pillars of a national manufacturing policy must be to fund and coordinate research and development in value-added technologies, and to support skills development in technical education.

6.72 Increasingly, Australian manufacturers will need to focus on innovation, rather than mass production. In 1996, the Howard Government cut the R&D tax concession from 150 to 125 per cent. The 1996 level of R&D expenditure was only exceeded in 2003–04, when Australian businesses spent $A7.2 billion.[79] Still, Australia's R&D spending remains less than one per cent of GDP (0.89 per cent) and on this basis, ranks 15th among OECD nations.[80] The manufacturing sector accounted

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77 Allen Consulting, *Growing Global Niches: Positioning Victorian ETMs for future export growth*, February 2005, p. xiii, http://www.business.vic.gov.au/CA256E36001D1550/WebObj/4F50B616C67064EFCA25705F0002BA7F/$File/ETM%20Final%20Report%2010%2002%2005.pdf (accessed 27 September 2005).

78 Australia–China Business Council, *Submission P40*, p. 15. See also T. Sutherland, 'Policy needed for China FTA', *Australian Financial Review*, 15 April 2005, p. 22.

79 P. Roberts, 'R&D spending bounces back', *Australian Financial Review*, 29 September 2005, p. 8.

80 'Research and Experimental Development, Businesses', *Australian Bureau of Statistics, Cat. No. 8104.0*, 2003–04, p. 6, http://www.ausstats.abs.gov.au/Ausstats/subscriber.nsf/Lookup/76F4C63E4C74ABC0CA25708900805B84/$File/81040_2003-04.pdf

for 46 per cent of the 2003–04 spend. In the year from 2002–03 to 2003–04, R&D spending increased on motor vehicles and parts from $631 million to $721 million, and on TCF products from $237 million to $260 million.[81] Some specific options that might be considered include increasing the R&D tax concession and reducing the upper limit—currently $50 million—on company turnover in order to qualify for the *Commercial Ready Program*.[82]

**Recommendation 5**

**6.73 The committee recommends that as part of a national strategy to promote innovation and value-adding in manufacturing, the Australian government must develop a wider range of incentives for CSIRO, the universities, private sector research centres and manufacturing companies to collaborate and invest in R&D.**

6.74 The committee is also concerned that Australia has the workforce to complement this focus on a high-tech, value-added manufacturing sector. It is important that the manufacturing and technical education sectors continue to collaborate to ensure the supply and flexibility of the skills base.

**Recommendation 6**

**6.75 The committee recommends that the Australian government follow through with recent initiatives to improve the manufacturing skills base, particularly the creation of independent technical schools and a streamlined national system of apprenticeships.**

*A coordinated export manufacturing focus*

6.76 This chapter has argued it is important that Australian manufacturing companies are able to tap into supply chains in China and East Asia. Ultimately, the onus is on company directors to formulate the appropriate strategy. However, the federal and state governments also have an important role to facilitate these opportunities.

6.77 The committee acknowledges the high-quality of existing arrangements for assisting Australian businesses in China. Several witnesses praised Austrade, the consul generals and the Australian Chambers of Commerce in Beijing and Shanghai

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81 'Research and Experimental Development, Businesses', *Australian Bureau of Statistics, Cat. No. 8104.0*, 2003–04, p. 10, http://www.ausstats.abs.gov.au/Ausstats/subscriber.nsf/Lookup/76F4C63E4C74ABC0CA25708900805B84/$File/81040_2003-04.pdf

82 Allen Consulting, *Growing Global Niches: Positioning Victorian ETMs for future export growth*, February 2005, p. xv, http://www.business.vic.gov.au/CA256E36001D1550/WebObj/4F50B616C67064EFCA25705F0002BA7F/$File/ETM%20Final%20Report%2010%2002%2005.pdf (accessed 27 September 2005).

for their assistance in establishing Australian businesses in China. For example, Mr Duncan Calder of the Western Australian branch of the ACBC noted that these organisations are 'extraordinarily helpful in terms of acting as an interface between the local community and the Australians going up there [China]'.[83] Austrade has recently established several offices in large regional cities such as Ningbo, Xi'an, Chendu, Nanjing and Qingdao.[84] In 2005, the number of Australian companies it assisted in China was more than double the corresponding number for 2002.[85] It is important that these networks continue to develop to assist large and small to medium sized manufacturing enterprises establish an export market or investment base in China.

**Recommendation 7**

**6.78 The committee recommends that Australian government agencies strengthen the coordination of efforts to promote Australian exports to, and investment in, China and East Asia. To this end, it is important that Austrade continues to establish offices outside of Shanghai and Beijing, and to develop further the avenues for consultation between large and small Australian manufacturers operating in China.**

6.79 The committee does not believe that better labour standards and enforcement of intellectual property rights in China will enable Australian manufacturers to compete with China on cost. This chapter has made the point that China's vast supply of labour will continue to ensure that its wage levels remain low. Even if China's wages increased sufficiently to make some of its factories uncompetitive, capital will simply shift to other low-cost countries in the region.

6.80 However, the committee does believe it is important that Australia and the international community continue to exert pressure on China to improve its standards of labour and intellectual property rights (see recommendations 13 and 20).

*Assisting the TCF industry—the importance of industry plans*

6.81 The committee supports the Australian government's approach of phasing out tariffs for the TCF sector. The FTA currently being negotiated may accelerate the rate of tariff reduction, although there is strong resistance from within the TCF (see chapter 12). The committee notes that Australia's FTAs with the US and Thailand reduced the level of tariff protection for clothing by only five percentage points to 12.5 per cent.[86]

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83 *Committee Hansard*, 1 August 2005, p. 11.

84 Chanticleer, 'Big opportunities, but be patient', *Australian Financial Review*, 22 September 2005, p. 64.

85 Chanticleer, 'Big opportunities, but be patient', *Australian Financial Review*, 22 September 2005, p. 64.

86 I. Porter, 'Real deal is in the fine print', the *Age*, 19 October 2005. p. 8.

6.82 Regardless of the extent and rate of tariff reduction, it is essential that there are programs in place that promote TCF exports and assist local manufacturers to adapt to import competition. It was noted earlier that the most common strategy of Australian TCF firms has been to use low-cost inputs from China and to scale down production. This focus on cost containment may partially reflect the sector's strong support for China as an export market and as a destination for foreign investment (Table 6.10). From this perspective, the failure to phase out tariffs on China's TCF imports will keep Australian businesses' input costs unnecessarily high.

6.83 The TCF industry is a good example of how the Commonwealth government can target assistance packages. In November 2003, the government announced a $747 million TCF Industry Assistance package to commence on 1 July 2005 until 30 June 2015. The funding details were announced in April 2005 as part of the Post-2005 Strategic Investment Program (SIP).[87] The SIP scheme is complemented by an increase in funding for various other TCF programs and schemes:

- $50 million for the TCF Structural Adjustment Program: the program assists TCF firms, workers and communities to restructure or leave the sector[88];
- $50 million for the TCF Product Diversification Scheme: the scheme enables participants to earn duty credits to assist Australian manufacturers to internationalise their sourcing[89];
- $27 million to extend the Expanded Overseas Assembly Provisions (EOAP) Scheme: the scheme enables participants to assemble particular TCF goods overseas, reimporting them for local sale with duty payable only on overseas added value[90];

87 The Hon. Ian McFarlane, '$575 million in investment in textile, clothing and footwear sectors', *Media Release*, 26 April 2005, http://minister.industry.gov.au/index.cfm?event=object.showContent&objectID=7C39B8E0-65BF-4956-BB8B5456D678B6CB (accessed 21 September 2005).

88 Department of Industry, Tourism and Resources, 'TCF Structural Adjustment Program', http://www.disr.gov.au/assets/documents/itrinternet/TCF_Structural_Adjustment_Program20050421093330.pdf (accessed 21 September 2005).

89 Department of Industry, Tourism and Resources, 'AusIndustry: Product Diversification Scheme', April 2005, http://www.disr.gov.au/assets/documents/itrinternet/Product_Diversification_Scheme20050421093536.pdf (accessed 21 September 2005).

90 Department of Industry, Tourism and Resources, 'Guidelines: Expanded Overseas Assembly Provisions Scheme', December 2003, http://www.ausindustry.gov.au/library/EOAP%20GUIDELINES%20December%20200320031216104226.pdf (accessed 21 September 2005).

- $25 million for the TCF Small Business Program: the program provides grants for small TCF firms undertaking design or production of TCF products[91]; and
- $20 million for TCF Supply Chain Program, which commences in 2010.[92]

6.84 The object of these schemes is to 'foster the development of Australian TCF manufacturing activity so that it is viable and internationally competitive'.[93] In terms of meeting the challenges that China poses, the committee sees particular merit in schemes that connect the Australian manufacturing sector to opportunities abroad. The Overseas Assembly Provisions Scheme—the forerunner of the EOAP—commenced in 1993, the same year that Australia abolished quotas on TCF imports. Originally planned for three years, the 1995 budget extended the scheme until 2000. The expanded scheme commenced in 1999 and was extended in 2003 until June 2010. The committee supports this extension and would welcome an analysis of the extent to which Australian TCF firms use the scheme to source from China and other East Asian markets.

## Conclusion

6.85 China's dynamic export-oriented manufacturing sector has provided the basis for its high growth rates of the past decade. The sector has earned China the reputation of being 'born global', in contrast to the mercantile model of other Asian economies.[94] It has transformed over the past decade to include the manufacture of high-tech electronics, often completing a regional production chain. China's ability to attract high levels of foreign direct investment and develop a highly skilled workforce has enabled this transition to occur at unprecedented speed. Combined with the low-cost, high-volume production of traditional labour-intensive manufactures such as textiles, China's manufacturing sector has been a significant source of competition, innovation and tension in the world economy.

6.86 Australian manufacturers are certainly not alone in facing the challenges that China poses. The package of assistance for the Australian manufacturing sector must

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91 Department of Industry, Tourism and Resources, 'Exposure draft TCF Small Business Program—Overview', http://www.disr.gov.au/assets/documents/itrinternet/DraftTCFSBPforpublications16120420041223161902.pdf (accessed 21 September 2005).

92 Department of Industry, Tourism and Resources, 'Exposure draft TCF Small Business Program—Overview', http://www.disr.gov.au/assets/documents/itrinternet/DraftTCFSBPforpublications16120420041223161902.pdf (accessed 21 September 2005).

93 AusIndustry, 'Fact sheet: Textile, Clothing and Footwear (TCF) Post 2005 Assistance Package—Overview', April 2005, http://www.ausindustry.gov.au/library/Factsheet_TCFPost-2005PackageOverviewPublishv1.0april05200505041032 56.pdf (accessed 20 September 2005).

94 D. James and A. Carroll, 'Along the silk road', *Business Review Weekly*, 22–28 September 2005, p. 38.

be continually refined in light of developments in China. First, a national policy on manufacturing is needed to promote research and development and address the shortages in basic engineering and technical skills. Second, Austrade and other supporting agencies must continue to monitor carefully the opportunities for manufacturing investment in China and East Asia. Austrade also has an important role promoting discussion among Australian manufacturers in China and urging Chinese authorities to improve regulatory consistency. Third, direct government assistance programs must continue to assist certain domestic industries to diversify, shift or phase out production.