10 September 2003

Industry Brief

Prospects for Australia's TCF Industries

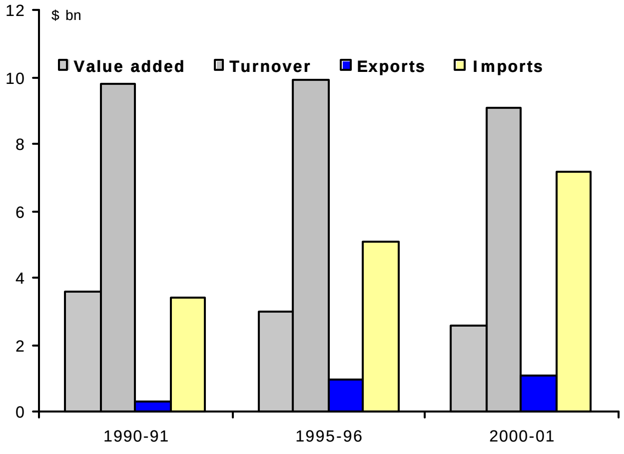
The textiles, clothing and footwear (TCF) industries have been undergoing a period of contraction, primarily due to strong competition from imports. This industry sector traditionally has been highly protected relative to other areas of Australian manufacturing; but protection is being progressively reduced. In November 2002 the Federal Treasurer referred the question of post-2005 assistance for the TCF sector to the Productivity Commission. This Industry Brief draws on the Commission's draft report, examining the drivers of the sector's past performance and its prospects for the future.

A long period of contraction

TCF industries (or more accurately TCFL industries) include: textiles (wool scouring, the production of natural fibres and synthetic fibres as well as textile finishing); textile products (including manufacture of blinds, tents and other canvas goods, carpets and other textile floor coverings, ropes, cordage and twine and other textile products; production of hosiery and knitted goods; clothing and footwear manufacture; and leather preparation and the manufacture of leather goods.

As a whole, TCF has been the poorest performing sub-division of manufacturing industry for many years. Following a trend decline averaging 1.9% a year during the ten years to December 2000, value added in the TCF industries (the value of production, less the value of inputs to the production process) has fallen by an average of 11% a year for the two years to March 2003.

TCF value added declines while imports rise



Source: Productivity Commission, Review of TCF Assistance, April 2003

Consistent with the decline in value added, sales by TCF industries declined over the five years to 2000-01 (the latest published survey of manufacturing activity) by an average annual 1.7%, to a sales level of $9.1 bn. The profit margin also has been relatively low and on a declining trend; it averaged about 3.3% a year over the six years to 2000-01, when it fell to an estimated 1.3%. Return on assets declined from 7.1% in 1995-96 to 2.2% in 2000-01.

Most industries within the sub-division suffered declining or fairly static sales in 2000-01. The better performing industries appear to have been wool scouring; made-up textile products manufacture; hosiery; and leather tanning and fur dressing.

The crux of the TCF sector's problem is its labour cost disadvantage. In particular, the local industry cannot compete with imports of standardised product from cheap-labour countries. In addition, the industry is challenged both by changes in consumer spending patterns, whereby the TCF share of household spending has declined, and by the continual need to invest in new labour-saving technologies to lower domestic production costs. These challenges are not unique to Australia, but are shared, to varying degrees, with other developed, TCF-manufacturing economies.

The consequential changes in the dynamics of the sector have been far reaching, including: substantial rationalisation, changes in product and in supply chains, growth in imports and exports and declines in production and employment.

Government assistance to TCF industries

The level of protection for TCF industries traditionally has been high among manufacturing industries. Effective rates of protection for TCF industries reached their highest level in the 1980s. (In 1987, clothing and footwear enjoyed a rate of around 175%, and textiles, a rate of some 70%.) Since then, Australian governments have pursued a policy of reducing the level of protection afforded manufacturing industries. An industry plan for TCF industries, which included an orderly reduction in tariffs, was introduced in 1987. It was modified in 1993 to provide for the termination of quota protection and an accelerated timetable for the reduction of tariff protection to a maximum 25% in 2000. Tariff amendments in 1999 provided for further reductions in tariffs to have effect in 2005. The current levels of TCF tariffs and planned reductions in 2005 are shown below.

Tariff at:	Apparel & some finished textiles	Cotton sheets, woven fabrics, carpets, footwear	Sleeping bags, table linen, tea towels, footwear parts	Textile yarns, sewing threads, finished leather
2000	25%	15%	10%	5%
2005	17.5%	10%	7.5%	5%

The Federal government has engaged with the industry to improve its competitiveness through the Action Agenda process since 1997. A TCFL Forum was established to progress the Action Agenda, which includes a number of goals for the industry to achieve by 2010. These goals include achieving turnover of $12 bn and exports of $6 bn. The Agenda strategies have concentrated on: stimulating innovation; improving leadership, management and technical skills; and developing niche markets.

The Government also put in place a TCF Assistance Package from 2000 worth over $700 mn. The main component of the Assistance Package is the Strategic Investment Program (SIP), designed to encourage capital investment by TCF industries, R&D, product innovation and to provide assistance for regional reconfiguration (the latter being especially significant considering the sector's role as a major employer in some regional economies).

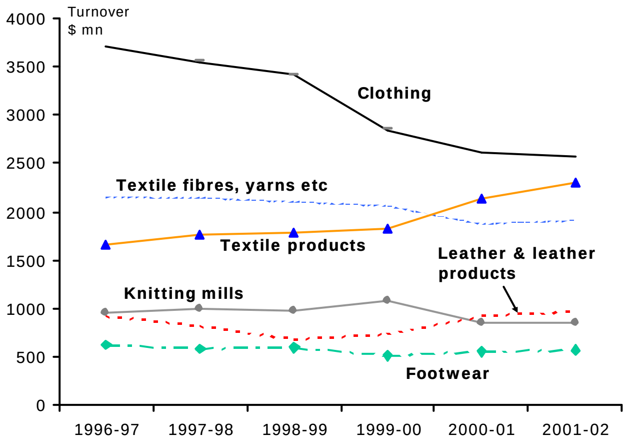
In addition to SIP, the Extended Overseas Assembly Program (EOAP) encourages the use of Australian fabrics and leather by manufacturers in low-cost developing countries, while aiming to keep the higher skilled elements of the manufacturing process in Australia. (Local firms export fabrics to overseas manufacturers, and pay duty only on the value added by those overseas manufacturers when they import the overseas-processed goods.) The Assistance Package also includes other programs to improve industry skills and develop markets.

Despite the reductions made over the past 15 years, assistance To TCF industries still remains relatively high – and costly. As well, there are some deficiencies in existing assistance arrangements. These factors preclude the mere 'rolling over' of current arrangements in 2005. Accordingly, the Productivity Commission was directed by the Federal Treasurer in November 2002 to examine how best to assist the industry when the current arrangements expire on I January 2005. In so doing it was directed to have regard to the Government's desire both to encourage the sector to pursue activities in which it can be competitive internationally - and thus require lower levels of assistance - and to improve the performance of the economy as a whole. In its examination of these issues the Commission also needed to take account of the impact of changes in assistance on regional economies with significant TCF activity; workplace issues in the industry and the scope for workplace reform; and the need for consistency with Australia's current and future trade obligations.

Issues shaping the future of TCF industries

One of the key points to emerge from the Commission's research is that, while further contraction of TCF enterprises is probable, and contraction in employment is a virtual certainty, the outlook for producers in some segments is positive, with opportunities existing, or likely to emerge, in both domestic and export markets. One such opportunity will be that provided by the removal or relaxation of trade barriers that inhibit expansion of export markets, through international agreements.

Textile & leather products show resilience



Source: Data from IBISWORLD

The Commission also identified certain general characteristics of emerging opportunities in the TCF sector, including:

- products where a quick turnaround for short run orders is important;
- products where physical proximity to the customer is important;
- the combining of a product with an associated service (e.g. inventory management of particular TCF lines for retailers);
- products that can be differentiated by technology, design, branding or marketing;
- products naturally protected by local requirements or standards;
- products/processes where proximity to raw materials can provide a basis for competitive supply; and
- having international links to the latest technologies and market information.

The Commission's investigations also brought to light a number of specific product opportunities in the TCF sector, including:

- lightly processed raw materials (e.g. wet blue hides, scoured wool);
- wool based products (e.g. carpets, knitting wool);
- specialist non-woven fabrics;
- industrial textiles;
- supply to the automotive sector;
- surf wear and 'wearable art where cultural recognition is a marketing factor;
- quick response fashion garments and garment fabric;
- complex, high fashion, low-volume garments, where proximity of fabric provider to designer/producer is important;
- niche product output, where Australian firms have expertise (e.g. defence apparel, fire retardant clothing and industrial footwear); and
- the corporate apparel market where service and buy local policies can provide an advantage to Australian producers.

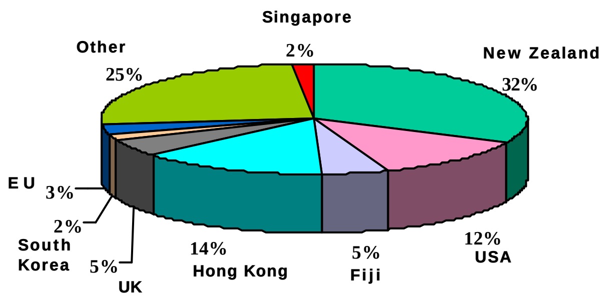
Export opportunities - for some

Exports by TCF industries have grown from around 3% of turnover to 12% over the ten years to 2000-01. At this latest proportion, exports are still low, and are an area where development is necessary in the face of a mature and highly competitive domestic environment. However, as the Commission noted, success in exporting will reflect the same mix of factors that has generated domestic success: e.g. competitive pricing, readily–available raw materials; differentiation of technologies employed; Australia-specific product identification a strong domestic production base and the capacity for low-volume, quick-turnaround supply. Thus, it is unlikely that exporting will be a solution for most companies that are struggling in the domestic market.

Prospective changes in global trading arrangements resulting from the WTO Agreement on Trading and Textiles will have an impact on opportunities in export markets (as well as in the Australian market) after 2005. The impact is likely to be mixed. China is expected to be the major beneficiary of a freeing-up of TCF trade, and is likely to displace some other suppliers in markets where trade barriers are reduced, creating increased competition for Australian exports. Nevertheless, China's benefit is likely to come mainly in the area of standardised TCF products, where Australian firms are already having difficulty competing, rather than in the 'opportunity product' areas. At the same time increased TCF export success for Asian region countries could benefit Australian suppliers of raw, or lightly processed, materials such as wool, cotton, leather etc.

In addition, some parts of the TCF sector could expect to benefit from a reduction in trade barriers that might result from multilateral trade initiatives such as the Doha round of WTO trade negotiations and the regional Asia Pacific Economic Cooperation. (In this connection, a study by the Centre for International Economics reportedly concluded that the removal of TCF trade barriers under the Free Trade Agreement currently being negotiated with the United States would lift Australia's TCF exports by 75% - over $US150 mn.) At the same time it should be noted that not all TCF industries have been optimistic about the benefits of a Free Trade Agreement with the USA. Overall, the main conclusion from examination of the impact of trade liberalisation on the TCF sector is that it would provide opportunities for some firms; but it will by no means be a panacea for all TCF industries, and could actually disadvantage Australian firms in some overseas markets.

Australia's TCF export markets



Source: Data from "Review of TCF Assistance," Productivity Commission, April 2003

TCF sector strengths and weaknesses

In general, TCF enterprises that have the best future prospects are those which have been able to demonstrate:

- flexibility (a quick production response);
- innovation (providing new solutions to changing customer requirements, including strong research linkages and connections to international market information);
- customer focus (attaching services to the supply of product in order to meet customer needs); and
- a commitment to performance (raising productivity and improving product development and workforce skills.

The difficult market conditions faced by most TCF industries have highlighted weaknesses that hinder competitiveness. While many TCF firms have achieved competitiveness with overseas suppliers in terms of productivity, the labour cost disadvantage remains a constraint on otherwise viable activities. In the Commission's view the productivity/wage cost equation is the key factor prompting manufacture offshore. Accordingly, the objective for government policy is seen to be facilitating adjustment into activities where labour costs are not dominant and where Australian firms possess other compensating advantages.

However, this direction is not clear-cut. For example scale of operations can have advantages and disadvantages. Low-volume/small-scale firms may have an advantage in achieving the flexibility and quick response often required in niche product markets. Yet, lack of size also can be a major constraint on performance, through: an inability to achieve productivity gains through greater capital intensity; a lack of access to finance, an inability to meet the cost of an export program; or to access training and government support programs such as SIP. As well, low volume suppliers are often disadvantaged in negotiation with large retail chains.

Another weakness of the TCF sector is its legacy of high levels of government assistance, which in some cases has produced a protectionist mentality inhibiting industry adjustment.

As well as those weaknesses in the TCF sector, over which it has some control, it faces a number of external threats over which it has no control. Competition from China and the next generation of low-cost suppliers will increase. For example, some participants in the Commission's inquiry noted that 'least developed' economies like Bangladesh would soon have duty-free access to the Australian market. Also, the volatility of the Australian dollar exchange rate is more of a concern for some TCF firms than the level of tariff protection. In addition, the inter-dependence of enterprises along the TCF supply chain means that any large-scale contraction in one industry along the chain can have repercussions for others - upstream or downstream. For example, further contraction in clothing would threaten upstream production of textiles and yarn.

TCF prospects and future assistance

In its preliminary findings on the TCF sector, the Commission noted that, rather than being sunset industries, some individual firms and even parts of the sector were performing well. Many other firms are in a process of transition and have reasonable prospects of operating successfully in an environment of lower government assistance. However, the future prospects for those firms producing standardised products in labour intensive parts of the sector were limited. In fact, it was considered that many would not survive, virtually regardless of the level of government assistance.

Further change in the TCF sector, therefore, is considered inevitable. There is little the government can do, except to manage it through encouraging the transition to increased competitiveness where possible, and by trying to minimise the disruption associated with adjustment through direct assistance and through its broader economic policy settings.

Most firms participating in the inquiry argued that further unilateral reductions in tariffs would be detrimental to the industry. They asked for an indefinite pause in tariff reductions following the legislated changes in 2005 – with any further reductions to be linked to matching declines in trade barriers in other countries and further government budgetary support. The Commission did not appear to find the arguments underpinning this position compelling. It concluded that the key question regarding the post-2005 assistance regime should be the timing and quantum of reductions in government support, not whether support should be reduced. This implies further stress for many TCF firms, their employees and surrounding communities.

The views of the Commission evident in the draft report are unlikely to have changed significantly in the final report to be tabled in Parliament soon. Given the cost of assistance, the government's commitment to trade liberalisation and the seeming inevitability of further rationalisation in the industry, it would appear most likely that the government will continue the lowering of protection and assistance to the TCF sector beyond 2005.

The TCF sector is heterogeneous, and there are areas where Australian firms can produce a sufficiently differentiated product that will allow them to prosper with further-reduced or even no protection. Nevertheless, the more competitive TCF sector that will eventually emerge can be expected to be substantially smaller than at present.

Frank Foley
Economics@ANZ
Email: foleyf@anz.com

ANZ is represented in:

AUSTRALIA by:
Australia and New Zealand Banking Group Limited
ABN 11 005 357 522
10th Floor 100 Queen Street, Melbourne 3000, Australia
Telephone +61 3 9273 6224 Fax +61 3 9273 5711

UNITED KINGDOM by:
Australia and New Zealand Banking Group Limited
ACN 005 357 522
Minerva House, PO Box 7, Montague Close, London, SE1 9DH, United Kingdom
Telephone+ 44 207 378 2121 Fax+44 207 378 2378

UNITED STATES OF AMERICA by:
ANZ Securities, Inc.
(Member of NASD and SIPC)
6th Floor 1177 Avenue of the Americas
New York, NY 10036, United States of America
Tel: +1 212-801-9160 Fax: +1 212-801-9163

NEW ZEALAND by:
ANZ Banking Group (New Zealand) Limited.
Level 10 215-229 Lambton Quay Wellington, New Zealand
Telephone +64 4 496 7000, Fax +64 4 496 7360

In Australia, ANZ Investment Bank is a business name of Australia and New Zealand Banking Group Limited, ACN 005 357 522 ("ANZ Bank"), which is a licensed securities dealer. In New Zealand, ANZ Investment Bank is a business name of ANZ Banking Group (New Zealand) Limited WN / 035976 ("ANZ NZ").

This report is being distributed in the United States by ANZ Securities, Inc. ("ANZ S") (an affiliated company of ANZ Bank), which accepts responsibility for its content. Further information on any securities referred to herein may be obtained from ANZ S upon request. Any US person (s) receiving this report and wishing to effect transactions in any securities referred to herein should contact ANZ S, not its affiliates.

This report is being distributed in the United Kingdom by Australia and New Zealand Banking Group Limited, ("ANZ Bank, UK") for the information of its market counterparty and intermediate customers only. It is not intended for and must not be distributed to private clients. In the UK, ANZ Bank is regulated by, and is a member of, the Financial Services Authority ("FSA"). Nothing here excludes or restricts any duty or liability to a customer which ANZ Bank, UK may have under The Financial Services and Markets Act 2000 or under the regulatory system as defined in the Rules of the FSA.

This research publication of ANZ Bank is issued on the basis that it is only for the information of the particular person to whom it is provided. This report may not be reproduced, distributed or published by any recipient for any purpose. Any recommendations relating to securities contained herein are based on a consideration of the securities alone, and as such are conditional and must not be relied upon without specific advice from your securities advisor as to the appropriateness to you given your individual investment objectives, financial situation and particular needs. Under no circumstances is this report to be used or considered as an offer to sell, or a solicitation of an offer to buy.

In addition, from time to time ANZ Bank, ANZ NZ, ANZ S, its affiliated companies, or their associates and employees may have an interest in any securities directly or indirectly the subject of this report (and may receive commissions or other remuneration in relation to the sale of such securities), or may perform services for, or solicit business from, any company the subject of this report. If you have been referred to ANZ Bank, ANZ NZ, ANZ S or its affiliated company by any person, that person may receive a benefit in respect of any transactions effected on your behalf, details of which will be available upon request.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable. The views expressed in this report accurately reflect the author's personal views about any and all of the securities and issuers referred to herein. The author however makes no representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this report and are subject to change without notice. No part of the author's compensation was, is or will be directly or indirectly related to specific recommendations or views expressed about any securities or issuers in this report. ANZ Bank, ANZ NZ, ANZ S, its affiliated companies, their directors, officers, and employees disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation.

Where the recipient of this publication conducts a business, the provisions of the Consumer Guarantees Act 1993 (NZ) shall not apply.

For further information, please email economics@anz.com