Key themes from the Treasury Business Liaison Program — February 2008

As part of Treasury's Business Liaison Program, Treasury officials met with more than 40 businesses, and some industry and government organisations, in Sydney, Melbourne, Bathurst and Orange in February 2008.[1] Collectively the firms interviewed directly employed or represented the employers of over 1 million Australians. An additional round of telephone interviews was conducted with retail firms in mid-April, with follow-up consultations in late May.

Most retailers had experienced very strong sales in late 2007 and early 2008, and were still anticipating solid outcomes, although there was wariness about the prospective impact of higher interest rates and weak consumer confidence. During March there was a significant slowdown in sales. Sales were better than expected in April, before slowing again through May.

More broadly, the strongest part of the economy continued to be the mining sector and associated construction activity. Manufacturers were concerned about the effect of the appreciation of the Australian dollar, though many benefited from lower input costs. Companies indicated the labour market remained tight and there were shortages of workers with key skills, but they anticipated this to cause only a modest acceleration in wages. The appreciation of the dollar, and competitive pressures, were limiting the impact of strong demand on inflation.

Treasury greatly appreciates the time and effort committed by the businesses, industry associations and government agencies that participated in the program.[2]

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1 A detailed explanation of the Treasury Business Liaison Program is provided in the Treasury *Economic Roundup*, Spring 2001.

2 This summary reflects the views and opinions of participants, which are not necessarily shared by Treasury. While Treasury's evaluation of the economic outlook is informed by findings from business liaison, a much wider range of information and data is utilised to ensure a rigorous assessment of the Australian economy.

Retail sales

Retailers reported very strong trading conditions through the end of 2007. However, there were growing expectations that the pace of sales growth would moderate over the course of 2008. Expectations of a softening were based on negative news reports regarding international financial and economic conditions, tighter domestic monetary policy, and weak consumer sentiment.

Many retailers reported that the strength of sales suggested that there was no evidence of any slowing in economic activity. Despite high levels of household debts and high interest rates, sales of 'big ticket' electrical goods were reported to be very strong, driven by price falls arising from rapid product development and exchange rate appreciation. Retailers spoke of continuing strong sales growth in Western Australia, the Northern Territory and south-east Queensland, reflecting the mining boom and strong population growth. Outcomes in South Australia had surprised on the upside, whilst slightly weaker than expected sales growth was reported in Victoria. Sales in New South Wales, and particularly Sydney, were mixed, with strength in the northern and eastern areas of Sydney offset by flat to falling sales in western Sydney.

Treasury's business liaison meetings were held following the increase in interest rates in February, but prior to the increase in March. Many contacts were anticipating the additional increase. Treasury conducted telephone interviews with a number of retail contacts following the increase in official interest rates in March, and additional increases in bank lending rates.

Intelligence from retailers indicated that retail sales dropped in a sharp and uncharacteristically abrupt fashion in March. Many retailers, who had been experiencing 5-7 per cent annual increases in sales, noted that sales were flat or up only slightly compared to the previous year. Retailers attributed the slowdown in spending to the confidence impacts of volatile financial market conditions and associated uncertainties.

Easter fell during March in 2008, clouding comparisons with previous years' sales data. Treasury conducted follow-up interviews with retail contacts in late May to ascertain how sales over the March/April period had performed. Some retail contacts were able to provide early indications of May sales outcomes.

Liaison contacts reported better-than-expected sales in April, though there was little change in the composition of goods sold during the month. Where available, sales were again weak through to the latter half of May, though not as significantly as the March downturn. State-by-state performances remained relatively comparable to recent history through March and April, with sales in Western Australia and Queensland growing strongly, and New South Wales and the ACT performing poorly.

However, a number of national retailers reported that sales in Queensland and Western Australia were weak during May, converging to around the national average in comparison to previous high rates of growth.

Retailers reported that though overall sales were down, it was still possible to move goods if priced correctly. Anecdotal evidence suggests many smaller retailers conducted unscheduled sales, and were prepared to take out advertising at premium rates. A number of larger retailers had anticipated some slowing and had factored this in to forward orders. These retailers were less encumbered by unplanned inventories, and suffered less of a contraction in gross margins.

Consumer demand for electronic goods such as plasma Televisions, entertainment consoles and accessories remained strong. Sales of grocery and food items remained solid, with food retailers reporting no evidence of consumers substituting higher end products for lower end goods (for example, moving down from steak to sausages and mince or name brand to cheaper home brand goods).

Sales of non-electrical big ticket items, such as furniture, were well down. Apparel sales were down, particularly children's wear and youth apparel which numerous retailers reported were down substantially.

Retailers' expectations were for weakness to continue through the coming quarters, with a number expecting possibly negative comparable sales growth. There was some concern that a range of smaller retailers had not experienced a significant downturn before, and this inexperience, combined with tighter access to financing, might see a number of smaller traders close.

Manufacturing

It was noted that the impacts of the ongoing appreciation of the Australian dollar were being managed well by most manufacturers. Though many manufacturers described the increased competition faced from importers and the challenges the higher Australian dollar presented when exporting, most noted the offsetting benefits of lower input costs. This was particularly the case for those importing agricultural commodities — especially dairy — where raw input prices have reached record levels in US dollar terms due to global shortages, but have increased by less in Australian dollar terms.

Some manufacturers noted that in a number of cases, rather than increasing margins, importers had taken advantage of the higher Australian dollar to increase the quality of and features included in their products. This was having an impact on the attractiveness of imported products, particularly in the automotive sector.

Housing

Reports of marked divergences continued to feature across the Australian housing market. House prices performed strongly in areas that had experienced rapid growth due to mining or minerals and energy-related projects. Contacts reported that housing markets on the outskirts of major capital cities, particularly Sydney, continued to attract little interest. Demand for larger houses in these areas remained weak, with downward pressure on prices.

Developers reported exceptionally strong demand for apartments. Demand for these dwellings was holding up given their usual location in more desirable inner-city neighbourhoods that are closer to jobs, services and major infrastructure. Weak demand for new dwellings in outlying markets was being driven by high petrol prices, lack of adequate public transport and the high cost relative to existing dwellings due to construction costs and urban infrastructure charges.

Contacts suggested that it was too soon to see significant evidence of investors rotating out of equities and into residential property as has occurred in previous cycles. There was suggestion that such behaviour may be more muted given increased financial literacy of households and the higher proportion of household assets held in superannuation accounts. An end to the current monetary policy tightening cycle, and potentially a return to looser policy, was suggested by contacts as a probable catalyst for the return of household investors to residential property markets.

As a result of continued weakness in housing construction, contacts expected that rents would continue to rise strongly in the short term. Vacancy rates remain tight across major capitals, and acute in more preferred regional sub-markets. Contacts expected this to result in increased reports of prospective tenants offering to pay higher rents to secure tenancies.

Low vacancy rates, and rising prices in some areas, had led to a growing recognition amongst developers and real estate agents of the present imbalance between supply and demand for housing. The costs, uncertainties and delays in approval processes, along with urban infrastructure charges, were cited as factors hampering the ability of the market to respond adequately.

Contacts remained concerned about the capacity of the housing industry to respond to what many expect could be a rapid pick-up in activity in the latter half of 2009. Skills shortages were expected to be exacerbated by demographic trends in the housing construction workforce, with major retirements anticipated at the same time as the expected resumption in housing activity. Lower levels of apprentice completions in building trades, relative to the number of skilled personnel exiting the industry, were expected to result in stretched-out completion times and lower build quality.

Business investment

With business activity strong, a number of firms were planning to increase capital expenditure. While some investment projects are designed to reduce the need for workers, a shortage of skilled workers was often stated as a reason that some of these projects were being deferred. This is because whilst some investments reduce the required number of relatively low skilled workers, they create a requirement for ongoing high-skilled maintenance and technical personnel. A large number of firms were undertaking investments to reduce their energy costs and water usage. These decisions were being driven by recent cost increases, and expectations of future rises.

Many contacts reported that they were not yet experiencing significant impacts from recent developments in financial markets. This was because many firms have long-term financing agreements with their lenders, and had locked in funding terms prior to developments in the middle of 2007. However, contacts reported they would have been paying higher financing costs and may have faced borrowing constraints if they negotiated these same agreements in February 2008. Those firms that are active in capital markets had modified their borrowing patterns to diversify risks and reduce costs. This included conducting smaller, more frequent capital raisings across a broader range of markets.

Firms reported that financing conditions were not having an impact on investment decisions already taken, but would be a consideration in future decisions and could thus begin to impact investment activity commencing from early 2009.

Consistent with reports from previous rounds, production and exports continued to be constrained by capacity in rail and ports, and considerable investment was continuing in these areas. A number of contacts mentioned they would like to make more use of rail transport (and noted that it is environmentally preferable) but reported that links between major centres were inadequate as there has been insufficient investment over many years.

Employment

Most firms indicated that they planned to increase employment over the coming year. Many said they would expand employment more if there were more workers available.

Highly skilled tradespeople remained difficult to find given general skills shortages and demand from the resources sector. Shortages of experienced employees were noted in highly skilled professional fields, particularly engineering, finance and project management. Firms also reported that the major accounting firms had raised prices and in some cases had rejected work due to personnel constraints.

Contacts reported that they were adapting their human resource management practices in response to increased turnover and competition from regions and industries benefiting from the resources boom. Contacts had identified and improved career development opportunities to retain existing staff, and had increased staff training in response to turnover and less experienced recruits.

Mining and associated activities continued to attract employees from other sectors of the economy. Farmers and rural towns near mining areas faced particular difficulty in retaining workers. Some firms had concerns about the ageing workforces in some trades such as bricklaying. The use of '457' visas was reported as becoming more widespread, though some smaller employers continued to claim that the scheme was administratively difficult.

Wages and other costs

Notwithstanding the tight labour market, there were no suggestions of a generalised surge in wages, but a gentle pick-up in expectations of wage increases.[3] Some firms scheduled to recommence wage negotiations had reported concern that the initial bargaining positions of employee groups were higher than previous negotiations, due to increased inflation expectations. However, other firms reported that they were feeling less pressure than they otherwise would have for wage increases because of increases in after-tax incomes driven by recent tax cuts.

Companies continued to report instances of 'grade inflation' — paying people at a higher grade for the same duties — and a tendency to promote people faster than their experience would normally warrant in order to attract new recruits and retain workers. A small number of firms reported that they were keeping some personnel on special projects whilst they did not have specific roles given the difficulties in finding suitable replacement staff when workflows pick up.

Though not widespread, contacts described cases of significant increases in electricity prices following the expiration of contracts. This may reflect some of the impacts of the drought and higher coal prices on generators, however the extent to which price rises represented catch-up by suppliers after long periods of price stability was unclear. Peak pricing of electricity loads was leading some firms to modify operations to reduce costs. Higher water prices, along with higher electricity costs, were driving some firms to reduce usage.

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3 Overall, the median increase in wages over the previous year reported by the companies interviewed in February was 4.0 per cent, with the same increase expected to be paid over the coming year. Weighting by employment, the mean wage increase was 4.7 per cent and the expected increase was 4.9 per cent.

Prices

Underlying inflationary pressures were rising, although the exchange rate appreciation was containing import prices. Companies suggested that competitive pressures were limiting price increases. This was compressing margins, although profits generally remained strong.

New car prices were static, with importers instead incorporating more features as 'standard' inclusions, while used car prices were falling.

Contacts reported that significant price increases in basic food commodities and inputs for producing those commodities domestically were being absorbed in upstream production processes. Rather than passing on significant price rises to consumers, retailers were reported to be pressuring processors and producers to absorb costs by reducing margins.

Reports of significant increases in food prices, and particularly dairy products, continued. Price rises were not solely due to the impacts of drought in Australia — increased climate variability has been having an adverse impact on agricultural output across a range of producing areas globally. Further, according to the contacts, global prices of food have increased as farmland is increasingly used to produce biofuels, subsidies have been removed, and global inventories have been run down. Contacts also noted that demand increases from emerging markets in Asia were driving a boom in agricultural product prices. In the midst of a strong outlook for demand in the future, production was not expected to return to previous levels across many Australian farming regions because of the exit of farmers from the industry.

Regional areas

Recent rains had boosted confidence in those areas that had received them. Improved seasonal conditions were expected to lead to increased plantings. Prices for many agricultural commodities had risen substantially, given climate variability and increased demands on food crops as alternative energy feedstocks. Contacts reported unprecedented strong demand for agricultural products — particularly beef and lamb — driven by strong employment and wages growth domestically, and income growth in emerging markets. Higher prices for many commodities and strong demand have reduced the adverse impacts of the appreciation of the Australian dollar.

The February business liaison round included meetings in Bathurst and Orange. Both towns have diversified economic bases which have insulated local economies from the impacts of drought to some degree. Orange has been experiencing some impacts from the mining boom due to expansions of the nearby Cadia gold and copper mine. Contacts reported the impact of the mine on the availability of skilled labour in the town, and on wages. The wine industry and manufacturing also remain important in Orange's economy.

Charles Sturt University has campuses in both cities, with around 2,500 students in Bathurst. The relatively large student population, including international students, has been helping drive the local economy, though this did have an impact on the availability of rental accommodation. Food processing operations have become increasingly important to Bathurst's economy, though there have been some reductions in operations due to rises in the Australian dollar. Robust employment in both cities has helped many rural families in the region survive the drought through supplementing farm income with other employment.

Carbon pricing and trading

Many companies supported a prompt introduction of an emissions trading or carbon pricing scheme to enable better business planning. The preparedness of firms varied, though most larger enterprises were aware of the reporting obligations that have been announced. Following ratification of the Kyoto Protocol many firms were commencing programs to meet their obligations and initiate reductions. A number of firms already had efficiency and reduction programs and investments in place.