Key themes from the Treasury Business Liaison Program — July-August 2004

The following article is a summary of findings from the Treasury Business Liaison Program conducted in July-August 2004.[1]

The general view of businesses on economic conditions remains positive. Domestic demand is holding up well and firms expect this to continue. Construction activity is expected to slow gradually. Investment plans in the resources sector remain very strong. Firms report labour cost pressures as generally contained, and inflation pressures appear subdued.

Treasury greatly appreciates the commitment of time and effort made by the Australian businesses and industry associations that participate in this 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 of business conditions reported in liaison meetings reflects the views and opinions of participants. It is provided for the information of readers. 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.

Overview

The latest business liaison round comprised meetings in Sydney, Melbourne, Brisbane, Perth, Adelaide and Newcastle. The discussions took place in July and August, prior to the recent run-up in global oil prices. While the meetings are a limited sample of business opinion, they do offer a useful window on developments and expectations in the economy. Given that the feedback from interviewees was generally informed by experience in their own businesses, views may conflict with the aggregated summaries of the economy presented in macroeconomic forecasts and more widely based surveys.

There was an overall optimistic tone in the interviews, consistent with more recent published surveys of business sentiment. Firms reported domestic demand as resilient and they expected this to continue. While construction was expected to slow gradually, there are many large projects starting up in the resources sector. This healthy outlook for activity was also reflected in many firms' expectations for increased employment.

As noted in the *Pre-Election Economic and Fiscal Outlook 2004* (PEFO), while rising household debt, and particularly the rising proportion of highly geared households, is rendering the household sector increasingly vulnerable to shocks, there is no evidence of immediate problems. This view was supported by financial intermediaries, which generally did not report any increase in delays in repayments.

Retail activity was reported as particularly strong in Queensland, largely attributed to migration from the southern states. The housing sector was also reportedly stronger in Queensland. The West Australian economy was also doing particularly well, buoyed by the strength of the mining sector. This pattern is consistent with recent ABS data on retail sales.

As in previous rounds, some skill shortages were evident, but it was reported that so far this has not led to an acceleration in wages. Many businesses emphasised their lack of pricing power, adding support to the PEFO forecast that inflation will remain within its medium-term target band despite higher oil prices.

Consumer spending

Consumer spending was envisaged in the Budget to remain robust but ease as flat house prices no longer generate large increases in wealth. Firms interviewed generally agreed with this scenario. Some contacts reported that the payments to families announced in the Budget had led to a surge in sales in the week the payments were received, while others had experienced a more gradual increase. This contrasts with the retail sales statistics in recent months.

Retailers were generally confident that underlying demand would remain robust. This accords with the results from consumer surveys which found sentiment around ten-year highs. Some retailers expected consumer durable sales to ease in line with reduced activity in the housing market (see below). The motor vehicle industry had achieved strong sales, with buyers thought to be attracted by additional features being added to cars with no increases in prices.

Housing sector

In most capitals, the liaison participants reported falling inner city apartment prices and flat suburban prices. This was occurring despite higher building costs. Reports of modest overall falls in house prices are consistent with published house price indices, and the Budget forecasts of a marked slowing in household wealth.

Lenders outside Sydney and Melbourne reported little decrease in demand from owner occupiers. However, some have noticed a cooling off by individual investors. At the same time, some lenders were becoming less willing to finance investors, particularly for inner-city apartments. Sales of apartments were said to have peaked in late 2003.

There is still considerable building activity underway, and some builders are turning away work. In many cases, contacts said that shortages of skilled workers, or of materials, were delaying construction. The many projects still in the pipeline should support activity for some time, but fewer new projects are being started by developers.

Commercial construction

Construction companies said that office building has been slower to come off than they had expected although commencements peaked some time ago. There have been large rises in steel prices, which have increased costs and may lead to the cancellation of some projects.

Other types of building — hotels, factories and warehouse construction — remain generally strong. Engineering works, such as facilities for the 2006 Commonwealth Games in Victoria and roadworks in Sydney, are also supporting activity.

Manufacturing

A common comment by manufacturers interviewed was that competition from China, and to some extent other Asian countries, is becoming more intense and now extends to more sophisticated goods. Contacts also referred to the Chinese firms becoming more savvy in their design and marketing.

The automotive industry noted that the exports of cars are the highest they have been for many years, with the Middle East being a particularly important market. But component manufacturers were under pressure as the domestic car producers are increasingly sourcing from overseas. Higher oil prices had not yet had a significant impact on demand for cars and related products.

Some niche manufacturers are thriving. Interviewees in this liaison round referred to successful manufacturers of such diverse products as specialist gases, hyperbaric chambers, electrical substations and electronic ticketing systems. Many of these had found export markets.

Commodity exports

Rural exports have recovered since the drought. The recovery has been more rapid for crops than for livestock, as pastoralists rebuild their flocks and herds. This is one reason why rural employment is lagging the recovery in rural production; but in some cases farmers wanting to expand employment said they had found it hard to attract back workers who moved to mining areas or the cities during the drought.[3] Grain harvests were expected to be strong in southern and western Australia, but there were concerns that prices may soften due to large global harvests. In contrast, some parts of New South Wales and Queensland were still very dry.

Resource demand continues to be very strong, with demand from China a driving force. While there were suggestions of the Chinese economy slowing in recent months, exporters report no noticeable effect to date.

Ports and shipping companies generally reported higher business. There has been some progress made in alleviating the supply chain constraints that have been limiting commodity exports. Notably, the queue of ships off Newcastle had come down from around 50 to more normal levels in the single digits.

Resource companies have a large number of investment projects underway, with the aim of increasing production capacity in order to take advantage of strong international demand, particularly for iron ore, coal and base metals. Some of these projects will provide a 40 per cent increase in production capacity, but in many cases the peak production will not be reached for another two to four years. For some projects the output of the mines has already been sold through long-term contracts.

3 For further information, see 'The impact of the 2002-03 drought on the economy and agricultural employment' in the *Economic Roundup Autumn 2004*.

Exports of services

Increasingly, an important component of Australia's export income comes from services. The two most important service exports are tourism and education.

Tourism suffered from traveller wariness following the terrorist attacks in the United States in September 2001 and Bali in October 2002, and the outbreak of SARS in the first half of 2003. As these concerns moderated, hotels and airlines reported higher occupancy rates. The Chinese government recently made it easier for tourists from China to visit Australia and with large numbers of Chinese households reaching income levels at which foreign holidays are affordable, this has been a significant source of new arrivals. As well as tourism, hotels reported good business from international meetings and conferences.

Academic contacts stated that foreign, fee-paying students now make up 10-20 per cent of students at many Australian universities. Computing and MBA courses are especially popular with overseas students. Asian students (mostly from China, Hong Kong, Malaysia and Singapore) generally come to do their whole degree in Australia, but US and European students often come just for a semester. While being located in a 'safe' part of the world makes Australian universities more attractive, contacts mentioned that the appreciation of the Australian dollar had caused some slowing in foreign enrolments. As well as teaching foreign students on domestic campuses, some Australian universities have been establishing arrangements to teach in other countries, sometimes as part of joint ventures.

Labour market

With demand expected to keep growing robustly, firms anticipated employment growth continuing at a healthy rate. This supports the forecast in the *Pre-Election Economic and Fiscal Outlook 2004* that unemployment would remain below 6 per cent.

There was increased concern this round about a shortage of skilled labour in certain regions and occupations. Some of the shortages, such as for draftsmen and bricklayers, were in the construction sector, and might be expected to ease as activity in that sector slows. But interviewees thought that other shortages would persist. Respondents noted that some kinds of engineers, mechanics, specialist drivers and certain skilled tradespersons were in short supply. Some contacts also considered that the trend towards earlier retirement may be worsening the problem.

The skill shortage was partly attributed to a lack of apprentices. Respondents suggested that the number of apprenticeships on offer had declined. Moreover, the pay rates for apprentices contributed to a 'stigma'. Respondents felt that apprenticeships were perceived as inferior to full-time tertiary education.

Unsurprisingly with the unemployment rate falling, some firms reported it harder to find quality staff even where there were plenty of applicants with the basic qualifications. This applied especially to accountants, although there were also references made to shortages of high quality managers, salespersons and programmers.

These observations are consistent with the increases in vacancies reported in the ANZ and Department of Employment and Workplace Relations (DEWR) surveys. It also accords with the Sensis Business Index, which has been reporting small and medium size enterprises citing skill shortages as their primary or secondary concern in recent surveys, and similar results from the July 2004 Australian Chamber of Commerce and Industry survey. The DEWR's 2004 Skill Shortage Lists identified national skill shortages for child care workers, accountants, nurses and health specialists.

Wages pressures were becoming evident in some areas of acute skill shortages. But overall wages were only strengthening marginally despite historically low rates of unemployment. This suggests that inflationary expectations are now well anchored within the 2-3 per cent band agreed between the Treasurer and the Reserve Bank as the medium-term target. It also gives support to the ideas advanced in Statement 4, Maintaining Low Unemployment in Australia in Budget Paper No. 1, *Budget Strategy and Outlook 2004-05* that unemployment can stay below 6 per cent.

Inflation

Few firms reported having much pricing power. As noted above, component suppliers in particular said that large companies were increasingly comparing prices around the world and sourcing supplies where they were cheapest. Communication and computing costs were continuing to fall. Car manufacturers suggested price competition could become more intense as the January 2005 drop in tariffs draws nearer.

The exchange rate stabilised in the June quarter, after a brief depreciation ended a prolonged period of appreciation. Some of these earlier exchange rate rises were yet to be fully reflected in prices so, on balance, firms expected the exchange rate to restrain prices.

The main inflationary impetus during recent months was the sharp rise in global oil prices. As well as the direct effect on petrol prices, this was feeding into higher prices for electricity, plastics and transport. Some airlines passed on the oil price rise in ticket costs. Most respondents were assuming the oil price would fall over coming months unless there were a major supply disruption in the Middle East. In the event that this assumption is incorrect it suggests firms may face tighter margins going forward. Sharp rises were also reported in steel and cement prices.

As mentioned above, wage pressures were reported as contained. With the ongoing productivity improvements companies are achieving, unit labour costs are consistent with inflation remaining within the medium term target range.