Key themes from Treasury's Business Liaison Program

As part of Treasury's Business Liaison Program, staff met with around 50 businesses and some industry and government organisations, in Sydney, Melbourne, Brisbane and Perth during September, October and November 2008.[1]

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

In general, the discussions revealed operating conditions to be somewhat more robust than current readings of consumer sentiment and business confidence would suggest. That said many businesses are anticipating more difficult conditions in the first half of 2009 before a turnaround in the second half.[3]

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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 in the liaison program, 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 used to develop a more rigorous assessment of the Australian economy.

3 This summary focuses in more detail on the construction, mining and retail sectors. Additional meetings were held with representatives from the banking and finance, manufacturing, wholesale trade, accommodation, transport, real estate and employment services sectors and the general themes arising are reported. The program encompasses the full range of sectors and Treasury aims to meet with a broad cross-section of the business community over time.

Business credit

Overall, firms reported that credit conditions had tightened over the past year, particularly in recent months. While lending standards have become more restrictive in recent months, contacts advised that in general the business case for new borrowing had also become unfavourable, suppressing demand for credit.

As might be expected, the smaller organisations were generally finding it more difficult to secure funds than the larger organisations — larger parent firms can more easily secure credit for their subsidiaries. Firms also reported that the cost of credit had increased significantly over 2008, due to higher interest rates on borrowings and more onerous fee structures.

Construction firms reported that credit for prospective building projects (residential and non-residential) had diminished significantly — from both domestic and foreign sources. This was also the case for some mining firms. In particular, small and mid sized firms (particularly base metal producers) were finding it difficult to secure credit for new mining projects. Larger miners were also becoming increasingly sensitive to credit market conditions. Retailers and distributors noted a general tightening of credit but no significant deterioration in accounts receivable.

Sectoral activity

The broad consensus among non-residential construction contacts was that the current investment cycle reached its peak earlier in the year. Levels of activity remained high, but the value of future work entering the pipeline has slowed. For the period ahead, construction firms expected the slowing domestic economy and tight credit conditions to weigh on activity.

Mining firms reported a slowing in activity, appearing first among smaller to mid sized firms and more recently extending to the larger players. Some mining firms reported that slowing global growth had begun to impact on exports, with foreign customers pushing back on orders. This had led to scaling back of production and a number of closures. However, mining (and related construction) firms were generally optimistic regarding the longer term outlook. Mining firms expected strong future demand growth for their product — driven by ongoing development in China and other emerging Asian economies.

Retail firms reported that trading conditions had been relatively weak since around March 2008. Retail sales spiked somewhat in July and August, due in part to the July 2008 tax cuts and, for retailers of household electrical items, the Olympics, however sales growth has since eased. Those exposed to the rural sector reported

relatively favourable conditions as somewhat better seasonal outcomes began to flow through.

In general, smaller retailers had found recent trading conditions more severe than larger retailers. Shifts in retail market share and changes in the composition of consumption away from more expensive, discretionary items were said to be buoying conditions for certain retailers, while worsening conditions for others.

As a response to potentially weaker sales growth, retailers (particularly the larger players) were undertaking aggressive advertising campaigns.

Retailers expected trading conditions to hold up over the Christmas period before weakening further into Easter, with most contacts not expecting an upswing until around mid-2009.

Investment plans

The investment outlook varied by sector, depending on credit conditions as well as the relative exposure to the domestic and international economies.

Construction firms reported a very uncertain investment outlook across much of the sector, but most notably for office construction. In particular, reduced credit availability meant that prospective projects which had not yet secured financing (but might still have been financially viable) could not be progressed. As a result, firms' forward investment pipelines were relatively empty. Over the next several months, firms had sufficient projects on their books (current projects and those that had obtained financing), to sustain investment activity at around current high levels. Beyond that, construction activity was seen to largely depend on the extent to which credit constraints ease and demand holds up.

The investment outlook for mining (and related construction) firms differed substantially, reflecting relative credit constraints and recent trends in output prices. Credit constraints and lower commodity prices are compelling some firms to review and in some cases defer expansion projects. Firms that had been unable to secure credit for new projects (mainly small and mid sized miners) had been forced to defer investment. Overdraft facilities and trade credit were also tightening. Recent commodity price falls, particularly for base metals, had also forced some firms to delay projects. Many firms were reassessing their investment plans amid softening export revenues, but widespread changes are yet to occur. However, miners remained relatively optimistic regarding the longer term investment outlook, maintaining significant forward investment profiles.

With trading conditions expected to improve by around mid-2009, most retailers were planning some form of investment in the period ahead. Some firms were planning expansions, while others were planning refits of existing stores as part of a rolling refurbishment schedule. In general, firms reported that tighter credit conditions and higher financing costs had not (as yet) significantly affected investment plans — although these were cited as major risks to investment plans.

More generally the outlook for business investment appears set to soften into 2009 as expansion programs and non-essential maintenance for plant and equipment are deferred. This should largely be a timing issue, albeit contingent on the expected recovery materialising.

Employment and skills

In line with the expected slowing in activity, firms reported a weakening employment outlook. As a result, the acute skills shortages, particularly within the mining and construction sectors, were expected to ease.

Construction firms expected to reduce employee numbers in line with softening construction activity. As with investment, the outlook for construction employment was reported as being uncertain. Some construction firms had reduced employee numbers in recent months, reflecting weakening construction activity — most notably in New South Wales.

Skill shortages were reported as still being a key concern for construction firms (with most firms reporting that shortages had not abated significantly over the past year), however firms expected shortages to diminish with easing labour demand. Shortages were reported as being most acute for categories of workers with skills which are readily transferable to the mining industry, for example project estimators and developers. This, as well as strong competition for workers within the construction industry, meant that firms were finding it difficult to retain staff.

The outlook for mining-related employment was also reported as being largely dependent upon the investment outlook, with mine (and related infrastructure) construction requiring significantly greater labour resources than mine operation.

For mining and related firms, shortages were still present across most professions, most acute for highly skilled workers such as engineers. Mining firms reported that skilled labour constraints had subsided somewhat, in part due to the 457 visa program.

With retailers expecting sales growth to slow in the period ahead, firms foresaw the need to reduce employee hours in order to protect margins. Some retailers had already made small adjustments to employee hours in recent months, in line with worsening

trading conditions. Compared to other sectors, retailers are more able to make such adjustments — employing a relatively high proportion of casual workers.

For retail firms, skills shortages were still a relatively minor issue. However, retailers reported that it was difficult to find and retain 'quality' staff, in particular those at management level. This was reported as being most acute in Western Australia.

Wages and other costs

Regardless of their sector, firms reported that wages growth had been relatively stable over the past year — notwithstanding the relatively tight labour market. However, rates of growth still differed widely across sectors and professions, with the resource boom in Queensland and Western Australia remaining the key driver in this regard.

Construction firms were still confronting strong wages growth, particularly for those professions that are transferable to the mining sector. There were expectations of some easing in wage pressures in line with moderating demand. For miners, construction workers and train drivers were reported as commanding particularly high wage rates. With regard to remote mining regions, wages growth was reported as being exacerbated by substantive house price growth, such that fly-in fly-out workers were more cost effective. For retailers, wages had been increasing broadly in line with the CPI over the past year.

Retail firms reported that prices of imports from Asia had begun to increase, reflecting wages growth and the removal of export subsidies. In addition, the rapid currency depreciation was expected to raise the landed cost of imports. As a consequence, retail firms were seeking alternative import sources. Overall, firms were still experiencing strong cost pressure from rising transportation and electricity prices, however this was expected to abate somewhat as cheaper fuel prices flow through to users.

Construction and mining firms reported ongoing sharp rises in the cost of materials, particularly steel and concrete, although steel costs were beginning to subside. For miners, freight costs had also eased recently reflecting softening global demand for shipping capacity. Retailers reported strong increases in rents, particularly in shopping malls.

Prices and profits

Margins for building construction firms had diminished significantly over the past year, largely reflecting strong increases in construction costs. Looking ahead, construction firms expected additional margin contraction as commercial property prices ease.

Mining firms stated that the recent commodity price falls represented a significant brake on their profitability. Over recent years, mining firms have generated substantial profits from high commodity prices. Falls in commodity prices will dampen revenue as lower prices are reflected in new contracts (the recent exchange rate depreciation has provided a boost to revenues for those miners that sell in US dollars).

Despite the recent commodity price falls and anticipated near-term weakness, mining firms were relatively positive on the longer term outlook for prices. In particular, while bulk commodity producers did not expect any further rises in contract prices this cycle, they did expect prices over the longer term to be supported by ongoing strong demand from China and other emerging Asian economies. In this context, miners expected revenue growth to be driven by strength in volumes rather than prices.

Retail firms reported that margins were tight, but were largely being maintained. Strong competition within retailing meant that prices growth had been limited, and with firms facing cost pressures, they had to continuously review their cost structures to protect margins. The impact of the currency depreciation on the price of imports may become more important into 2009.

Regions

From a regional perspective, there was a broad consensus among firms that the New South Wales economy was experiencing particularly weak conditions. Construction firms reported little interest in pursuing developments in the Sydney CBD (were credit constraints not an issue), with developers citing a lack of demand. Retailers observed that the New South Wales market had been weak for some time and they expected it to perform relatively poorly in the period ahead.

The other key theme to emerge was that contacts considered activity in the resource States (Western Australia and Queensland) was beginning to slow following very strong growth in recent years. For retailers, the resource States had generally been the best performing markets, particularly Western Australia. However, sales growth was now expected to moderate in these regions.