# Key themes from the Treasury Business Liaison Program[1] May/June 2002

*The following article is a summary of findings from the Treasury Business Liaison Program conducted in May and June 2002. Treasury greatly appreciates the commitment of time and effort made by the Australian businesses and industry associations that participate in this program.*

## Background

Treasury has conducted a formal Business Liaison Program with the business community for nearly a decade, with the information obtained playing an important role in Treasury's regular assessment of the Australian economy and development of economic forecasts.

Treasury conducts business liaison rounds on a regular basis, with each round typically involving between 80 and 100 contacts (approximately 300 on an annual basis) with individual firms and industry groups over a four to six week period. The contact is predominantly via face-to-face meetings and is supplemented by telephone contacts.

Business liaison meetings typically cover developments in a range of key economic variables: sales, production, stocks, investment, employment, costs, prices, wages, exports, imports and profitability. The focus of meetings is on recent trends, the short-term outlook and gaining an understanding of the factors driving these outcomes.

Although the principal focus of business liaison is the economic outlook, it also provides an opportunity to seek feedback from business on broader policy issues. The key policy comments that emerge from the round are drawn to the attention of the Treasurer and relevant officers within Treasury for their consideration.

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

## Summary

The May/June 2002 business liaison round comprised a total of approximately 90 interviews with contacts in Sydney, Melbourne, Brisbane, Adelaide, Perth and Canberra. Most industry sectors were covered during the business liaison round, with particular emphasis on the mining, agriculture, residential construction, insurance and tourism industries.

The results from the May/June business liaison round indicated that, in broad terms, domestic activity remained quite robust in the June quarter 2002, consistent with ABS statistics and relevant business surveys to date, with business and consumer confidence remaining at healthy levels. Contrary to the overall outlook, the rural economy continues to face many challenges, especially in New South Wales and Queensland.

Looking over the remainder of 2002, indications from business liaison are that the underlying domestic economy is likely to remain quite strong, with healthy consumer demand being partly offset by a modest weakening in the dwelling sector. The employment outlook and hiring intentions were reported as being sound, while inflation and wage pressures appear to remain subdued. That said, these discussions were held prior to the recent increases in uncertainty surrounding the global outlook.

**A summary of business conditions described by liaison contacts is provided for the information of readers, noting that it is based on a sample of 90 observations. A full evaluation of the economic outlook necessarily draws on other information as well as business liaison findings.**

## Sales and production

Strong **retail sales** in the June quarter were attributed to solid consumer confidence and low interest rates, with food and beverages and general merchandise sales particularly solid.

- There appeared to be no discernible difference in the performance of retail trade on a state by state basis.

**Motor vehicle** sales and production continued to perform strongly, with manufacturers and car dealers reporting a high level of sales so far in 2002. Although the industry's earlier production estimates for 2002 were revised down significantly following the events of September 11, strong sales to date have resulted in a large upward revision to these estimates. Going forward, the car industry notes that there is a considerable degree of pent up demand in the market, especially given the current Australian fleet age.

- The release of new and updated models is expected to provide a stimulus for the industry in 2003. Additionally, the clearance of outdated models has accounted for some of the recent strength in passenger vehicle sales.

- The motor vehicle industry and many component manufacturers noted that while overall production levels had been maintained for the year, the adverse impact of industrial disputes on supply chains is a major concern to the industry.

**Manufacturing** companies exposed to the building construction, mining and automobile industries continue to report strong activity. However, those manufacturers with significant export exposure or competition from imported items were concerned about the appreciation of the Australian dollar in the June quarter. The impact of the higher exchange rate on manufacturing production has so far only been noticed in current margins and is yet to affect actual sales or production. Nevertheless, some contacts noted that a sustained higher exchange rate could impact on sales in 2003.

- Currency hedging appears to be used less aggressively by many manufacturers and exporters following the losses made by many companies in the 1990s.

- Residential building supply manufacturers noted that the June quarter of 2002 was very strong, although some commented that they were involved in the final stages of house construction and hence it would be some time yet before they would be affected by any downturn in the housing sector.

## Construction

Contacts in the construction industry indicated that the strength of the **residential** sector in the March quarter 2002 continued, in part, into the June quarter, which was largely attributed to the extension of the First Home Owners Scheme and low interest rates. This pattern was also reflected in the manufacture of building supplies, with sales recovering strongly since September 2001.

The outlook for the next six months was reported to remain quite positive, although there are signs that the new residential construction market is slowing. This view was shared by housing industry associations, agents, developers and material suppliers. The decline in new residential construction is expected to be marked in 2003, especially in New South Wales, although the fall is not expected to be as sharp as the decline in housing activity in the second half of 2000. The expected decline in 2003 is expected to be ameliorated somewhat by a further increase in spending on alterations and additions, continuing an upward trend already evident.

- Industry contacts noted that the downturn in activity is likely to affect apartments relatively more than houses given the degree of oversupply in Sydney and Melbourne. This is reflected in higher vacancy rates, with inner city apartment rents facing downward pressure.

- Slowing in residential construction is expected across most states, with the notable exception of Queensland. Contacts suggested that the strength in the Queensland market is due in part to interstate migration and changing demographics, resulting in growth in inner city and coastal living, especially around the Gold Coast and Sunshine Coast.

Prospects for the **non-residential** sector were reported by contacts to be quite sound and are expected to improve over the remainder of the year. In particular, engineering construction activity continues to rise, especially within mining and oil/gas related sectors. Transport development also continues to dominate, with rail, road and port authorities experiencing a notable increase in activity, in both the public and private sectors.

Many suppliers of construction materials expect that softness in the residential market will be countered by an increase in non-residential construction, especially with transport and infrastructure development.

Current activity in commercial and office space was reported to be flat, with some limited indication that this might improve over the next 2 to 4 years, although hampered by the current high levels of office vacancies.

- Health, including hospitals, continues to be an area of strong growth and solid potential. However, only moderate activity is expected in construction of retail and shopping centres.

## Service industries

A continuing improvement in the **tourism** industry was noted by many contacts, although some tourism operators and related industries are still feeling the effects of the collapse of Ansett and the events of September 11, especially from key markets such as the United States. Additionally, the global economic downturn has had a considerable impact on both arrivals of overseas visitors and their spending habits, with many tourism operators competing more aggressively for a share of the domestic market.

- Up market hotels, which tend to attract a disproportionately higher US clientele, have been hard hit and are still experiencing high vacancy rates. On the other hand, more moderately priced hotels are faring well, with a high level of domestic business and a reported shift in corporate travel toward lower cost accommodation.

- A number of factors were cited that are expected to assist the industry going forward, including the likely economic recovery in Australia's key overseas markets, the expansion of fleets and routes by the major Australian airlines, and Australia's reputation as a safe destination.

**Communication and information technology services** are, in parts, still coming to terms with the collapse of the technology investment bubble and the very strong mobile phone market penetration of the 1990s. Investment in telecommunication infrastructure has fallen significantly in the past year and is expected to remain subdued over the medium term. Contacts suggested that any impetus for further investment will likely be the result of a take up in new technology (for example 3G Spectrum), although there is considerable uncertainty surrounding the current demand for such technology.

- Mobile phone sales are expected to weaken from their previous highs, although margins continue to improve in this sector.

An unprecedented series of events in the domestic **insurance** industry, with the collapse of HIH and the September 11 attacks, have resulted in significant increases in premiums across many classes of businesses. Commercial insurance classes, such as public liability, professional indemnity and builder's warranty insurance, have seen significant increases. Further premium rises are expected, although less pronounced than that of the past six months. Contacts indicated that consumer insurance classes, such as home and contents and car insurance, are likely to have premium rises of around 7 to 10 per cent over the coming year.

- Although big business (the majority of contacts) noted that higher insurance costs had only a minor impact on their overall costs, this appears not to be the case for small companies and community organisations.

- A greater degree of self-underwriting or the carrying of a higher excess have enabled firms to reduce the impact of higher insurance premiums.

## Agriculture and mining

Grain producers (with the exception of Queensland) have enjoyed favourable prices and higher production over the past couple of years, which has led to a significant rise in farm income. However, dry conditions throughout much of Queensland and New South Wales are expected to have an adverse impact on broad acre crops in 2002-03. Water allocation policies were therefore noted to be a very important issue for farmers.

A continuation of low returns for sugar cane growers is expected in 2002-03 with depressed world sugar prices and an uncertain harvest in prospect. Dry conditions in central and southern parts of Queensland and the impact of orange rust is likely to see lower than expected production next year. Also, competition from low cost producers (for example Brazil) and protectionist policies in the United States will contribute towards lower revenue in the near term.

- The cotton industry is also expecting lower returns next year, with a significant decline in area planted to irrigated cotton and depressed world prices.

The current conditions and outlook for many mining companies are reported to be quite positive in the short term. Production of bulk commodities (coal and iron ore) is high, and in some cases is running at record levels, with exports remaining strong. A gradual pick up in world industrial production is expected to provide a boost to both the production and prices of many base metals, although concerns regarding coal and iron ore prices remain. Aluminium production volumes are expected to remain at their current levels, with the outlook for alumina being reported as quite strong.

- Contacts noted that capital expenditure in the mining and oil/gas industries is expected to rise significantly in 2002-03.

## Capital expenditure

The prevailing sentiment on **business investment** was positive.

The mining and petroleum industry noted that there were some significant projects proceeding in the period ahead, with the general outlook for mining investment appearing quite solid.

- Prospects for agricultural investment were reported as being strong this year, reflecting last year's relatively high incomes and the placement of forward orders. Over the medium term, the outlook for agricultural investment appears sound, although investment plans in the short term are likely to be sensitive to developments in seasonal conditions.

Transport infrastructure plans were reported as being on track. Large scale private and public infrastructure plans for roads, ports and rail will provide a momentum for business investment over the next couple of years.

- Reported capital expenditure plans of airlines seems likely to significantly contribute to business investment in 2002-03.

However, contrary to the strong reports in mining and transport, contacts in the manufacturing sector suggested that investment would focus on increasing efficiency rather than increasing capacity.

## Employment and wages

**Employment** demand has been recovering since the December quarter 2001 and is expected to remain reasonably positive in the near term. Contacts indicated that the outlook for employment in the residential construction and related industries remains strong. Abstracting from these sectors, employment intentions were reported to be sound overall. While hiring intentions are modest, no large redundancies were expected by the majority of contacts. Nevertheless, employment in the information and communication technology industries remains subdued, despite the large rationalisation that has already occurred in the industry.

- No major skill shortages were noted by contacts in the majority of industries, with the notable exception of the engineering and construction industry.

**Wages** are expected to increase moderately in the year ahead. Wage increases were reported to generally be around 3 to 4 per cent per annum, with firms continuing to seek productivity gains to offset wage increases.

- A notable exception to this benign outlook is in the Melbourne construction industry. This has been somewhat reflected in higher costs, with the cost of construction in Melbourne now claimed to be in excess of that in Sydney.

## Costs

The main cost pressure noted by firms was rising insurance premiums which were coming up for renewal, although this cost was not expected to have a significant impact on overall profits.

Security costs have increased for some firms, especially those easily identifiable as an American company, and for airports. On the whole, the majority of firms did not view security as a significant rising cost.

Electricity and water charges in some states were on the rise, although much of the increase simply brought prices back in line with their levels of a few years earlier. Telecommunication charges have also risen in some areas. Overall, costs have been moderate and have fallen in many places (for example raw materials).

## Prices

Price pressure overall were reported as being restrained. All contacts continue to experience resistance to price increases to cover any higher costs. Their principal focus is on fighting higher costs by improving productivity. The general theme is one of tight revenues and increasing costs putting pressure on margins, although there were reports that some margin repair was occurring in recent months in some industries.

The appreciation of the Australian dollar during the June quarter has also aided some recovery of margins for some businesses through lower imported input costs. Conversely, some firms face fiercer competition from imported goods, requiring them to squeeze margins and reduce prices. Overall, the appreciation of the Australian dollar against the United States dollar in the June quarter appeared to have placed downward pressure on prices.