Key themes from the Treasury Business Liaison Program — July/August 2003

The following article is a summary of findings from the Treasury Business Liaison Program conducted in July and August 2003.[1] Treasury greatly appreciates the commitment of time and effort made by the Australian businesses and industry associations that participate in this program.[2]

Overall business conditions in the non-farm sector of the economy remained strong in the first half of 2003. However, the external sector, which was affected by the drought, weak world growth and the SARS epidemic, remained weak. Contacts were generally optimistic about the outlook for 2003-04, with emerging signs that the drought is breaking and that the SARS epidemic and the war in Iraq had only a limited and transitory effect on economic activity.

1 A detailed explanation of the Treasury Business Liaison Program is provided in the Treasury *Economic Roundup Spring 2001*. More recent information is contained in the February 2003 business liaison summary report in the *Economic Roundup Autumn 2003*.

2 Summary reports of Treasury's business liaison reflect the views and opinions of contacts. A summary of business conditions reported by liaison contacts 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 is utilised to ensure a rigorous assessment of the Australian economy.

Overview

The July/August business liaison round comprised approximately 110 interviews in Sydney, Melbourne, Brisbane, Adelaide, Perth and Canberra and a series of phone interviews.

The round focused on consumer trends, the construction industry and exports. Conditions in the farm sector continued to be monitored. Treasury met with contacts in agriculture, mining and energy, manufacturing, construction, retail, transport, tourism and accommodation, finance and other services.

In the main, contacts reported solid business performance over the past year. However, contacts in the rural sector and related industries, highlighted the negative impact of the drought on activity. The impact of international security concerns and the SARS epidemic were mixed — with some sectors suffering from reduced international travel while other sectors gained from increased domestic demand.

Most sectors recorded solid sales or production and only moderate pressure on wages and costs. In a number of sectors contacts reported that increased competition was pushing down prices and/or profits.

Contacts generally had a positive outlook for the 2003-04 but highlighted risks around the global economy and the exchange rate.

Retail and manufacturing

Following very strong activity in 2002-03, retail sales were expected to continue to grow in the year ahead, although at a lower pace.

A number of retailers noted that the recent appreciation of the Australian dollar had reduced their input costs, allowing them to recover margins without increasing prices. It was also noted that significant discounting by large retailers was keeping prices down.

Motor vehicle sales and production were reported to be very strong, and heading for another record year in 2003. The industry benefited from strong consumer confidence — driven by higher household wealth, increased access to credit and low interest rates — and the introduction of new models. Businesses were also updating their fleets with newer model vehicles.

More recently, the appreciation of the Australian dollar was a positive for car companies that are net importers in Australia. In addition to improved margins, the appreciation allowed them to provide improved specifications in cars without raising prices (that is, providing effective price reductions).

Views on the outlook for 2004 were mixed. Some contacts anticipated higher interest rates and saturation of the domestic market, making it difficult to increase sales beyond 900,000 per year. However, other contacts remained bullish on the outlook for the industry.

Manufacturing contacts reported sound performance over the past year and were generally optimistic about the year ahead. However, conditions had been tougher in some sectors, particularly those related to rural industries.

Manufacturing companies linked to the automobile and construction industries continued to perform strongly. However, manufacturers of components for the car industry are facing increased competition from low labour cost countries, forcing them to innovate to remain competitive. The push from parent companies for best global sourcing practices and the appreciation of the Australian dollar have added to these competitive pressures.

Manufacturing companies in the pharmaceutical sector reported solid growth in their businesses with only a limited impact from the suspension of Pan Pharmaceuticals. Looking forward, contacts considered their ability to get new products listed under the Pharmaceutical Benefit Scheme to be important.

Construction

Recent business conditions were favourable for the residential sector. However, while the owner occupied segment of the market remained strong, contacts reported some quietening in the investor segment of the market. Some contacts reported no expected new project commencements for the next 1½ to 2 years. This emerging softening in sales was particularly evident in the high rise and medium-density residential segments, although sales for those with prime location remained strong.

Contacts reported that the market in Sydney remained solid, while Melbourne was 'coming off a bit'. However, forward indicators for Brisbane, such as the number of deposits taken, indicated substantial building activity was likely over the year ahead. According to contacts this strong activity is partly being driven by strong interstate migration flows into Queensland.

Work on alterations and additions remained strong, with some builders booked for up to two years. Some contacts also noted that upward pressure on construction costs was making renovations very expensive.

Contacts' views on house prices were mixed, with some expecting them to plateau around mid-2004 while others noted a risk of declining prices. The scarcity of land was reported as one of the main factors behind the recent escalation in house prices. Low interest rates, the poor performance of alternative investments and buyers trying to beat further price increases were also seen by contacts as contributing factors.

The non-residential building segment, was seen by contacts as 'holding up', despite being a bit soft in some markets. For example, in Melbourne an increase in office vacancies and a fall in yields were deterring further investment activity. Some contacts expected office construction to peak by the end of 2003.

Business activity in engineering construction continued to be very strong. The outlook for infrastructure projects remained very positive with several large infrastructure projects on the horizon. Major projects in NSW include the Western Sydney Orbital, the Sydney Cross City Tunnel, the Lane Cove Tunnel and the Parramatta Rail Link.

There are also substantial resource projects currently underway; however, the outlook for new resource project commencements was uncertain. In particular, the appreciating Australian dollar and low prices for some commodities, in Australian dollar terms, had led to deferrals or cancellations of a number of resource projects. Some contacts noted that a further appreciation of the Australian dollar could increase pressure on small to medium-sized players in some segments and stem the flow of new projects.

Agriculture

Contacts expected a very strong rebound in wheat and barley crops with strong planting in South Australia and Western Australia. These high planting acreages reflect the need to generate cash and the reduced demand for grazing pastures associated with the low livestock levels.

Western Australia was reported as having its best start in 20 years with rains having commenced a month earlier than usual. In contrast, as of mid-July, parts of New South Wales, Victoria and Queensland were still experiencing dry to poor farming conditions which, combined with the appreciation of the Australian dollar, was affecting rural exports and farm incomes.

Contacts reported in mid-July that the drought through most parts of Queensland continued to have a substantial negative impact on agricultural production, particularly for cotton and the dairy industry. Some contacts also reported that uncertainty surrounding water management was putting expansion plans on hold in the cotton industry. Although sugar production was not affected by the drought as badly as other commodities, the outlook was uncertain given low world prices and competition from Brazil.

The general view was that livestock numbers were not expected to recover fully until 2005. However, some contacts indicated that solid spring, summer and monsoonal rains could bring the recovery forward into 2004.

The aquaculture export industry was badly affected by the SARS epidemic, which reduced demand from Asia.

Mining

The outlook for mining was mixed, reflecting the improving demand for particular commodities and the impact of the appreciation of the Australian dollar.

According to contacts, demand for coking coal and iron ore — which are used in the steel industry — remains particularly strong. China is the main driver of the strong demand. Japan was also recording increases of 10 per cent per annum in steel production, adding to the strength of demand. Increased competition from Indonesia and China was reflected in a continued downward trend and 'gloomy' outlook for the price for steaming coal.

The market for aluminium was expected to be flat in 2004 but to pick up in 2005, when some contacts expect world growth to have returned to its long-run average.

The appreciation of the Australian dollar, which came on top of relatively low prices, was eroding export margins.

The regulatory treatment of greenhouse emissions remained a key concern for the mining industry, and contacts reported that it will influence investment plans.

Service industries

The year to date has been mixed for the tourism industry, with much of the drop off in international travel being offset by solid demand for domestic travel.

- The strong trading performance for the high end of the accommodation market (five stars) at the start of the year was interrupted between April and June by the SARS epidemic (which reduced overseas tourist arrivals from Asia and Europe). However, business started to pick up again in July.

- The steady growth in the domestic travel segment meant that budget-type accommodation had continued to perform well.

In response to recent global trends, the industry is restructuring and consolidating, with a number of operators converting structures from hotels to serviced apartments. The outlook for the industry is positive, with forward indicators, such as room bookings, conference bookings and airline bookings, all pointing towards a strong second half of 2003.

The 2003 Rugby World Cup is expected to have a positive impact on businesses, with overseas visitors likely to stay longer and travel more widely than visitors who came for the Olympics.

Contacts in the insurance industry reported that, after a recent period of upward corrections, further price increases should more closely reflect inflation. While in general premiums were levelling out, they were still rising sharply in some segments. Profitability was returning to the industry and the outlook was considered promising.

Some contacts in the finance industry reported that activity in consultancy services had started to pick up, following two years of poor trading performance. Tax services in particular were performing strongly. Contacts also reported signs of an emerging turnaround in investment banking services, following significant consolidation over the last two years.

Employment, wages and prices

Contacts generally reported that employment intentions were expected to remain stable and positive in the near term. Hiring intentions for construction and engineering services remained particularly strong. Employment growth in the health sector was expected to remain solid. Some contacts reported that they are increasing their proportion of part time or casual labour as a means of controlling their labour costs and increasing responsiveness to changes in business conditions.

Most contacts expected wage increases to remain moderate — in line with inflation or slightly above — and to be offset by productivity gains. An increased use of bonus or performance linked payments was mentioned by a number of contacts, as a means of keeping wage costs in line with productivity gains.

The appreciation of the Australian dollar, in addition to strong competition in a number of sectors, helped constrain price pressures across the economy. Going forward, contacts expected price pressures to remain limited. The most notable exception was the construction sector, where contacts expected continuing cost and price pressures.