Box A

Insights from Liaison

This Box summarises information collected by five Reserve Bank teams based in Adelaide, Brisbane, Melbourne, Perth and Sydney during discussions with around 250 businesses, industry bodies, government agencies and community organisations over the period from the beginning of February to early-May 2023. Further information on the Reserve Bank's liaison program is provided in the September 2022 *Bulletin* article 'The Reserve Bank's Liaison Program Turns 21'.

Information from the Bank's liaison program suggests that growth in private sector economic activity continued to slow over recent months as higher interest rates and the increased cost of living weighed on consumer demand. Retail spending looks to have declined slightly in real terms since the start of the year. Sales of new detached housing are very weak and firms continue to report financial stress in parts of the construction industry, consistent with the recent increase in business failures in the industry. Community services contacts have reported a sharp increase in demand for their services, in large part reflecting increased living costs for essentials such as rent, energy and food.

There is still a large pipeline of business investment to be delivered, although the sharp rise in costs means that, in real terms, investment at many firms may not increase over the period ahead. Hiring intentions remain positive but have moderated in response to softening demand and are slowing as some firms seek to contain costs. Firms generally report that inflationary pressures have eased and that this is expected to continue over the next 12 months. Reported wages growth has stabilised and expectations for wages growth in the next 12 months have moderated. Conditions for rural, commodity and services exporters and the domestic tourism sector remain relatively strong and these businesses are more optimistic.

Household sector

Growth in household spending has slowed

Retail contacts report that customers have gradually reduced their purchases of goods over recent months in response to cost-of-living pressures and in the context of a pivot to services consumption. Reported declines in sales volumes have so far been modest and some firms have continued to report strong year-ended sales growth over recent months. For stores that have seen a decline in sales recently, the shift in consumer demand is said to have been more noticeable in geographic areas that have below-average income. In these areas, firms have observed more consumers trading down to cheaper products within categories or reducing the number of items they purchase each trip.

Demand for leisure-related services has only recently seen some signs of softening. Domestic tourism demand has remained strong, largely driven by leisure travel, with business travel demand expected to recover further over the next 12 months. Spending on entertainment and hospitality was reported to have been strong overall in recent months but with signs of slowing demand.

Looking to the period ahead, retailers expect the decline in retail sales volumes to continue over coming months, primarily driven by reduced spending in areas that tend to have below-average income. By contrast, tourism contacts are largely positive about the near-term outlook for domestic tourism demand, even though they expect cost-of-living pressures and the increases in interest rates to weigh on leisure demand in the latter part of the year.

Universities generally expect domestic student numbers to remain subdued, following flat or lower domestic university student commencement numbers in early 2023 relative to 2022. Contacts attribute this subdued demand to potential students choosing to work rather than pursue full-time study amid strong labour demand. By contrast, demand from overseas students has picked up strongly (see below).

More people are turning to community services for assistance

Community services organisations have raised concerns regarding the sharp increase in demand for their services over recent quarters, including for financial aid, domestic violence and acute mental health support, food bank services and housing assistance. They note that there has been a rise in the number of people seeking assistance for the first time, including renters and people with mortgages. There are also reports of an increasing number of people presenting with multiple personal debts. These organisations note that those seeking assistance have often already significantly rationalised how they are spending and that in many cases this includes reducing their spending on essential goods and services.

The increase in demand for their services has mainly been attributed to increased living costs from high inflation – for example, on rent, energy and food. Moreover, community services organisations have stated that they are finding it very difficult to meet this increased demand as they face staffing and volunteer shortages and higher costs. These organisations are also concerned about their ability to meet future demand given their funding levels.

Business sector

The outlook for business investment is steady

Most contacts plan to maintain nominal investment at or above average levels over the next 12 months. A large pipeline of renewable energy, transport, storage and infrastructure construction is planned. However, many contacts report that the high level of investment spending intentions is largely due to the costs of materials, labour and equipment having risen. In real terms, it is possible that non-mining investment over the period ahead will be relatively flat for these firms. Some firms, particularly smaller businesses, said they have already reduced their investment plans because of the increases in interest rates and their uncertainty regarding the macroeconomic outlook.

Liaison suggests that resources investment will increase over coming years, driven by bulk commodity projects and supported by investment in minerals used in the production of batteries, particularly for electric vehicles. The expected timing of some bulk commodity projects has been delayed over recent months, which in a few cases is said to be partly due to delays in receiving approvals.

Firms have continued to note that difficulties in securing appropriately skilled labour are delaying the progress of their investment. Such challenges also pose a downside risk to the investment outlook. Most firms have said that finance remains readily available, although the cost of debt has increased in line with the increases in the cash rate. Financial conditions are tighter in the construction industry (see below) and for businesses exposed to fossil fuels.

Residential construction activity is expected to decline

The current level of residential construction activity is being supported by the backlog of work. Completion times have improved over recent months, but shortages of trade labour are contributing to ongoing project delays. The level of residential construction activity is expected to decline around the latter part of this year following the sharp decline of sales since mid-2022.

Sales of new detached housing and off-the-plan apartments are at very low levels, which firms attribute to the increases in interest rates, higher prices for land and construction, as well as poor consumer sentiment. Households are concerned about lengthy build times, builder insolvencies and declines in established house prices. Some contacts noted that cancellations have increased, partly because purchasers are struggling to obtain the requisite finance. A few contacts also noted that some projects have been scaled back to manage cost increases.

Firms continue to report that financial stress and insolvency risks in parts of the construction industry are elevated; this has been a feature of discussions with firms in this industry since early 2022. A key issue highlighted by firms as having contributed to these stresses was much higher-than-expected increases in costs that, in many cases, were not passed on to customers because of the use of fixed-price contracts. Construction firms have also experienced several difficult years that included COVID-19-related disruptions and poor weather, which contributed to a significant increase in build times of around six to nine months in many cases. Many firms are still absorbing cost increases through lower margins for delayed projects. Cost pressures for new projects have eased, although costs relating to trade labour and energy-intensive materials such as bricks and concrete are continuing to increase.

Despite these challenges, some industry contacts are optimistic about the medium-term outlook, citing strong underlying demand for housing due to low rental vacancy rates and strong population growth.

Services exports are expected to continue to grow over the period ahead

A bounce-back in international student commencements is supporting growth in services exports. Commencements at most universities have recovered further over recent months and are expected to continue doing so over coming months. Students have largely returned to studying onshore, which brings their spending on living expenses into the scope of services exports. The rebound in demand has been strongest from South Asia.

International student enrolments in the vocational education and training sector (where courses are typically of shorter duration) have already exceeded pre-pandemic levels.

The number of international tourists has also grown over recent months. Contacts expect the recovery in international tourism to continue but to take some time to reach pre-pandemic levels; views on when this is expected range from the end of this year to sometime in 2026. Flight capacity to and from Australia is gradually improving but is still regarded as a constraint on a full recovery. There is also uncertainty over the speed of return of Chinese tourists.

Liaison discussions indicate that bulk commodity export volumes are expected to remain broadly steady in the near term, before increasing moderately over coming years. Exports of non-bulk commodities will be boosted over the period ahead by investment to expand the production of battery-related minerals that is currently underway in response to elevated prices. Despite a difficult year for many farmers affected by flooding and labour shortages, Australia's aggregate rural exports have been supported by recent favourable weather conditions and bumper harvests. Contacts suggest the outlook for rural exports remains favourable but drier domestic conditions and improved global supply of agricultural commodities is expected to lead to a decline in rural exports over the next 12 months from the very high levels seen in the past couple of years.

Hiring intentions have moderated and labour availability has improved

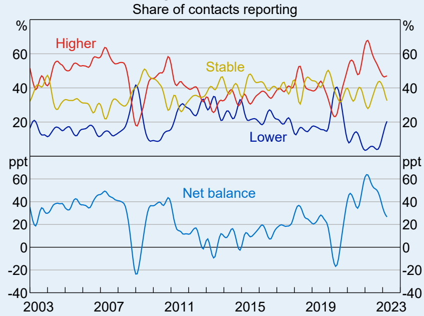
The hiring intentions of liaison contacts have moderated over the past few months, although they remain positive overall (Graph A.1). This is in response to the softening in the demand environment as well as an effort to focus more on cost containment. The easing in firms' employment intentions has been broadly based across industries and intentions are now back to around levels seen in the lead up to the pandemic. Firms connected to the residential property sector have pulled back their hiring intentions more sharply, as the existing pipeline of work starts to approach completion and new orders have declined.

Sourcing labour has become a little easier for most firms in recent months. Staff turnover rates have also generally declined. However, both labour availability and turnover remain more difficult for firms than prior to the pandemic and some firms report little improvement in conditions. For firms that have found that hiring conditions have improved, some contacts have linked this to an increasing availability of both skilled and unskilled foreign workers in recent months.

Graph A.1

Employment Intentions*

Share of contacts reporting



* Over the year ahead; smoothed with a 13-month Henderson trend.

Source: RBA

Costs and prices

Contacts report their wages growth has stabilised at around 4 per cent, but expect growth to moderate in the near term

Firms reported that year-ended growth in private sector wages has remained around 4 per cent in recent months. A smaller share of firms reported wage increases above 5 per cent than was the case in the latter part of 2022 (Graph A.2). Overall, reported wages growth over recent months remains above pre-pandemic growth rates in all industries, and the distribution of current wages growth is broadly similar to that seen during the previous period of tightness in the labour market in the mid-2000s. Firms continue to report the use of non-base wage payments to attract and retain workers.

Wages growth expectations for the next 12 months have moderated over recent months and in aggregate are now around 3¾ per cent. Factors noted by those firms expecting wages growth to slow include softening business conditions, increased internal focus on cost control, lower voluntary turnover and improved labour availability. Expectations of lower wages growth are more common among firms in business services and goods production industries, and are most evident for roles that experienced larger wage increases over the past 12–18 months.

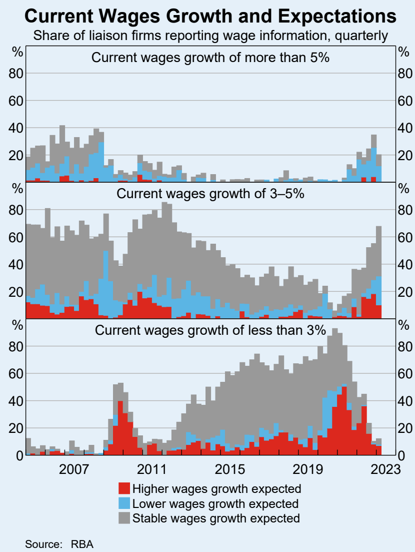
Some firms negotiating new enterprise agreements expect wages outcomes to be higher than current or expired agreements, with expected outcomes generally ranging between 3 per cent and 5 per cent on average. This year's Fair Work Commission decision has been noted as a key uncertainty for firms whose wages are directly or indirectly linked to award rates.

The pace of growth in firms' total costs is easing

Many contacts have reported a slowing in the pace of input cost increases over recent months. The cost of imported goods has declined as international supply chains have normalised. International freight rates paid by firms have declined further over recent months as contracts have been renegotiated, supported by slowing global demand and increased shipping capacity.

By contrast, firms report that some of their domestic costs have increased further over recent months, particularly for energy, wage bills and logistics. Firms on the east coast report large increases in their energy costs where prices are variable or contracts have been renewed. Some contacts report that they have been less exposed to rising energy prices because of pre-existing long-term contracts or access to cheaper renewable energy. Firms report that parts of domestic supply chains are still strained, primarily due to shortages of pallets and truck drivers, and

Graph A.2



some continue to hold elevated levels of inventory as a precaution, adding to logistics costs.

Firms expect their aggregate cost inflation to ease further over coming months. They expect their imported costs to continue to decline but for growth in their domestic costs to remain relatively strong.

Price inflation is expected to moderate gradually

Firms expect to increase their prices at a more moderate pace over the next 12 months than they did over the past year. That said, many firms expect that their prices will continue to grow at above pre-pandemic rates. Some firms have said they will try to maintain or recover their margins as they deal with higher costs, while some services firms said they intend to increase their prices to incorporate the higher labour costs they now face. A small number of non-food retailers have said they might cut prices as the costs of imported goods and freight declines.

Many firms have, however, highlighted that the pricing environment is quite uncertain and economic conditions could evolve differently from what they expect. Firms also indicate that their competitors' behaviour and demand conditions are important factors in their pricing decisions.