Box B

Insights from Liaison

This Box summarises information collected by five teams based in Adelaide, Brisbane, Melbourne, Perth and Sydney during discussions with around 200 businesses, industry bodies, government agencies and community organisations over the period from the beginning of November 2022 to early February 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 contacts indicates that growth in the private sector economy has moderated over the past three months. Firms report that conditions remain generally favourable. Activity continues to be elevated for many firms and investment intentions are around their long-run average. The labour market remains tight, but there is evidence that labour availability has improved a little over recent months.

The tenor of firms' comments suggests that upstream cost pressures are easing. Firms' non-labour cost pressures have lessened following a decline in global demand and the gradual normalisation of supply chains. While many contacts expect their energy costs to increase over the year ahead, recent declines in wholesale electricity and gas futures prices mean increases may not be as large as previously expected. Alongside these developments, some goods-related firms implemented fewer and smaller price increases over recent months than earlier in 2022 and expect price growth to slow further over coming quarters. By contrast, labour cost pressures generally increased as wages growth picked up over the December quarter. Firms surveyed in the liaison program expect wages growth to stabilise around 4 per cent in coming quarters. A key concern for most firms is around how household spending will evolve over coming months in response to the higher cost of living and interest rates, and the related implications for the broader economy.

Household sector

Household spending has held up well given the higher cost of living

Retail contacts report that the level of sales remain elevated, consistent with the strong labour market; in real terms, household spending has been relatively flat over the past few months. A few retailers noted that their sales over Black Friday, Christmas and Boxing Day were stronger than the year before when lockdowns were being lifted. However, several others indicated that sales growth was not as strong as they expected or that demand had plateaued or declined in recent months following the sharp increase in the cost of living over 2022. Retail contacts generally remain reasonably optimistic about the outlook for the first half of 2023.

Demand for domestic travel remains at or above pre-pandemic levels, largely driven by leisure travel. Business travel has not fully recovered. Households' spending on other services has been mixed. Spending on entertainment and hospitality is reported by some contacts to have continued to grow over recent months. By contrast, domestic university student numbers were lower in 2022 compared with 2021, which contacts attributed to people choosing to work rather than study given the strong labour market. Operators of health care, child care and early education noted that they have been unable to expand their services to fully meet demand due to capacity constraints.

Firms are navigating a number of uncertainties around the outlook for household spending. Tourism operators are generally optimistic about the year ahead, but remain concerned that ongoing labour shortages and airline capacity constraints will limit their ability to meet demand. Operators in some parts of the country faced disruptions during the peak holiday season due to flooding; the historic flooding in the Kimberley also presents a risk to activities in the surrounding areas, including tourism, over coming quarters. Retailers have highlighted the uncertainty around the outlook for demand in coming months as consumers continue to rebalance their spending back towards services and as rising interest rates and higher living costs erode consumers' spending power. A number of retailers are observing more value-conscious behaviour among consumers.

Community service providers are finding it challenging to meet demand

Liaison contacts in community organisations have noted strong growth in demand for their services, particularly for financial stress relief, financial counselling, food bank and housing assistance. Those seeking assistance are primarily renters, who tend to be lower income households. Contacts partly attribute this increase in demand to increased living costs from high inflation and the frequency of increases in some income-support payments; some groups are also still finding it challenging to gain employment. These pressures are noted to come at a time when many are still dealing with recent natural disasters and the ongoing financial and social effects of the pandemic. In the context of these drivers of demand, high staff turnover, lower volunteer rates and a significant decline in donations are all said to be making it very difficult for community service organisations to meet demand.

Business sector

Investment plans are little changed despite higher costs

Most firms spoken to plan to maintain investment around their long-run average over the period ahead (Graph B.1). Projects in the renewables and transport & storage industries, as well as activity associated with infrastructure investment, are supporting the pipeline of non-mining business investment. Many firms also report ongoing elevated spending on information technology related to digitisation projects and cybersecurity enhancements. The investment intentions of mining firms are around their long-run average. Some mining firms plan to increase their capital expenditure over the coming year, though others intend to invest to sustain their operations rather than to expand production.

Firms have noted some risks to their investment plans over coming years, including concerns about difficulties or delays to securing machinery, equipment and labour, even though global supply chains have improved. Most firms are continuing with their investment plans, despite the cost of these projects now being higher than was initially expected. Some contacts have noted that cost inflation is causing delays as the business case for some projects is reviewed or contracts renegotiated. While most firms reported that the cost of debt has increased in line with the increases in the cash rate, finance remains readily available. Financial conditions in the construction and fossil fuel-exposed industries remain tighter than other industries. Increased insolvencies, low margins and expectations of further housing price declines are all contributing to tight financial conditions for construction firms.

The pipeline of housing construction activity remains very large, though new demand has declined sharply

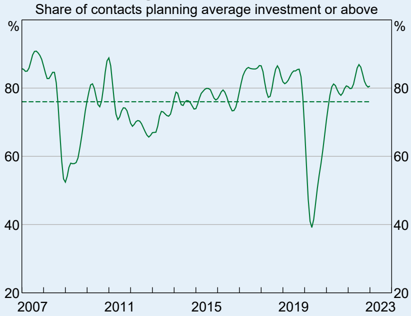
A high level of construction activity is being supported by an elevated backlog of work, stemming from the earlier period of strong demand (partly due to fiscal and monetary policy support during the pandemic) and supply constraints. Shortages in trade labour persist and are delaying the completion of projects. While shortages of materials are still being reported, over recent months a number of firms noted that obtaining materials had become easier and that cost inflation is abating.

Contacts report that higher interest rates and prices for land and construction have led to a sharp fall in sales of new detached housing and off-the-plan apartments as well as an increase in cancellations over the past few months. The low levels of sales were also attributed to a decline in customer sentiment due to lengthy build times and expectations of further established house price declines, making new homes more expensive in relative terms. That said, some contacts are optimistic about the medium-term outlook for housing construction due to the expected recovery in population growth.

Graph B.1

Non-mining Investment Intentions*

Share of contacts planning average investment or above



* Over the year ahead; solid line is a 13-month Henderson trend; dashed line is the series average.

Source: RBA

Goods and services exports are expected to increase over the period ahead

The number of international students recovered further in the second half of 2022, with the pace of this recovery exceeding some contacts' expectations. Tourism contacts have noted that international tourism is gradually picking up, supported by the recovery in airline capacity; at this stage, contacts do not expect international tourism to fully recover until at least 2024. The outlook for Australia's agricultural exports remains positive, supported by high winter crop yields in some states, although colder-than-normal weather, flooding and labour constraints have impacted production and exports over recent months in some regions.

Information from mining contacts suggests that bulk commodity exports will remain broadly steady in the near term, before increasing moderately over coming years. Current investment to expand the production of battery-related minerals, in response to strong prices, will support exports of non-bulk commodities in the period ahead.

Hiring intentions remain elevated, though labour demand has moderated

Based on firms spoken to in liaison, around half are looking to expand headcount, which is a decline from the peak in 2022 (Graph B.2). Most other businesses now expect headcount to remain stable over the year ahead. Hiring intentions remain strongest for firms in the household and business services and transport & storage industries.

Acquiring additional labour remains difficult for most firms, and this is common across locations, industries and occupations. In addition to increasing wages to retain staff (see below), some firms are responding to labour shortages by changing their hiring practices to fill vacant roles – for example, by hiring additional junior staff or staff with less experience or training than would have previously been required. However, a small but growing number of firms have noted an improvement in labour availability over recent months, with some firms also reporting lower turnover rates of late. The majority of firms now report that illness-related absenteeism is no longer a significant issue, or has at least improved from its peak in mid-2022.

Costs and prices

Private sector wages growth strengthened in the December quarter

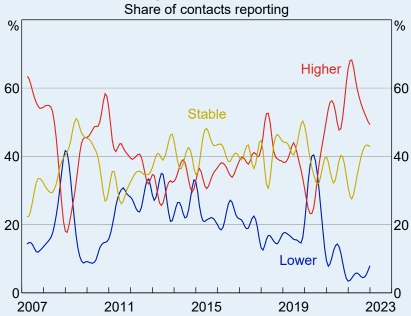
Firms reported that year-ended growth in private sector base wages increased further in recent months to be around 4¼ per cent in the December quarter. This compares with an average increase of around 3½ per cent reported by firms in the September quarter. Firms across a broad range of industries have reported stronger wage increases in recent months, typically attributing this to ongoing labour market tightness and higher inflation outcomes.

Around one-third of private sector firms reported wage increases above 5 per cent in the December quarter (Graph B.3). This is in contrast to the years leading up to the pandemic when very few firms reported wages growth above 5 per cent. Firms have also continued to report the use of various non-base wage measures to attract and retain staff.

Graph B.2

Employment Intentions*

Share of contacts reporting



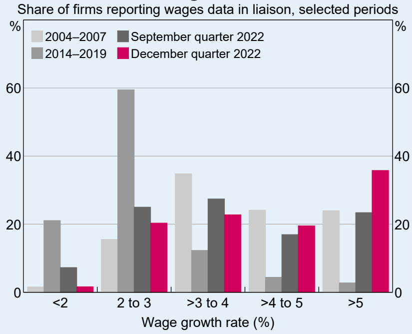
* Over the year ahead; smoothed with 13-month Henderson trend.

Source: RBA

Graph B.3

Distribution of Wages Growth Outcomes

Share of firms reporting wages data in liaison, selected periods



Source: RBA

Firms increasingly expect some stabilisation in wages growth in coming quarters. Nevertheless, many firms note that the outlook for wages growth is uncertain and will depend on future Fair Work Commission decisions, inflation outcomes and how labour market conditions evolve over the period ahead.

Other costs are expected to increase further but at a slower pace

Many contacts have reported a slowing in the pace of input cost increases, partly due to improved availability of imported goods and lower freight costs following the slowing in global demand. The easing of cost pressures has broadened over recent months, in particular for non-food retailers. However, many firms report they are still adjusting to the higher costs for materials, energy and freight. Almost all firms note considerable uncertainty about the outlook for their non-labour costs and remain concerned about the risk of freight delays for imported goods.

Elevated wholesale energy prices continue to be passed through to retail prices

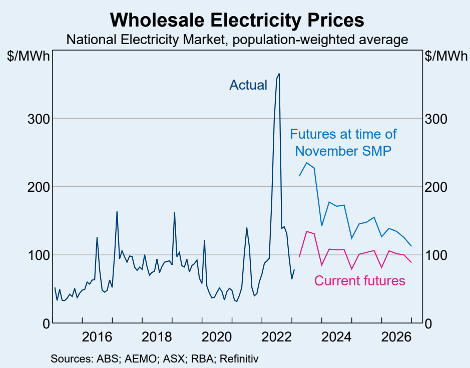
Wholesale electricity and gas prices declined in response to the announcement of the temporary price caps on domestic gas and thermal coal in the Energy Price Relief Plan on 9 December 2022 (Graph B.4). Futures markets now suggest that wholesale electricity and gas prices will be lower in 2023 and 2024 than previously expected, though they remain elevated compared to this time last year. Contacts have noted that further supply disruptions – such as bad weather delaying coal production or transport, or unexpected outages at electricity generators – may still lead to spikes in wholesale electricity and gas prices.

Firms on the east coast continue to report large increases in their energy costs where prices are variable or contracts have been renewed. Some contacts have been less exposed to rising energy prices because of pre-existing long-term contracts, hedging arrangements or access to cheaper renewable energy. Energy costs are expected to increase further in the period ahead as contracts are renewed.

Firms expect to increase prices further in response to costs, albeit at a slower pace than in 2022

Over recent months, price increases have remained widespread among liaison contacts. Firms for which labour is a large share of their costs, such as tourism and hospitality businesses, continue to pass through higher wages to their prices. Many manufacturing and construction firms expect to increase their prices further over coming months to incorporate ongoing cost increases and to maintain margins. Wholesalers and retailers have lifted prices for some fresh fruits and vegetables in response to the recent floods, but these price rises have been small relative to increases earlier in 2022.

Graph B.4



By contrast, some non-food retailers that have a higher share of imported goods have reported they now expect smaller price increases over coming months than originally planned. Some firms have also reported increased discounting or that they are no longer passing through cost increases. Contacts note they are increasingly taking into account their competitors' behaviour and the risk of a more pronounced softening in demand, which could weigh on price increases.