Bank of England
Agents' summary of business conditions

April 2005

- The growth of **consumer spending** weakened a little further, with the slowdown spreading to parts of the consumer services sector.
- Conditions in the **housing market** were little changed compared with the previous month. According to contacts, potential buyers remained cautious, possibly nervous of further interest rate increases and house price falls. There were fewer first-time buyers.
- **Export growth** remained modest. Exporters of low value-added goods found that margins and sales were increasingly under pressure owing to the weak dollar.
- **Investment intentions** were reasonably firm, supported by improving corporate balance sheets and cash flow.
- **Manufacturing output** was rising gently. Domestic markets were expected to remain subdued in the near term.
- **Construction output** growth remained strong.
- **Service sector output** growth was brisk, though perhaps a little off its recent highs.
- **Private sector employment** growth eased further and contacts reported only modest plans to expand employment in the near term.
- **Capacity utilisation** remained slightly above normal. Spare capacity was least among professional and business services, which continued to report skill shortages.
- **Pay pressures** continued to edge up. That was not yet a major concern for most contacts, partly on account of improvements in labour productivity.
- A further rise in oil prices contributed to continued strong growth of **input prices**.
- Gradually increasing cost pressures were having little impact on **consumer price inflation**.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with around 800 businesses in the period between late-February and late-March 2005. It provides information on the state of business conditions, from firms across all sectors of the economy. The report does not represent the Bank's own views, nor does it represent the views of any particular firm or region. The Bank's Monetary Policy Committee uses the intelligence provided by the Agents, in conjunction with information from other sources, to assist its understanding and assessment of current economic conditions. A copy of this publication can be found at www.bankofengland.co.uk/agencies/index.htm.

The Bank of England has Agencies for Central Southern England, the East Midlands, Greater London, the North East, the North West, Northern Ireland, Scotland, the South East & East Anglia, the South West, Wales, the West Midlands, and Yorkshire & the Humber.

The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, *obtained from: www.bankofengland.co.uk/inflationrep/index.htm.*

DEMAND

Consumption and housing

The Agencies reported that the pace of consumer demand had eased a little further. The growth of spending on consumer services may have declined slightly, with signs of weakening sales in restaurants, pubs and hotels. And there were reports of reduced demand for housing-related financial services, due to the slowdown in housing transactions. Spending on durables showed few signs of recovering. New car registrations in March were expected to be at least 10% lower than a year earlier. There were some reports that dealers' stocks of new cars were relatively high and could increase further in March, as sales fell short of expectations.

Retail sales growth may have picked up slightly, though that followed several months of weak demand. Some retailers attributed the recent weakness to expectations of higher interest rates, coupled with uncertainty ahead of the recent Budget and the prospective General Election. Retail sales may also have been reduced by higher prices of petrol and utilities, resulting in lower consumer spending on other goods and services. While few retailers expected a rapid improvement in spending patterns, some of the factors restraining consumer demand were thought to be temporary.

The Agencies' reports suggested that households might have increased their saving. Contacts in the financial services sector noted that sales of household saving products had risen, possibly as a result of higher deposit rates and firmer sentiment in the stock market. And some reported that consumers had a shrinking appetite for debt and were paying off their outstanding credit card balances more quickly.

Activity and prices in the housing market were little changed compared with the previous month. Overall, estate agents were confident that the market would pick up steadily in the year ahead, reflecting the underlying strength of the economy. In the short term, however, potential buyers (especially first-time buyers) remained cautious, partly due to their perceived risk of further interest rate increases and house price falls. It was reported that the share of new mortgage advances accounted for by first-time buyers had declined sharply in recent months.

Exports and imports

Export growth continued its recent modest pace. For manufacturers, areas of strength were exports of high value-added capital and intermediate goods, particularly those destined for the United States. By contrast, exporters of commodity-based goods found that margins and sales were increasingly under pressure, owing to the weak dollar and resultant increased competition from dollar-based suppliers. Many businesses had previously covered themselves against future dollar weakness. But in some cases those contracts were now drawing to an end and their extension would be at much less favourable exchange rates. Demand in the euro area remained subdued. The market share of imports in domestic markets continued to increase, if at a slower rate. The recent slowdown in demand for consumer durables may have resulted in some moderation in the growth of imports.

Investment

Contacts' investment intentions continued to suggest further recovery in capital spending in 2005. Business confidence appeared somewhat stronger than that of consumers. According to some banking contacts, that may have been associated with stronger corporate balance sheets and cash flow, the result of past restructuring and improved profitability. With capacity utilisation typically slightly above normal levels (see below), contacts were more willing to invest in new capacity. And some of the larger retailers were planning to expand, in spite of weakening demand. Nevertheless, there were further reports of contacts whose investment decisions were being constrained by the need to fund pension deficits.

OUTPUT

Primary production

Dairy and arable farmers reported that margins were being squeezed further, partly as a result of growing international competition. For some contacts, that had necessitated diversifying into non-farming activities. Farmers expected to see some benefit from the expected pass-through of higher retail prices for milk.

Manufacturing

Output continued to increase, though the pace of growth was widely reported to have slowed in recent months. That largely reflected weaker domestic demand, particularly for consumer goods. In the near term, contacts expected domestic markets to remain subdued, so that any pickup in the pace of output growth would be dependent on the acceleration of exports. Factors mentioned as restraining sales in domestic markets included an increased market share of imported consumer goods and the continual relocation of manufacturing customers overseas.

Construction

The construction sector remained strong, with several Agencies reporting a pickup in the growth of activity recently. Public sector demand was still the principal driving force, though there were reports of stronger private sector demand as well, including retail and distribution and utilities. In most regions, house builders reported that activity has so far been little affected by the housing slowdown. But margins have been reduced by the need to offer greater incentives and discounts, while land prices and labour costs continued to rise.

Services

Service sector output growth was little changed. It remained above trend, though slightly off its recent peak. The buoyancy of activity in the service sector was reflected in a strengthening corporate lending market, with the ready availability of funds to finance expansion.

Slightly weaker output growth of consumer services (see above) was broadly offset by a further strengthening of growth in the business services sector, where business confidence was rising. Legal and accountancy firms were benefiting from growing numbers of management buyouts and private equity backed transactions. Growing regulation, strong demand for tax planning and an active commercial property market also boosted activity.

EMPLOYMENT

Private sector employment growth continued to weaken and contacts reported only modest plans to expand employment in the near term. That partly reflected competitive pressures on manufacturers, some of which were cutting back their operations or relocating overseas.

Most Agencies reported that the labour market remained fairly tight, though it continued to ease gradually. There were contrasting reports of the labour markets for skilled and lesser skilled workers. The market for more skilled workers was relatively tight. Nevertheless, there were some reports that employment intentions for skilled workers had eased a little. It was uncertain to what extent that was cyclical, reflecting the recent slowdown in private sector output growth, or if it was due at least partly to structural factors, such as the need to improve competitiveness. By contrast, lesser skilled workers were more readily available. That was partly due to the steady increase in the number of migrant workers, who were mostly employed in lower paying industries.

LABOUR PRODUCTIVITY

In February and March the Agents conducted a survey of selected contacts on the growth of their labour productivity. The survey sought to cast light on the factors which had been driving productivity growth in the previous year and the extent to which they were expected to continue in the next twelve months. The survey found that, while labour productivity would continue to increase, it might do so at a slightly slower pace in the year ahead, with fewer companies expecting substantial improvements in performance. That seemed to reflect expectations among contacts of a cyclical slowdown in the growth of turnover. Contacts reported that the principal means of enhancing productivity was through more efficient organisation of work processes and by the application of information technology (IT). By contrast, relatively few contacts reported spending on non-IT capital goods as a significant driver of productivity growth at present. Companies showing the fastest productivity growth were predominantly manufacturers, reflecting the particularly strong pressures to reduce costs in that sector.

CAPACITY UTILISATION

Whole-economy capacity utilisation remained slightly above normal.

Agencies reported that overall capacity utilisation in manufacturing was currently close to normal levels. There were several reports that manufacturers were running their UK plants at close to full capacity, with some reducing their domestic operations to eliminate unprofitable plant. By contrast, there were few signs that contacts' labour forces were being worked much harder than normal, which would have been reflected, for example, in increased overtime working.

Conditions were rather different in the service sector, where capacity utilisation was reported to have remained at around its highest level for nearly four years. Shortages of professional staff were reported, though office space remained in plentiful supply. Capacity utilisation in the distribution sector continued to rise.

COSTS AND PRICES

Pay

Contacts reported that wage settlements continued to edge higher. Contributory factors were the increase in RPI inflation in the previous year; past and prospective increases in the National Minimum Wage (which have had knock-on effects on the pay of staff earning more than the minimum rate); and skill shortages. By contrast, contacts reported that pay pressures were mitigated to some extent by job uncertainty among their work forces. That was partly due to corporate restructuring (sometimes involving the relocation of operations overseas) and the influx of labour from abroad. The gradual increase in pay pressures was not yet a major concern for most contacts, partly on account of improvements in labour productivity.

Input prices

A further rise in oil prices contributed to continued strong growth of input prices. Contacts reported lagged effects of past oil price increases, which were steadily feeding through into higher prices of related materials such as plastics and paint. The jump in utilities prices remained of concern. But the news was not all one-sided. For example, there were several reports that steel price increases had started to tail off.

Output and consumer prices

Contacts' reports suggested that further increases in cost pressures continued to have relatively little impact on consumer price inflation.

Increased cost pressures were evident in several parts of the supply chain. Contacts reported that they were more able than previously to pass on cost increases of materials to their customers by way of price surcharges. And some noted a strengthening of prices of imported finished goods. Strong demand was underpinning relatively high rates of price increases for professional services.

By contrast, contacts in the distribution sector found it much harder to raise prices, so that rising transport costs were squeezing margins. Major supermarkets continued to resist most pressure for price increases by suppliers. Lastly, there were some reports that weakening demand for consumer services, coupled with over-capacity in the leisure sector, may have resulted in a slight easing of consumer services price inflation recently.