Bank of England
Agents' summary of business conditions

February 2005

- **Consumer spending** growth continued to moderate.
- **Export growth** slowed further and some contacts were concerned whether current volumes could be sustained in the months ahead.
- **Investment intentions** remained firm, though there were downside risks should the economy slow.
- **Manufacturing output** continued to grow modestly.
- **Construction output** growth eased a little.
- Estate Agents reported tentative signs of a pickup in **housing market** activity levels.
- **Service sector output** growth was brisk, underpinned by demand for professional and financial services.
- **Private sector employment** growth weakened slightly.
- **Capacity utilisation** remained a little above normal.
- **Pay settlements** edged higher. There were prospects of further modest increases in wage inflation in the year ahead.
- **Input price inflation** may have peaked. Prices of materials were expected to remain at or slightly above current levels in 2005.
- **Output and consumer price inflation** picked up a little, particularly in the service sector.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with around 600 businesses in the period between late-December and late-January 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: Publications Group, Monetary Analysis, Bank of England, London EC2R 8AH (Price £3.00).*

DEMAND

Consumption

Contacts reported that the annual growth of retail sales continued to moderate. Private new car sales remained weak and some contacts reported that buyers had traded down to cheaper models. Sales of other big ticket items such as carpets and furniture were generally sluggish, in part due to the slowdown in the housing market. By contrast, spending on consumer services, such as hotels, restaurants and leisure activities, was rather firmer. The demand for credit weakened and lenders tightened their terms.

Exports

Exports continued to grow, though the pace of growth may have weakened further. Some contacts were concerned whether current export volumes could be sustained in the months ahead. That was partly on account of the squeeze on margins in dollar markets. There were no signs of a recovery in demand in the euro area and most contacts were unable to gain market share in those markets, despite favourable exchange rates. Instead, more companies were looking to develop new customers in Eastern Europe and the Far East.

Investment

Contacts' investment intentions may have levelled out in recent months. Nevertheless, most were reasonably positive with regard to their planned capital spending in the year ahead. That was due to a number of factors. For the majority, there have been reasonable increases in output and profits in the past year; capacity was limited; and financing was readily available at a favourable cost, with interest rates not expected to rise sharply looking forward. However, with some contacts expecting the growth of demand to slow in the months ahead and margins to come under further pressure, there were a few reports that any future adjustment to planned investment was more likely to be downward than upward. Contacts continued to report that they favoured low-cost overseas locations to the United Kingdom for new capacity. The main strength in capital spending was in distribution and the public sector.

OUTPUT

Primary production

Agricultural prices were reported to have stabilised in recent months, following earlier falls. Even so, pressure on margins remained fierce for contacts in the dairy and arable sectors. Price competition among supermarkets had resulted in lower prices for farmers, whose costs for fertiliser and other inputs have risen sharply. The new European Union finance support system, which is to be phased in over the next seven years, was expected to accelerate consolidation in the sector.

Manufacturing

Contacts reported a rather mixed picture for recent trends in output growth. Many were fairly optimistic about prospects for 2005. By contrast, others reported that confidence was waning, largely due to increased competition from suppliers located in dollar-based markets. On balance, manufacturers continued to report modest growth in output, mostly driven by exports. But UK output was growing at a slower pace than suggested by contacts' order books, as increasingly the overseas orders of larger companies were being met from their overseas factories that have lower unit costs and were closer to their customers. Prospects were generally the strongest for those contacts with niche, high-value products that were sheltered from overseas competition.

Construction and housing

Construction output growth eased slightly. Demand from the public and retail and distribution sectors continued to underpin activity. And with major projects still unfinished, contacts were not expecting activity to tail off significantly over the year ahead.

Many were a little less confident about prospects than they were a year ago. That was partly due to the slowdown in the housing market and there were some reports that the number of houses under construction had fallen a little. Even so, the major house builders mostly expected to hit their sales targets in 2005. That was as a result of price discounting and sales incentives.

Annual house price inflation continued to slow. Nevertheless, several Agencies reported that, after allowing for seasonal influences, there were tentative signs of improvement in the housing market following the weak end to 2004. Some estate agents reported a pickup in activity levels, with more properties coming onto the market and being sold. Potential buyers were a little more confident to make offers on properties. Most estate agents thought that house prices were unlikely to decline much from current levels.

Services

Output growth was brisk in the past month, underpinned by demand for professional and financial services. Corporate finance continued to strengthen, with an increased number of AIM stock exchange flotations and buy-outs, the latter supported by readily available funding from banks and venture capitalists. That was benefiting executive search firms and recruitment agencies, which reported a strong level of assignments from financial companies and government bodies. And there were some reports of a pickup in corporate expenditure on marketing and advertising.

Outsourcing by private companies began to recover and consultants in the information, communications and technology (ICT) sector reported stronger growth. The expansion of retail capacity and the introduction of Chip and Pin payment systems had buoyed demand for ICT services.

Contacts reported strong growth in rail travel, with industry-wide growth in volumes estimated to be around 7% in the previous twelve months. Leisure services also saw good growth. By contrast, housing-related firms, such as estate agents and conveyancers, continued to feel the chill from a cool housing market. Some contacts in the overseas travel sector reported a fairly slow start to the year.

EMPLOYMENT

There was a modest slowdown in employment growth in services, mainly due to the need for contacts to improve productivity and cut costs (particularly for housing-related services). The main exception was the ICT sector, where recruitment was reported to have accelerated in recent months. Increased corporate finance work had resulted in selective recruitment in financial services, though some contacts were planning to reduce numbers employed in the United Kingdom by moving their back office jobs overseas. Manufacturing employment continued to decline. That was largely on account of job losses in traditional sectors that were most vulnerable to plant closures. By contrast, employment trends were brighter in industries such as electronics and biochemicals. Looking forward, contacts in the private sector on average expected to increase employment modestly over the next six months, although some of that growth was on account of the anticipated outsourcing of activities from the public sector.

CAPACITY UTILISATION

Capacity utilisation remained slightly above normal levels for the economy as a whole. Constraints to output were mainly among the most strongly growing parts of the services sector and took the form of shortages of skilled staff rather than of plant or office space. In manufacturing, by contrast, capacity utilisation was at or slightly below normal levels. For an increasing number of contacts in services and manufacturing, the rate of utilisation of their UK plants was no longer a limiting factor. That was because they could source from their overseas operations.

COSTS AND PRICES

Pay

There were further signs of a slight increase in pay pressure. Settlements edged higher, as wage bargainers took into account the rise in RPI inflation in the past year. Contacts reported a somewhat stronger increase in the growth of their employees' total earnings, due to increased overtime and performance-related bonuses. Those were financed largely by increased productivity. Overall, most contacts concluded that pay pressures were modest and their employees were not looking for pay rises that would be unaffordable. For many contacts, the size of their companies' pension contributions still added significantly to labour costs, though some reported that their contributions were no longer expected to rise further.

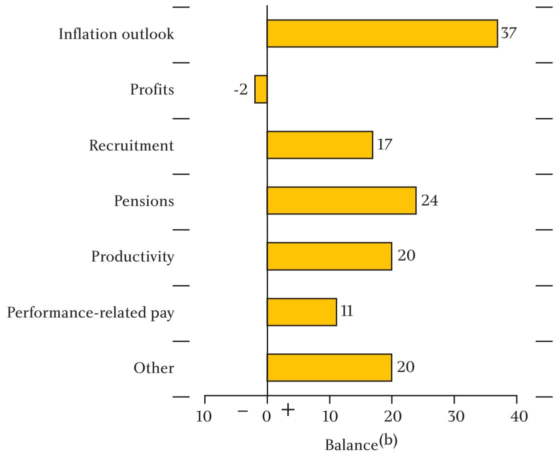
The Agencies carried out a survey of their contacts in December and January, concerning the prospects for pay and total labour costs in 2005. The results of the survey pointed to a continuation of recent trends in the year ahead.

The net percentage balance of contacts expected to have a higher settlement in 2005 than in 2004. A larger number of contacts expected that total pay growth per employee in 2005 would be higher than in 2004. That suggested a stronger pickup in total pay growth than in settlements, due to increased payments such as bonuses and overtime. And a larger number still expected a higher growth rate in 2005 than in 2004 of total labour costs (a wider definition including non-pay elements such as pension costs). The outlook for inflation was seen as the main factor putting upward pressure on labour costs (Chart 1). That contrasts with the results of the survey carried out a year earlier, when contacts were most concerned with the increased cost of their pension contributions.

Input prices

The rates of price inflation for metals and oil-related products had moderated in recent weeks. There were some reports that the price of steel had fallen back by around 6% since its peak in mid-2004. But many contacts remained concerned about increases in the prices of other inputs, particularly utilities and freight charges. Gas prices were typically around 30%–40% higher on contract renewal. Looking ahead, contacts in heavy engineering reported that the continuing strength of the Chinese economy was expected to keep the prices of materials at or slightly above current levels in 2005.

Chart 1
Agents' survey: sources of upward pressure on private sector labour costs(a)



(a) Based on 301 responses, weighted by employment, from a survey of companies in December 2004 and January 2005.
(b) Percentage of firms citing that factor as a reason for higher labour costs in 2005, less the percentage of firms citing it as a reason for lower labour costs.

Output and consumer prices

An increasing number of manufacturing contacts were able to pass on most of their cost increases by raising prices. Contacts in the services sector generally faced less intense competition, especially from overseas, and were better able to maintain margins, particularly in business services. There were some reports that estate agency fees had risen to offset the relatively low number of housing transactions. In the retail sector, goods prices continued to fall but, after allowing for seasonal influences, the level of discounting was less marked than in the immediate post-Christmas sales period.

The Agencies reported an increased market share for those contacts that sold goods and services on the internet, which were typically at lower prices than on the High Street and were becoming an increasingly important downward pressure on consumer prices.