

# Bank of England

## Agents' summary of business conditions



### January 2005

- After allowing for seasonal influences, the monthly growth of **retail sales** values may have slowed a little, resulting in greater-than-normal price discounting around Christmas.
- **Export growth** slowed and imports continued to gain market share in the United Kingdom.
- **Investment intentions** may have levelled out. Manufacturing investment remained mostly targeted at achieving greater efficiency.
- **Manufacturing output** continued to increase, but growth eased slightly.
- **Construction output** growth declined a little and house builders reported falling sales.
- Activity in the **housing market** continued to weaken. Even so, many contacts expected a recovery in the first half of 2005.
- **Service sector output** growth declined slightly, partly related to the slowdown in the housing market.
- **Private sector employment** growth weakened.
- **Capacity utilisation** in the manufacturing and services sectors remained above normal. Skill shortages may have eased a little in the construction sector.
- There was a modest increase in **pay settlements** and wage growth, but pay pressures were not seen as a cause for concern by most contacts.
- **Input price inflation** may have peaked on account of recent falls in oil prices.
- Competitive pressures and overseas sourcing continued to keep in check **manufacturers' margins and prices**.

*This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with around 700 businesses in the period between late-November and late-December 2004. 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.*

*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.*

## DEMAND

### Consumption

Contacts suggested that consumer confidence was fairly resilient to the housing market slowdown, with few signs of belt tightening. Even so, having allowed for seasonal influences, the monthly growth of retail sales values may have slowed a little compared with November. That resulted in greater-than-normal price discounting around Christmas. Growth of retail sales volumes may have been around its average of recent months.

The contrasting experience of different retail contacts made it especially difficult for the Agents to judge the overall strength of consumer demand in the Christmas period. Spending on many 'big ticket' items had declined. That was mostly ascribed to recent falls in housing market activity, which reduced demand for some housing-related goods such as furniture. And new car sales were weaker, due in part to rising interest rates over the past year and the reluctance of consumers to undertake further mortgage equity withdrawal when house prices were easing. By contrast, demand grew strongly for some high-priced goods such as jewellery and consumer electronics.

After allowing for seasonal influences, demand strengthened as the month progressed. Consumers remained particularly cost conscious and waited for late promotions and discounts to get value for money. That resulted in the timing of consumer spending in the period under review being slightly later than in recent years. Some contacts reported strong growth of spending on gift vouchers, to be redeemed in the post-Christmas sales, and further rapid acceleration in internet sales. Internet retailing gained market share in a wider range of products.

### Exports and imports

Contacts reported that the pace of export growth had eased recently and short-term prospects were a little weaker. Recent falls in the sterling exchange rate have so far had relatively little impact on export volumes and were mostly affecting contacts' profit margins. Most contacts reported that the United States and the Far East were the strongest export markets, though margins have been squeezed. By contrast, demand in the euro area generally remained subdued and was restraining the overall growth of export volumes, though margins had improved due to sterling's depreciation against the euro. Looking forward, some contacts believed that there was a generally confident mood among US companies concerning prospects for the US economy. But sterling's past appreciation against the dollar was expected to start to affect export volumes to dollar markets in the months ahead.

Turning to imports, the underlying trend remained one of increasing import penetration of domestic markets, perhaps at a slightly quicker rate recently. That partly reflected the continued relocation of manufacturing capacity overseas and UK manufacturers were increasingly sourcing parts and materials from cheaper overseas suppliers, often in the Far East or Eastern Europe.

### Investment

Contacts indicated that their investment intentions had levelled out in the fourth quarter. Although an increasing number of manufacturers reported that they were operating at close to full capacity, many were cautious about expanding capacity in the United Kingdom. That was because higher profits were available from investing overseas. Manufacturing investment in the United Kingdom was mostly targeted at cost reduction and regulatory requirements.

Investment in information, communications and technology (ICT) grew strongly as contacts looked to upgrade their systems. There was also continued steady growth of investment in the retail and distribution sector, aimed at increasing efficiency and adding new capacity. The rapid growth of internet sales was cited by some contacts as one factor promoting investment in new distribution centres. The public sector continued to underpin a significant proportion of investment in property.

## OUTPUT

### Primary production

Contacts in the agricultural sector continued to be affected by uncertainty ahead of the forthcoming reforms to the Common Agricultural Policy. That was expected to result in further consolidation in arable farming, so raising efficiency. In the oil and gas sector, contacts reported that their budgets for exploration activity in 2005 were significantly higher than in the previous year.

### Manufacturing

Contacts reported that although growth had slowed a little recently, the level of output continued to increase and orders were generally satisfactory. There were mixed views concerning the prospects in 2005. The majority expected some further increase in production. Even so, many contacts were fairly cautious and expected profit margins to come under downward pressure. That was partly on account of their reduced competitiveness in dollar markets. In the automotive sector, the stocks of finished cars and components had risen and production

was being cut back. Components suppliers had lost market share to overseas competitors.

## Construction and housing

Construction activity in the retail and distribution sector continued to grow strongly. Public sector demand was also robust, although there were some reports of temporary delays to road projects by local authorities due to end-of-year budget pressures. Overall, construction output growth may have eased slightly in the fourth quarter.

House builders reported that, despite increasing incentives, properties remained more difficult to sell and turnover had fallen significantly in recent months. That was mostly attributed to the current high level of house prices in relation to earnings and the increase in interest rates in the previous year. So future house buyers were nervous that prices could fall, which was restraining demand. Even so, most house builders reported that the slowdown had not had a major impact on their construction activity and land acquisition, partly because they expected the housing market to pick up again fairly quickly in the first half of 2005.

That view of the housing market was shared by most estate agents, who reported that future buyers were waiting for a price correction to take place. And the introduction in November of new rules by the Financial Services Authority for mortgage approval may have temporarily reduced the number of mortgage completions as lenders became familiar with the new regime. There was no consensus as to how far house prices might have to fall, though most expected that demand would recover to normal levels in the first half of 2005. The Agents' reports suggested that prices were currently either flat or falling gently. Many contacts believed that the recovery would start once future house buyers were more confident that interest rates had peaked and house prices had stabilised.

## Services

Service sector output growth eased a little. That was in part related to the sharp fall in turnover in the housing market, which had reduced demand for a variety of consumer services including financial services, estate agents (some of which were reducing staffing), surveyors, solicitors and removals companies.

Though contacts reported a decline in the volume of job advertising, output growth of contacts serving business customers strengthened further. Professional services such as accountancy and law were seeing the strongest growth, partly on account of a pickup in corporate mergers and acquisitions and capital market issuance.

Demand was also being driven by regulatory issues such as international companies' need to meet new accounting standards, as well as health and safety and employment legislation.

## EMPLOYMENT

Most contacts reported that recruitment difficulties had eased slightly. Employment growth in the private sector weakened. Also, labour shortages were probably easing due to steadily rising inward migration of workers from Eastern Europe, who were filling a widening range of vacancies. A growing number of contacts reported that they planned to employ more overseas labour in 2005, as they became more familiar with systems for recruiting overseas.

## CAPACITY UTILISATION

Capacity utilisation in manufacturing and services was somewhat above normal. Some manufacturers reported lengthening delivery times arising from insufficient capacity to meet their orders. And there were growing skill shortages in business services, such as accountancy and law. By contrast, skill shortages in the construction sector, while still severe, may have eased a little and many firms in housing-related consumer services were now operating below capacity.

## COSTS AND PRICES

### Pay

There was a modest increase in pay settlements and total pay growth, particularly in business services where activity was growing strongly and skill shortages were most evident. Overall, however, pay pressures stemming from recruitment difficulties were not seen as a serious cause for concern for most contacts, who were planning to keep pay growth to around the levels of the previous year. That was partly on account of the greater availability of labour recently relative to demand. Some contacts noted that the recent increase in the National Minimum Wage had squeezed differentials for lower paid workers, who were in short supply. That resulted in above average pay increases for the lower paid.

### Input prices

Reports from contacts suggested that input price inflation was perhaps close to peaking or may already have peaked. Large increases in the prices of steel and oil in the past year were responsible for most of the upward pressure on input prices. Those increases were continuing to feed through into higher prices of derived materials such as plastics. And contacts continued to report sharp rises in their energy costs. However, with

the dollar weakening further and oil prices coming off their peak, some contacts believed that inflationary pressures from this source may have started to abate. There were also some reports that the official figures tended to exaggerate the upward pressure on manufacturers' material costs, as companies were often able to find cheaper suppliers to offset price increases.

### Output and consumer prices

An increasing number of manufacturing contacts were able to pass on at least some of their recent increases in materials costs. But the overall message remained one of competitive pressures and overseas sourcing keeping in check manufacturers' margins and prices. The same factors were constraining retail goods prices, and accounted for the more extensive than usual pre-Christmas price discounting on the High Street. Competitive pressures were generally less severe in the service sector, particularly for professional services where many contacts were working at full capacity.