Bank of England

Agents' summary of business conditions

June 2005

- **Retail sales** values were broadly flat in May compared with the previous month. Demand remained subdued for consumer durables. Growth of household spending on services may have eased a little, partly reflecting reduced spending on housing-related financial services.
- **House prices** and transactions were stable. Estate agents now expect the housing market to remain fairly flat in the months ahead.
- **Export growth** remained modest. Sterling's recent weakening against the dollar improved margins for some contacts. Euro-area demand remained subdued.
- **Investment intentions** were firm, underpinned by the need to raise efficiency and, in the service sector, a lack of spare capacity.
- **Manufacturing output** growth seemed to have stalled and some contacts expected the level of output to fall slightly in the second half of the year.
- **Construction output** growth was steady.
- **Service sector output** growth may have slowed a little, reflecting lower growth of household spending on services.
- **Employment** growth weakened a little, mostly due to an increased rate of job loss in manufacturing and weaker recruitment in the public sector.
- Whole-economy **capacity utilisation** remained a little above normal.
- **Pay pressures** continued to edge up.
- **Input price inflation** was little changed.
- Gradually increasing cost pressures were having little impact on **consumer price inflation**, partly because some retailers' margins were squeezed by the slowdown in consumer spending.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with over 850 businesses in the period between late-April and late-May 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/publications/agentssummary/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/publications/inflationreport/index.htm.*

DEMAND

Consumption and housing

After allowing for seasonal influences, the Agents reported that the value of retail sales was little changed compared with the previous month. Few retailers had seen any clear signs of recovery and there was general disappointment that consumer spending in the immediate post-Election period had not been stronger. Demand remained subdued for durable goods including cars, furniture, white goods, televisions and home computers. Retailers and wholesalers reported that their stocks of those goods had increased, resulting in lower orders from suppliers as they sought to clear surplus inventory.

The volume of purchases of lower-priced goods, such as clothing, had been rather stronger, partly due to price discounting. That was not so much associated with weak underlying demand, but more the actions of the major supermarkets which continued to gain market share in the non-food sector by competing on price. Growth of household spending on services had eased slightly. That was partly on account of reduced spending on housing-related financial services and leisure services such as restaurants.

Many contacts attributed the slowdown in spending on durable goods to weaker activity in the housing market and the lagged effects of past increases in interest rates. There were some reports that consumers had started to repay debt. In the food retail sector, consumer caution was being reflected in a search for greater value with, for example, households generally trading down to cheaper brands.

In the housing market, prices and transactions were broadly stable and most estate agents expected them to remain so in the months ahead. Few expected the market to weaken significantly.

Recent speculation that short-term interest rates may have peaked had not resulted in any improvement in market sentiment. Sellers outnumbered buyers and the stock of unsold houses continued to increase. Some reports indicated that the average time between a property coming onto the market and a sale being agreed had risen from around 5 weeks a year ago to around 15 weeks presently. Activity in the buy-to-let market weakened with some investors continuing to switch their attention to the commercial property market.

Exports and imports

Exports continued to grow at a moderate pace, underpinned by strong US demand. The very recent weakening of sterling against the US dollar had not given any discernible boost to export volumes, though margins had improved. Demand continued to be weak in Western Europe, particularly in Germany.

High oil and gas prices have stimulated global exploration activity, which to some extent has increased the demand for UK manufactures. But with more UK suppliers manufacturing abroad, contacts noted that the main impact has been on the demand for UK-based consultancy and design services.

The Agents reported that the slowdown in demand for consumer durables was being reflected in weaker growth of imports. Nevertheless, for most consumer goods the underlying trend remained one of rising import penetration and there were some reports that the resultant boost to imports had outweighed the effects of weaker consumer demand.

Investment

Overall, contacts' investment intentions remained firm. That was despite some weakening in the investment intentions of manufacturers due to a deteriorating outlook for orders. The main influences on investment remained the need to raise efficiency and drive down costs, together with some shortages of spare capacity.

Retailers continued to invest in new stores and the refurbishment of existing stores, as well as in distribution centres. There were few signs that their investment plans had been revised down in the light of the recent slowdown in sales. The appetite of most contacts for IT improvements was undiminished. And telecoms operators continued to invest at high levels in networks.

OUTPUT

Primary production

Business confidence has remained high in the oil and gas sector and contacts reported that investment in the UK Continental Shelf has risen strongly this year. Nevertheless, equipment, such as oil rigs, was in short supply, pushing up rental rates and constraining output. Farmers reported that changes to the Single Farm Payment were finalised too late to affect the 2005 harvest, though the amount of land devoted to arable and livestock was expected to start to decline in 2006 as a result of the decoupling of production and CAP subsidies.

Manufacturing

Contacts' reports suggested that manufacturing output growth has stalled. And with order books weakening, some contacts expected their output to fall slightly in the second half of the year. The growth of output continued to be restrained by increasing overseas competition and the relocation of UK production offshore.

In addition to the direct effects on manufacturers of the slowdown in demand for consumer durables, there had been second-round effects on orders from domestic suppliers of components. In the automotive sector, carmakers reported excess stocks and falling output and activity had slowed in the glass and metal industries. But not all sectors had seen a decline in activity and demand remained strong for contacts with defence and construction-related businesses and for companies in the information, communications and technology sector.

Construction

Construction output growth remained steady, underpinned by a combination of firm demand for commercial property and from the public sector.

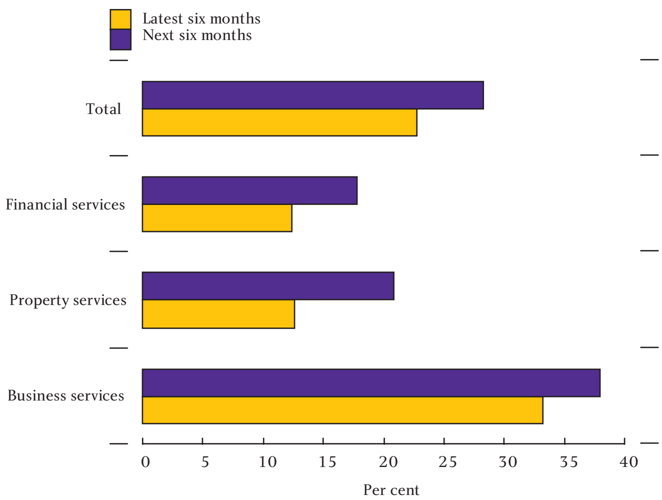
Investor demand for commercial property has persisted at very high levels, supported by overseas investors and pension funds. Looking ahead, however, there were some reports that the commercial property market was looking less robust in the face of weak occupational demand. In the housing market, there was an upturn in social housing schemes, with increased public funding for key worker housing. But smaller house-building companies were scaling back activity due to reduced cash flow.

Services

Private services output growth slowed a little in May compared with the previous month. That largely reflected lower growth in services such as mortgage providers and conveyancers. Demand for personal loans had also diminished. Growth of business services output remained strong. Greater business confidence was increasingly filtering through to the activities of smaller and medium-sized business service providers. Accountancy continued to be the most active sector, with changes to pensions' regulations next April providing a new source of demand growth. The recent strength of the commercial property market had resulted in strong demand growth for architects, surveyors and property consultants. And the Agents cited a wide range of other businesses that were reporting good growth, including those in marketing, advertising, public relations, and management and information technology consultants.

In May, the Agents carried out a survey of their contacts regarding prospects for the business services and finance sector (Chart 1). The survey, which covered 139 companies with a total turnover of around £18 billion, pointed to healthy output growth in the previous six-month period. The balance of companies expected demand to continue increasing over the following six months, if perhaps at a slightly slower rate than in the previous six months. Past and prospective demand growth was particularly strong in the business services sector, most notably accountancy and computer services. Financial companies reported more modest demand growth, especially from households. Demand growth from the government sector was robust, though that was a relatively small source of demand for most of the firms covered by the survey.

Chart 1
Demand in business services and finance: net balances by sector(a)



(a) Weighted net balance of firms reporting higher output compared with the previous six-month period. The survey covered 139 firms in nine different subsectors, and the results in each subsector were weighted according to their relative share of ONS gross domestic product.

EMPLOYMENT

The labour market eased slightly and recruitment difficulties faced by contacts declined. The rate of job loss in manufacturing increased and public sector recruitment declined. Employment agencies reported weaker demand for their staff, particularly for lesser skilled workers. By contrast, labour demand was much firmer in professional services, where capacity utilisation was at high levels. Part of the explanation for a slight easing in labour market conditions was an increase in labour supply. There were continued reports of a plentiful supply of Eastern European workers and the greater willingness of older age groups to return to (mostly part-time) work.

CAPACITY UTILISATION

Whole-economy capacity utilisation was little changed in the past month and remained slightly above normal. For some contacts, shortages of capacity were being addressed through investment in new buildings and machinery. But for most contacts, capacity utilisation was not so high that increasing output presented major problems or resulted in additional cost pressures. The main exception was the construction sector, where difficulties in securing planning permission continued to result in shortages of land for development and upward pressure on land values, though a greater supply of (often Eastern European) labour had eased skill shortages in the industry. Contacts in professional services were operating close to full capacity and some reported that shortages of skilled staff were holding back the growth of business.

COSTS AND PRICES

Pay

Pay pressures continued to increase, though only gently. Rising pay settlements mostly reflected higher RPI inflation and improved corporate profitability than a year earlier. So employees needed larger pay rises to maintain the growth of their pay in real terms, while employers were more able to afford those increases. Also, past increases in the National Minimum Wage were affecting the pay settlements of higher paid employees, who sought to restore differentials. By contrast, the greater availability of workers and weaker labour demand had added to job uncertainty. That had tempered pay growth for some contacts. And in manufacturing, some contacts reported that their overtime payments had declined as a result of weaker orders.

Input prices

Input price inflation was steady. Past increases in oil prices continued to feed through the supply chain, resulting in higher prices for a wide range of products including plastics, polymers and chemicals. But for some contacts, the chief concern remained the sharp increase in the costs of gas and electricity, with annual increases of around 45% and 30% respectively mentioned. Partly offsetting those cost pressures, there was a slight easing in the prices of steel and other metals. However, looking ahead there were some reports that manufacturers' input prices may start to accelerate again, with some contacts pointing to rising prices for materials imported from the Far East (particularly China, where strong output growth continued to put upward pressure on commodity prices).

Output and consumer prices

There was a range of views among manufacturers regarding recent developments in their pricing behaviour. Some reported that there was little resistance among their customers to price increases that were driven by higher costs of materials, though higher costs of utilities could not be passed on. Others noted that it was becoming more difficult to pass their cost increases on to customers. On balance, it appeared that price inflation for manufacturers continued to edge higher.

Consumer price inflation was little changed in May compared with the previous month. There were some reports that the softening in demand for consumer durables and increases in retailers' stocks has resulted in lower retail goods prices. With overall cost pressures increasing slightly, that was squeezing the profit margins of some retailers.