BANK OF ENGLAND

Agents' summary of business conditions

April 2008

- Consumption growth eased further, driven by slower growth in discretionary spending.
- Housing demand remained weak.
- Investment intentions fell sharply again in the services sector, and eased across most industries and regions. Tighter credit conditions continued to weigh on investment plans, mainly through their effect on uncertainty about demand.
- Demand for exports remained at a high level, though growth of export orders had eased slightly.
- Growth in manufacturing output remained firm while that in construction and services sector output slowed further. (An Agents' survey examined the gap between actual and expected outcomes.)
- Labour demand softened, with a marked fall in employment intentions in the services sector. The inflow of migrant labour had slowed and recruitment difficulties eased.
- Capacity pressures were expected to ease significantly over the coming six months.
- Growth in total labour costs remained well contained, though there were some reports of modest upward pressure on settlements in response to increases in the cost of living.
- Annual input price inflation rose sharply and annual output price inflation increased as manufacturers sought to restore margins.
- Annual consumer price inflation increased, driven by higher prices of both goods and services.

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**. It provides information on the state of business conditions, from companies 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 company 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 & Oxfordshire, 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.**

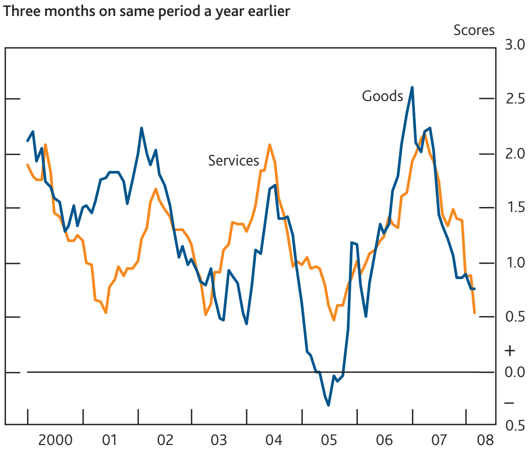
Demand

Consumption

The Agents reported a slowdown in overall consumption growth in March, driven largely by a further easing in discretionary spending (**Chart 1**).

Chart 1 Consumption values

Three months on same period a year earlier



The Agents' score for growth in retail sales of goods was little changed in March, but had been on a downward trend for much of the past year. That slowdown had been most pronounced for spending on homewares, fashion and leisure goods, with particular weakness in spending on 'big ticket' items. In contrast, growth in spending on food remained firm, largely reflecting higher prices.

The Agents' score for growth in spending on consumer services fell sharply again in March (**Chart 1**). The easing in demand was most pronounced for services provided by domestic tourism operators, hotels, clubs and restaurants. Within these categories, contacts also reported a tendency for households to reduce the average value of their purchases.

Housing market

Housing demand remained weak. In the market for established homes, estate agencies reported that enquiries were well down on a year ago. Given the resultant excess supply, sale periods were unusually long. There was a rise in the cancellation of sales, attributed to tighter credit conditions, and vendors were accepting sizable discounts on asking prices. In response to these developments, annual price inflation for established homes fell further.

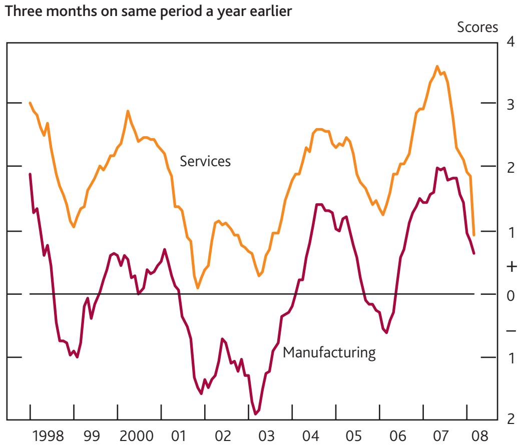
Demand for new housing continued to weaken, reflecting tighter credit conditions. As a result, home builders had accumulated unwanted stock and were discounting heavily. Consequently, annual price inflation for new homes also slowed further. Given the subdued volume of sales and extensive discounting, some developers were reportedly selling land to maintain cash flows.

Investment

Agents' scores for investment intentions fell in March, continuing the steady decline seen over much of the past year (**Chart 2**). The fall was most pronounced in the services sector, for which Agents in eight of the twelve regions lowered their score. Agents' scores also fell in manufacturing. And growth in intentions continued to fall in other sectors for which Agents do not assign scores, including commercial property and, to a lesser extent, retailing and utilities.

Chart 2 Investment intentions over the next twelve months

Three months on same period a year earlier



While investment intentions had been easing since April 2007, much of the recent sharp slowdown was attributed to uncertainty stemming from financial market events. Agents reported that the direct effects of tighter credit conditions remained greatest for contacts in the commercial property and finance sectors, and for highly leveraged companies seeking to refinance their debt. Most other contacts were still not reporting material increases in borrowing costs. Many had access to internal funds or funds from a parent company, while others had secured credit during the earlier, more lenient borrowing environment. They were, however, reassessing the likely returns to investment projects in view of the predicted slowdown in domestic and global growth. As a result, more companies were scaling back or suspending their investment plans even if their access to finance was little changed.

Overseas trade

Overseas demand remained robust in March. Weaker demand from the United States continued to be offset by strength in the volume of sales elsewhere. The depreciation of sterling had enhanced margins on exports, particularly those to Europe. And forward orders remained supportive of near-term strength in external demand. Nonetheless, some contacts reported a slight easing in the growth of orders.

Demand by UK companies for intermediate imports remained elevated. There were, however, more reports of a slowing in imports of consumer goods, consistent with a slowdown in household spending.

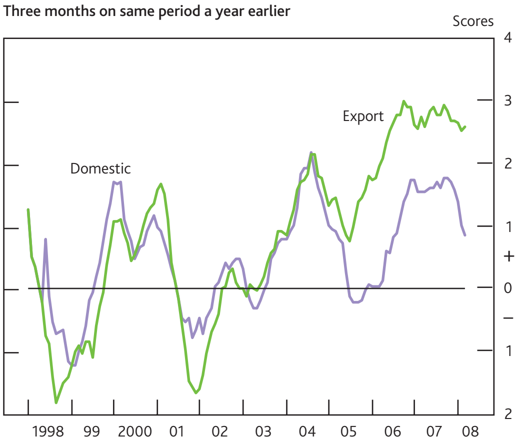
Output

Manufacturing

Manufacturing output growth slowed in March, but remained firm (**Chart 3**). Overseas demand remained the key driver of growth. In contrast, production for domestic markets eased markedly, particularly for manufacturers of building materials and consumer goods. Domestic orders pointed to a further slowing in production for local markets, while export orders remained healthy.

Chart 3 Manufacturing output

Three months on same period a year earlier



Construction

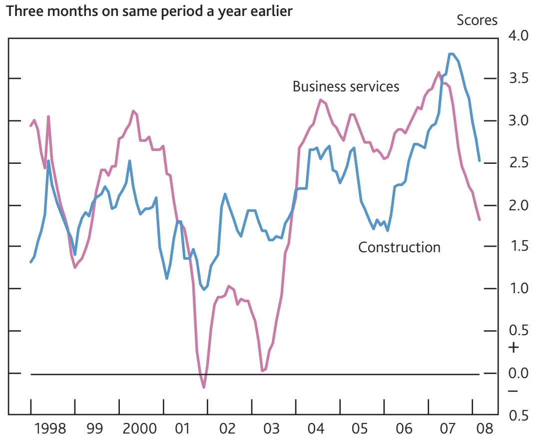
Growth in construction output eased again, largely driven by slower private sector house building (**Chart 4**). But so far, the level of activity remained high, supported by non-residential building. And with large amounts of non-residential work already pre-committed, the level of activity was set to remain high in the near term. But more commercial projects were under review due to recent financial events, and there was little appetite for speculative building. This, combined with concerns about the outlook for property prices, was weighing on expectations for construction activity later this year and into 2009.

Services

The Agents' score for growth in business services output fell in March to its lowest level in over four years (**Chart 4**). While the slowdown in business services from its earlier rapid pace had been under way for some time, it had clearly been amplified by financial events. This was most evident in scores for professional and financial services, which fell sharply following the financial turmoil. But in recent months there had also been a reduction in scores for other business services

Chart 4 Sectoral output

Three months on same period a year earlier



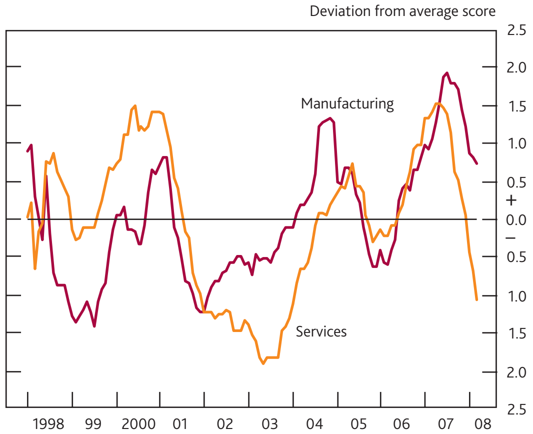
(like logistics and business catering), pointing to a broader slowdown in the services sector and possible spillover effects from tighter credit conditions.

Capacity utilisation

Contacts reported that capacity pressures were expected to ease significantly over the next six months (**Chart 5**). Although that partly reflected earlier additions to capacity, the main influence was an actual and projected slowing in activity. Capacity pressures were expected to ease most in the services sector, to be below their average of the past decade. They were also expected to ease in manufacturing and in other sectors not scored by the Agents. In residential construction, for example, builders were already operating well below capacity.

Chart 5 Capacity constraints over the next six months

Deviation from average score



Employment

The slowdown in activity, and attendant easing in overall capacity pressures, was reflected in a marked softening in labour demand. For the first time since 2003, Agents' scores for employment intentions indicated that private-sector employers did not expect to add to their workforce. Weakness in labour demand was most evident in the services sector. To achieve desired levels of labour input, some contacts were reducing the number of hours of paid work. Others were increasing their reliance on temporary workers. There was also a greater tendency to leave existing vacancies unfilled so that headcount could be reduced through natural attrition.

Consistent with the easing in labour demand, recruitment difficulties were now falling back towards more normal levels. This easing had been associated with a reduction in staff turnover as employees became less confident about seeking alternative positions. Employers were still hoarding skilled labour, however, given the structural shortages of selected occupations.

Against the background of a softer labour market, there were reports from employers and employment agencies that the inflow of migrant workers from the A8 accession countries had slowed.

Costs and prices

Labour costs

Agents reported that across-the-board pay settlements remained little changed in March, though there were a few reports of modest upward pressure in some areas. The rise in the cost of living was the most commonly cited factor putting upward pressure on settlements as employees sought to preserve their real incomes.

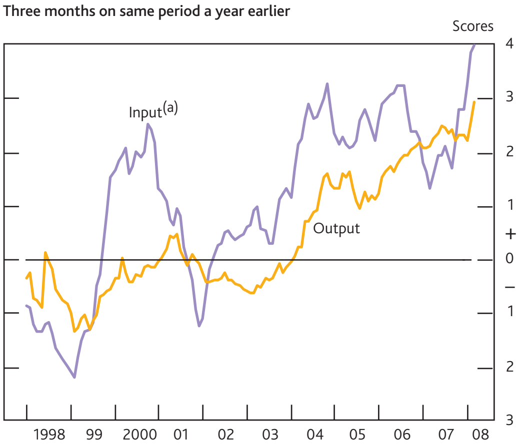
Broader measures of labour cost growth were stable in the month. In the services sector, however, growth in total labour costs eased slightly as a result of smaller contributions from the variable component of pay.

Input and output prices

The Agents' score for input price inflation surged again in March to its highest level since scores began in mid 1997 (**Chart 6**). This reflected ongoing increases in the world prices of basic inputs — energy, oil derivatives, building materials and food — combined with the effects of sterling's depreciation. In addition, contacts reported further increases in the cost of importing finished and intermediate goods from China, where domestic price pressures were evident.

The Agents' score for manufacturing output prices also increased in the month. Following sharp increases in input costs over the past year, and a consequent compression of margins, manufacturers had become more active in passing on cost increases. While food and beverage manufacturers had experienced the greatest success in securing price rises, other producers were also successfully passing on commodity-based cost increases.

Chart 6 Manufacturers' input and output prices



(a) Non-labour input prices.

Business-to-business service price inflation remained little changed. Some contacts had increased prices for specialist business services and transport services. Offsetting this, however, was the downward pressure on prices from increased commoditisation of services and the easing in demand.

Consumer prices

The Agents' score for annual goods price inflation increased again in March, reflecting further increases in the prices of energy and food. Annual service price inflation also increased for the second consecutive month, driven by higher prices for transport, utilities and services provided by hotels and restaurants. Consequently, overall consumer price inflation was higher.

The outlook was for additional upward pressure on consumer price inflation in the near term. Major retailers were awarding higher contract prices to suppliers — in some cases for the first time in several years – and were becoming more active in passing on commodity-related cost increases to consumers. The cost of final imports was increasing. Furthermore, several large retailers indicated a reluctance to continue the depth of discounting of recent months, claiming that the frequency of such discounts had reduced their effectiveness in stimulating demand and was eroding profitability. But while these influences were putting upward pressure on consumer prices, many retailers remained keen to offset higher price inflation for some products with lower price inflation elsewhere, as indictated in the Agents' survey on cost pass-through reported on in last month's *Summary*.

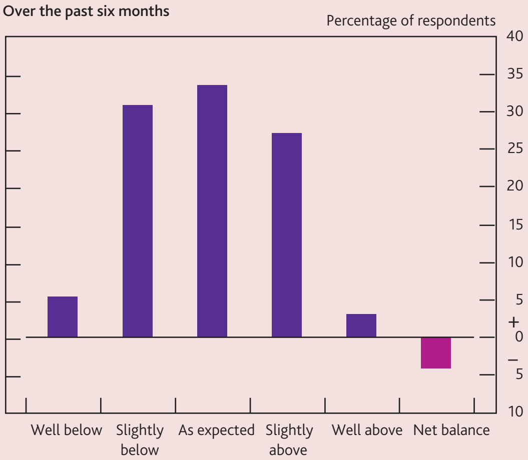
Agents' survey of demand conditions

As highlighted in recent *Inflation Reports*, the MPC has anticipated a slowing in activity during 2008. Preliminary GDP for Q4 indicated that stocks had increased sharply, and implied that consumption growth may have been weaker than businesses were expecting. Consequently, an important question is whether demand conditions faced by companies have differed from their expectations. During March, the Agents surveyed around 250 of their contacts, across all key sectors of the economy, to explore this issue. This box summarises the main findings.

When asked whether actual sales had differed from expected levels over the past six months, most respondents reported that sales were at or close to expectations. Only a small net balance indicated they were below expectations (**Chart A**). However, this outcome was still consistent with forecasts of slower economic growth, as for many respondents sales growth had slowed in line with their projections.

Chart A Actual sales compared with expectations

Over the past six months

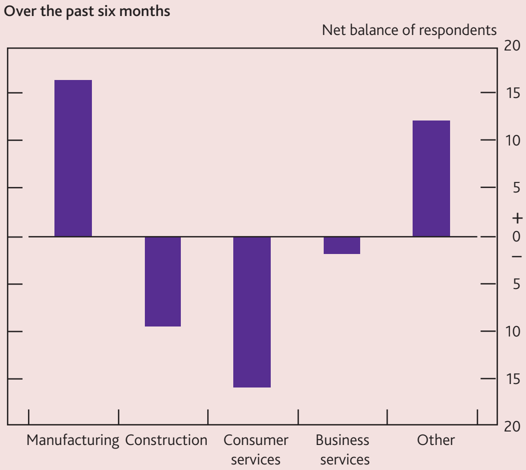


Actual sales had fallen most below expectations in the construction and consumer services industries (**Chart B**). The small negative expectations gap for business services reflected the diversity of this sector, with weakness in financial services being partly offset by strength in other business services. In contrast, conditions in manufacturing had continued to exceed expectations, consistent with positive feedback from export-oriented manufacturers for much of the past year.

Where sales outcomes had differed from expectations, respondents were asked about the consequences of this for their businesses. As shown in **Chart C**, the largest adjustment over the past six months had occurred in terms of a build-up of stocks. Other firms experiencing an expectations gap had increased prices or lowered production.

Chart B Expectations gap by sector

Over the past six months



Looking ahead to the next six months, much of the recent stock build-up was expected to dissipate as firms ran down existing inventories. Consistent with this, a greater share of firms anticipated reducing their production. Furthermore, a greater share of firms expected that the length of their order books would fall. But a positive net balance still expected to increase their output prices in response to upstream cost pressures.

Chart C Response to expectations gap

For firms reporting a gap between actual and expected sales