BANK OF ENGLAND

Agents' summary of business conditions

July 2008

- **Consumption** growth eased further, reflecting weaker demand for consumer services.
- The sharp downturn in **housing demand** continued.
- Companies remained cautious in terms of their **investment intentions**. The majority still remained largely unaffected by the tightening in **credit conditions**, though firms seeking external finance had more hurdles to satisfy.
- Demand for **exports** remained firm.
- Growth in **services** and domestically orientated **manufacturing** eased further, and there was a sharp decline in **construction**.
- **Labour demand** softened and **recruitment difficulties** eased.
- **Capacity pressures** continued to ease.
- Growth in total **labour costs** rose slightly but nonetheless remained moderate.
- Manufacturers' **annual input and output price inflation** rose further, though their margins continued to be squeezed.
- Annual **consumer price inflation** increased sharply.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with about 870 businesses in the period between **late May and late June**. 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.

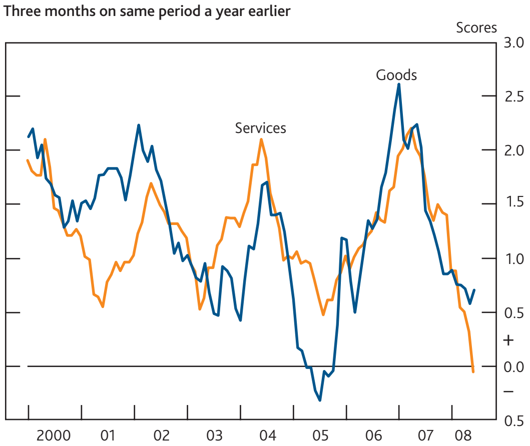
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

The Agents' score for the value of spending on consumer goods was stable in June (**Chart 1**).

Chart 1 Consumption values



Spending on necessities such as food, utilities and fuel increased due to rising inflation. The volume of retail spending on food and drink to consume at home had also been boosted as households curtailed their visits to restaurants and bars. By contrast, spending on durable goods continued to decline, particularly on high-tech electrical goods such as flat-screen TVs. New and used car sales weakened significantly in June, having been supported in previous months by higher-than-normal levels of price discounting. Demand for home-ware goods such as carpets and furniture remained exceptionally weak.

In contrast to the official data, few contacts had seen especially strong demand in May. Warm snaps during parts of May had stimulated demand for summer clothing and footwear somewhat. But this had largely unwound in June.

The Agents' score for spending on consumer services fell sharply in June, reaching its lowest level since the scores began in 1997. Reports of a slowdown were widespread, including weaker demand for transport and communications, visitor attractions and restaurants and bars. The contraction in housing transactions had further reduced demand for conveyancing and other housing-related services such as removals.

Housing market

Housing demand continued to contract at a rapid pace. Many contacts judged that the level of activity was currently more depressed than during the early 1990s. The number of repossessions remained low, however. In the market for established homes more transactions were falling through, with some estate agents reporting a cancellation rate of up to 40% recently. That was partly due to the unwillingness of many sellers to accept a lower offer. Also, increasing numbers of potential buyers had either had mortgage offers withdrawn or had pulled out of transactions due to fears of capital losses. Both of these factors were exacerbated by the lengthening period of time between the acceptance of an offer and the purchase being completed, due to a rising number of transactions breaking down elsewhere in the housing chain. Confidence of estate agents continued to decline and more were either making staff redundant and/or closing offices. There were a number of reports of estate agencies refusing to accept new instructions, particularly if the seller was unwilling to negotiate on price, and some had raised their fees to reflect the increased cost of finding buyers.

In the market for new housing, the number of starts continued to dwindle. With rising amounts of unsold stock on their books, some house builders were attracting buyers by paying the deposit themselves — having first obtained the agreement of the mortgage lender — or by offering shared equity schemes. Prices of new houses were generally falling faster than in the market for established homes. In some towns and cities, prices of newly built apartments had fallen by over 25% in the past year, reflecting the degree of excess supply.

Investment

The Agents' scores for investment intentions were little changed this month.

Some businesses with longer product cycles — for example aerospace, telecommunications and utilities — were able to look beyond the current slowdown and their investment plans had been little affected by recent events. But others remained cautious about implementing major capital expenditure projects. Some had postponed investment decisions until at least next year, reflecting uncertainty about future levels of demand, the deterioration in cash flow recently and the tightening in credit markets. Those contacts most exposed to the slowdown — particularly in property-related businesses and retailers of bigger ticket home-ware goods — had either scaled back their expansion plans or were looking to sell off capital assets.

The majority of businesses were still largely unaffected by the tightening in credit conditions. That was either because they had access to adequate amounts of internal finance or their committed facilities remained sufficient — particularly where investment plans had been cut back. However, even high-quality borrowers reported having more hurdles to satisfy to gain access to new loan facilities and that the cost of finance had risen.

Overseas trade

External demand remained firm in June and the score for manufacturers' exports increased slightly. Export growth to the euro area was steady, supported by resilient German markets, and demand in Eastern Europe continued to accelerate. With the exception of consumer goods and construction equipment, US demand growth was reported to be stable. But the strongest growth remained in Asia, and also the Middle East where pricing in euros had become more common — to the advantage of UK manufacturers. In the service sector, architects and consulting engineers had successfully expanded their sales overseas in response to weakening demand at home.

The volume of imports decelerated further. There were a few reports suggesting that import growth had not slowed by as much as consumer spending, however. Because the slowdown in consumer demand had exceeded contacts' expectations, stocks of imported goods were accumulating in the supply chain.

Output

Manufacturing

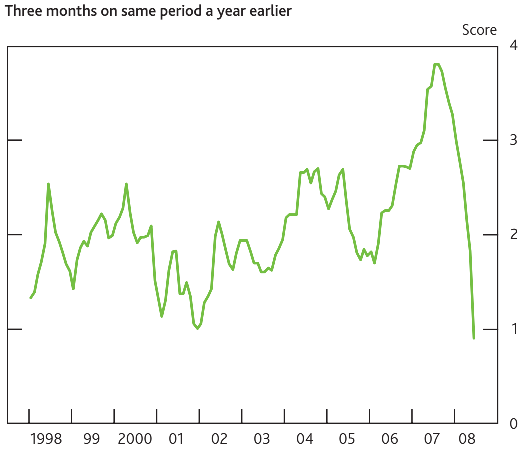
Manufacturing output growth was unchanged in June, reflecting slightly weaker domestic demand but slightly stronger overseas demand. Production of capital goods continued to expand strongly in areas such as commercial and military aerospace, agricultural machinery and a variety of energy-related sectors. But demand continued to weaken in domestic markets for consumer goods and building materials.

Construction

The score for construction output fell sharply in June (**Chart 2**). The rapid decline in recent months reflected the speed of the downturn in private house building, which contacts reported was unprecedented. House building financed by the public sector had also slowed, though not to the same degree. Activity in the commercial property market remained fairly steady, underpinned by the pipeline of work in progress. However, contacts anticipated weakening demand going

Chart 2 Construction output

Three months on same period a year earlier



forward. Until recently, the volume of work arising from the 2012 London Olympics had been expected to add to an already overheated construction sector. But many contacts now viewed the Olympics as an important stabiliser.

Services

The Agents' score for business services output fell again in June, its fourteenth successive monthly decline since its peak in April 2007. There were declines of similar magnitude in the scores for professional and financial services, and other business services. In professional and financial services, the tightening in credit conditions continued to restrict the availability of funds for commercial property developers and private equity companies. That had contributed to sharply reduced volumes of corporate transactions for lawyers and accountants. Insolvency practitioners were expecting a sharp increase in their workload this year but most reported that it had yet to materialise. In other business services, advertising agencies had suffered a sudden slowdown in demand from house builders and retailers. And hotels had seen reduced business spending on banqueting and conferencing facilities, which they attributed to cost-cutting measures by their customers.

Capacity utilisation

Capacity constraints in manufacturing and services continued to ease. Some manufacturers reported lower levels of outstanding orders and a reduced backlog of work, suggesting capacity utilisation would weaken in the coming months. In the service sector, the score for capacity constraints fell sharply this month. That largely reflected the rapid weakening in demand for property-related services, which had also begun to induce a reduction in supply capacity, especially of estate agents. Capacity constraints had also declined in the retail sector. Professional services firms such as accountants and lawyers reported that capacity utilisation had returned to more normal levels, having been elevated in recent years.

Employment

All of the Agents' national average scores for labour market quantities declined in June.

Many contacts reported fewer recruitment difficulties and reduced turnover of skilled workers. Labour demand had fallen sharply in the house building industry and in property-related services such as estate agencies and conveyancing, with widespread reports of redundancies and business closures. In other parts of the economy, redundancies were uncommon — though some firms had reduced staffing through natural wastage and some had either frozen or cut back on recruitment. By contrast, firms with a preponderance of highly skilled workers such as in professional and financial services were prepared to hold on to labour during the slowdown and many were continuing with their graduate recruitment programmes.

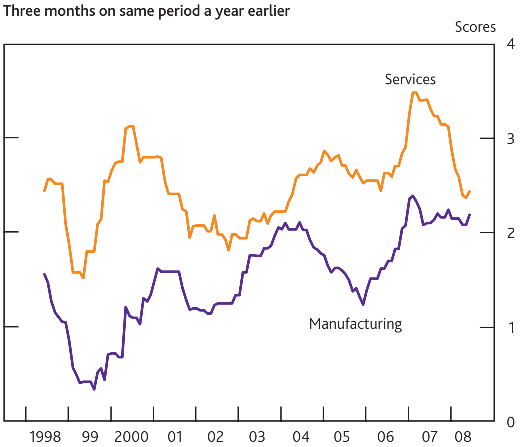
Costs and prices

Labour costs

The Agents' scores for labour costs in manufacturing and services rose fractionally in June (**Chart 3**). That largely reflected employees seeking to maintain real earnings in the face of rising price inflation. Conflict in pay negotiations was mostly confined to the public sector. Some private sector employers with unionised workforces were more apprehensive about their next pay round. But the majority of firms which had settled recently indicated that employees were more concerned about job security than receiving a larger pay rise. Many of those firms hit hardest by the slowdown had awarded smaller basic pay rises than last year. And those that incentivised staff with commission and bonus payments had seen a sharp reduction in their total remuneration bills. In the construction sector, some contacts reported that pay rises this year would be well below the negotiated percentage increases, which applied only to workers on minimum pay levels. Pay differentials would thus be compressed as employers looked to reduce their wage costs.

Chart 3 Labour costs

Three months on same period a year earlier

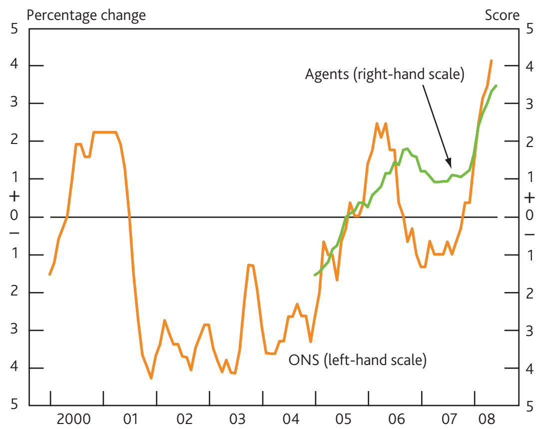


Input and output prices

The Agents' score for manufacturers' input prices edged higher in June. Most input price increases were related to the spike in crude oil prices; for example contacts cited sharply higher costs of petrochemicals, plastics, foam, packaging and transportation. But food manufacturers' input costs also accelerated due to further increases in soft commodity and meat prices, and there were renewed reports of rising costs of iron ore, steel, tin and scrap metal. Many contacts anticipated further cost increases in the months ahead as their annual or multi-year utility contracts expired; some planned to move to shorter-term purchases in the expectation that wholesale prices would decline from current levels. The cost of imported finished and intermediate goods continued to accelerate, mostly reflecting increasing world cost pressures and the strength of the euro (**Chart 4**).

Chart 4 Imported finished goods prices

Three months on same period a year earlier



The Agents' score for manufacturing output prices rose sharply in June. Notwithstanding that, the score for manufacturers' profitability continued to decline. Contacts reported that, although they had much greater scope to pass on higher material costs, full pass-through was rare so that margins continued to be squeezed. Most manufacturers had not anticipated the magnitude of input cost inflation in 2008. Consequently the selling prices agreed with customers in advance had proven to be too low. Some would request further large price increases. However, customers were expected to resist, especially in the retail sector.

Overall price inflation for business-to-business services was unchanged this month. Advertising rates and fees charged for legal services had softened, but freight transportation charges continued to escalate.

Consumer prices

The Agents' score for retail goods price inflation increased sharply in June due to further acceleration in the prices of fuel, energy and food. Abstracting from those price hikes, however, consumer price inflation for other goods was slightly lower, reflecting weakening consumer demand. Many retailers had launched their summer sales earlier than normal this year in order to clear surplus inventory, examples including retailers of furniture, electrical goods and summer fashions. Looking forward, there were some reports that the annual rate of retail food price inflation was likely to remain elevated until the autumn, but would then start to fall back due to price increases a year earlier dropping out of the annual comparison. Weakening demand had also restrained consumer services price inflation, with the Agents' score little changed in June. Hotels in particular were reported to have cut their room rates to stimulate demand.

Agents' survey of migrant labour

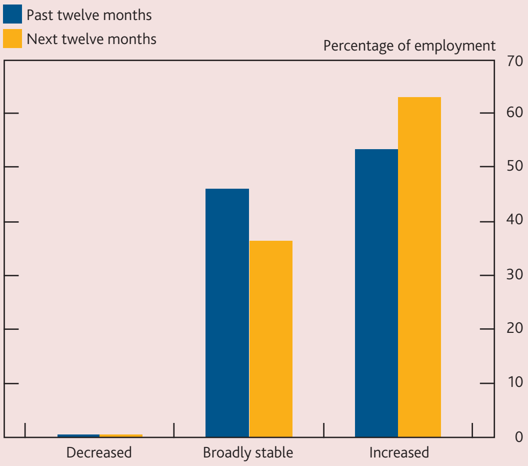
Net migration is of interest to monetary policy makers because it may affect the balance of labour demand and supply, wages, and firms' investment decisions. Following a steady upward trend in the previous decade, net migration to the United Kingdom increased sharply in 2004, and it has remained at a high level in much of the period since then. Recently, however, there have been reports that flows have eased back somewhat.

To investigate this issue, the Agents surveyed over 200 contacts regarding their use of migrant labour during May and June. The survey had a particular focus on those sectors of the economy which employ large numbers of migrants such as hospitality and catering. This box summarises the main findings.

The majority of contacts reported that migrants made up between 1%–10% of their workforce. For over one fifth of respondents the proportion was over 20%.

In the Agents' previous survey of migrant labour undertaken in December 2006, a large net balance of contacts reported that the proportion of migrant workers in their workforces had risen over the previous year, and was expected to increase further over the following twelve months (**Chart A**).

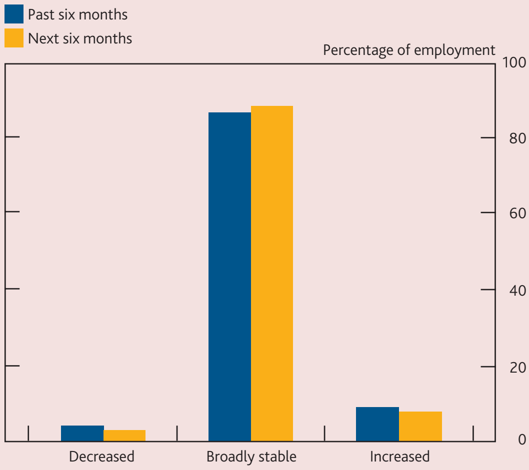
Chart A Changes in the migrant share of the workforce (December 2006 Agents' survey)



By contrast, in the latest survey the majority of contacts reported little change in the proportion of migrant workers over the past six months; and anticipated little significant change over the next six months (**Chart B**).

In part that weaker outlook may reflect lower demand for labour from businesses experiencing or anticipating weaker output growth. That would be consistent with the sharp decline in the Agents' scores for employment intentions in recent months.

Chart B Changes in the migrant share of the workforce (2008 survey)



Contacts also reported on whether migrant workers were becoming: more difficult to recruit; less skilled; more likely to return home; or if they had employed fewer migrants because of changes to work permit regulations. While the majority of employers had not observed a marked change in those factors, nearly half reported that migrant workers were more likely to return home and one third said that migrants were more difficult to recruit.

Employment agencies reported that Poland had been the main source of workers in the early wave of migration from A8 countries. Many of the early Polish migrants were graduates who had found employment in lesser-skilled occupations. However, the zloty's rapid appreciation against sterling and improved economic prospects in Poland had encouraged some Polish migrants to return home recently. While employment agencies had found a sufficient number of migrants from elsewhere to replace those Poles returning home, these had tended on average to be somewhat less highly skilled.