BANK OF ENGLAND

Agents' summary of business conditions

June 2008

- Consumption growth eased further.
- Weakness in housing demand and transactions intensified and new housing starts contracted sharply.
- Investment intentions fell in the service sector. Tighter credit conditions affected a growing number of companies, especially in the residential and commercial property sectors.
- Demand for exports was firm and was expected to remain so over the next six months (see the box on the Agents' survey of export conditions).
- Growth in domestically orientated manufacturing eased slightly, and there was more pronounced weakness in construction and services.
- Employment intentions remained depressed, having fallen sharply last month. The net inflow of migrant labour slowed and recruitment difficulties eased further.
- Capacity pressures eased a little.
- Growth in total labour costs remained well contained.
- Annual input price inflation remained at very high levels and annual output price inflation increased as manufacturers sought to maintain margins.
- Annual consumer price inflation increased, largely reflecting higher prices of fuel, energy and food.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with over 670 businesses in the period between **late April and late May**. 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.

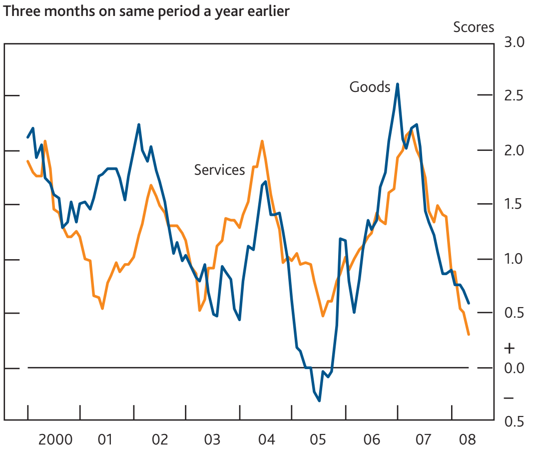
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

Agents reported a further easing in consumption growth, to its weakest pace since the autumn of 2005 (**Chart 1**).

Chart 1 Consumption values



With regard to spending on consumer goods, households had responded to the growing squeeze on their real incomes by restraining discretionary spending on perceived luxuries and/or searching for better value, including trading down to unbranded products. That had increased the market share of 'value' retailers of food, clothing and other essentials, and of internet retailers of bigger-ticket items such as electronic goods. Demand for homeware goods such as carpets and furniture had declined most sharply, which contacts partly ascribed to the rapid tail-off in housing transactions. By contrast, sales of new motor vehicles were steady, although car dealers reported that some consumers were trading down to cheaper models, partly on account of sharp increases in fuel prices.

The Agents' score for growth in spending on consumer services eased again and was at its lowest level since 1999. There were further signs of weakness in leisure spending, especially on eating and drinking out and cinema visits. The rapid decline in housing transactions had reduced the demand for conveyancing and home removal services. Contacts considered that the volume of bookings for summer holidays was stable, however, after adjusting for seasonal factors. But consumers were trading down to cheaper and nearer destinations.

Housing market

Housing demand decelerated further. In the market for established homes, many estate agencies reported that sales were at least 50% down on a year ago. First-time buyers were scarce, owing to a lack of finance; transactions were taking longer to complete; and stocks of unsold houses were growing. In addition to the shortage of mortgage funds and the widespread expectation that house prices had further to fall, a further constraint on housing transactions was the large increase in interest rates faced by existing homeowners when refinancing their mortgages. House prices were judged to be falling in most regions. In the rental market, demand had strengthened on account of the lack of mortgage availability for prospective first-time buyers, and rents were rising as a result.

In the new housing sector the shortage of mortgage finance was constraining demand, particularly from buy-to-let investors, and cancellations were at record levels despite increased incentives. Stocks of unsold new houses were increasing and house builders were mothballing new sites so that activity was largely confined to completing houses already started. Some builders reported that the volume of construction was currently around 50% lower than a year ago.

Investment

Agents' scores for the investment intentions of contacts in the service sector fell further. But intentions stabilised in manufacturing.

Agents largely associated the rapid decline in investment intentions in the service sector with the weakness of the commercial property market. Growing uncertainty about the economic outlook and tighter credit conditions had resulted in a sharp decline in demand for additional warehousing, offices and retail space.

By contrast, the slowdown in the investment intentions of manufacturers in recent months had been more restrained. That reflected a number of factors. First, demand in overseas markets had held up well and confidence among exporters was solid, helped by sterling's depreciation. Second, some manufacturers had still to catch up from past periods of underinvestment. Third, there was still considerable scope for many manufacturers to increase productivity and competitiveness through additional capital spending on machinery and IT.

The direct effects of tighter credit conditions on contacts had intensified over the past month. This was most apparent in the residential and commercial property sectors where lenders had tightened banking covenants, reduced loan to value ratios and significantly lowered property valuations, causing some projects to be postponed. These changes in bank lending policies had also affected (albeit to a lesser degree) companies in other sectors, particularly those where margins remained under severe pressure such as retail, car distribution and food manufacturing. Finally, with less, and more costly, access to bank overdraft facilities, invoice discounting and trade credit, many contacts reported greater strains on working capital and an increase in debtor days. That was most evident for smaller and medium-sized companies, some of which were deferring capital spending in order to conserve cash. Estate agents had been particularly affected. Some were unable to negotiate overdraft facilities and had been forced to close.

Overseas trade

External demand remained firm in May and the score for manufacturers' exports was close to its record high since the series began in 1997. Weakening demand, especially for consumer goods and construction equipment, was evident in the United States, Spain and Ireland. But that was offset by further acceleration in exports to emerging economies in Eastern Europe, the Middle East and Asia. In other EU countries, growth in the volume of demand was reported to be steady with several contacts singling out the solidity of German industrial demand. And the sterling value of exports to the euro area continued to be boosted by favourable currency movements. The results of a special survey of export conditions are reported in the box below.

Contacts reported slower growth in the volume of imports, mostly reflecting weaker consumer demand and residential investment. Faced with higher prices due to the stronger euro, some importers of euro-area goods had searched for alternative suppliers, including in the United Kingdom, but so far this had largely proved fruitless. By contrast, the rising cost of some goods manufactured in China — largely associated with higher local wage inflation — had resulted in many distributors sourcing from lower-cost countries such as India and Vietnam, where low value-added, commoditised products were also readily available.

Output

Primary

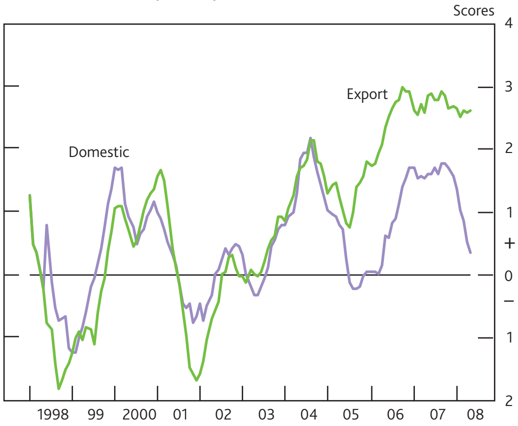
Farmers continued to grapple with sharply rising costs of fuel, fertiliser and feed and, in some regions, an impending shortage of migrant workers for the summer harvest. Arable farmers reported that total acreage under production would be about 5% up this year, reflecting the relaxation of set-aside regulations and the stimulus from elevated grain prices. Many farmers had chosen to increase acreage devoted to wheat.

Manufacturing

Manufacturing output growth slowed a little further, driven by softer domestic demand (**Chart 2**). Even so, the Agents' scores suggested that this remained the steadiest sector of the economy, with a continuation of modestly positive growth. Manufacturers of building materials and consumer goods for the domestic market continued to report the most pronounced easing in demand. By contrast, car production remained firm due to strong growth in overseas sales. For many contacts, vibrant world markets in aerospace, oil and gas exploration and mining, and power generation, continued to underpin the strength of their export orders.

Chart 2 Manufacturing output

Three months on same period a year earlier



Construction

Growth in construction output declined quite sharply in May and was significantly down on a year earlier. That mostly reflected the slowdown in housing starts. Small builders also reported lower demand from households for home improvements. While the pace of non-residential construction remained brisk, there were tentative signs of softer demand, reflected for example in greater competition at tenders, an easing in price pressures and lower order books. Some large public sector projects had been delayed.

Services

The Agents' score for business services output fell again, with a similar rate of decline in both professional/financial and other business services. The slowdown in the residential and commercial property markets had depressed demand for a number of professional and financial services. Activity levels in mergers and acquisitions, corporate finance and private equity transactions all remained weak, while the growth in demand for legal services continued to slow. Contacts in the more cyclical parts of the financial services sector such as investment banking expected the recovery to be delayed until 2010. But not all sectors were in decline. For example, employment agencies were busy and the demand for advertising, marketing and public relations services remained buoyant as clients sought to defend market shares in a tougher economic climate. Regarding the demand for other business services, cost-saving measures had reduced the amount of corporate discretionary spending on travel, hotels and conferences.

Capacity utilisation

Contacts reported that capacity pressures expected over the next six months had eased slightly and were significantly lower compared with their peak last summer, particularly in the service sector. The rapid build-up of surplus capacity in the home building industry had resulted in a sharp deterioration in profitability and contacts anticipated that a substantial downsizing in operations would be set in train shortly to correct that imbalance.

Employment

The scores for employment intentions remained depressed, having fallen sharply in April, and were suggestive of some modest contraction in labour demand over the next six months. Property-related sectors — especially house builders and estate agencies — had already started to make sizable layoffs and larger redundancies were anticipated. Given the uncertain outlook, more contacts were looking to increase the flexibility in their workforces by recruiting temporary and/or freelance staff in preference to permanent employees. But many contacts, especially in professional and financial services, were hoarding skills and had no wish to lose staff that would be difficult to replace at a later date. Larger professional services firms continued to recruit new graduates to ensure an adequate skills base in the longer term.

Consistent with the easing in labour demand, recruitment difficulties eased further. Staff turnover continued to moderate as employees became less confident about seeking alternative positions.

There were growing concerns that the future availability of migrant workers might not be sufficient to meet demand. The net inflow of migrants from A8 countries continued to slow. Also, recent changes to work permit regulations were limiting the supply of non-EU nationals, increasing skill shortages of, for example, chefs and pharmacists.

Costs and prices

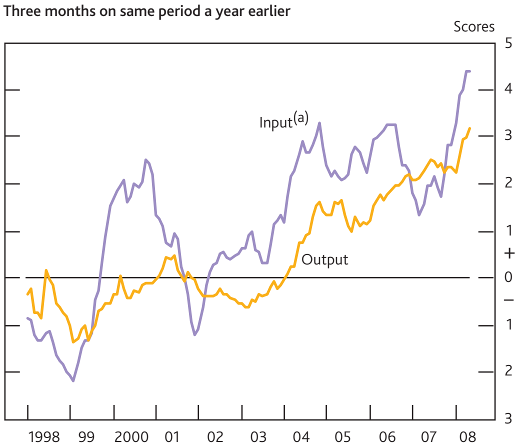
Labour costs

Pay settlements were steady in May. Contacts reported that the weaker economic climate, coupled with a great deal of negative media commentary on the outlook, had taken some of the heat out of employees' pay expectations, giving the advantage in negotiations to employers. That was despite a continued perception by employees that inflation was higher than recorded by official figures. Many employees in sales positions whose remuneration was largely determined by commission payments had seen either flat or falling take-home pay recently, reflecting the economic slowdown. Looking forward, bonus payments in the financial sector in 2009 were expected to be substantially lower on average than in 2008.

Input and output prices

The Agents' score for manufacturers' input prices remained at record levels since the series began in 1997 (**Chart 3**). The surge in oil prices continued to raise the costs of a wide range

Chart 3 Manufacturers' input and output prices



(a) Non-labour input prices.

of oil-based materials and other inputs, notably of utilities and transportation charges. There were some reports that steel prices were expected to increase sharply later this year. Construction costs faced by commercial property developers were also rising rapidly and some expected this would feed through to higher rents once the market started to recover. The cost of imported finished and intermediate goods continued to accelerate, mostly reflecting increasing cost pressures in Asia and the strength of the euro.

The Agents' score for manufacturing output prices rose further. Manufacturers' perceptions of their pricing power continued to increase and higher input costs were feeding through to output prices more speedily, though not usually one-for-one. For many contacts, the resultant downward pressure on margins has necessitated vigorous cost control in production and purchasing.

Price inflation for business-to-business services eased slightly this month, with slower growth in rates for professional services, industrial cleaning, hotels and conferences more than offsetting the higher prices charged by freight and finance providers.

Consumer prices

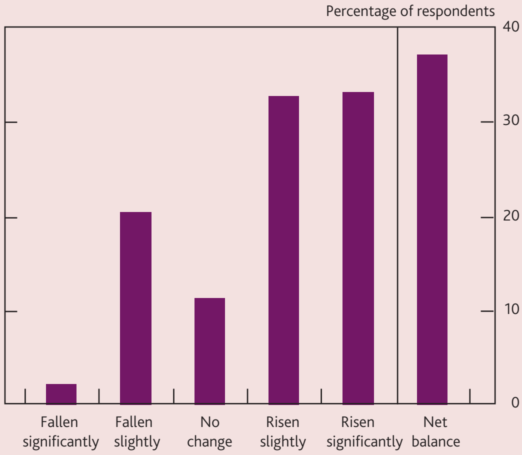
The Agents' score for retail goods prices increased sharply in May due to further acceleration in the prices of fuel, energy and food. The score for retail services prices also rose, albeit to a lesser extent, largely reflecting the same factors. Fuel surcharges were increased by many airlines and holiday companies. Restaurants and bars passed on a little of their higher food and drink costs to customers, although competitive pressures resulted in most of the increases being absorbed within the business so that margins were squeezed further.

Agents' survey of export conditions

As highlighted in the May *Inflation Report*, weaker growth in overseas markets is expected to bear down on the growth of UK exports. But the gain in competitiveness associated with sterling's depreciation should help to boost the contribution of net trade to GDP growth over the next few years. During April and May, the Agents surveyed around 200 of their contacts, across all the main sectors of the economy, to identify current trends in exports of goods and services. This box summarises the main findings.

When asked what had happened to the sterling value of export sales over the past six months, the majority of contacts reported either slight or significant increases, resulting in a strong net positive balance (**Chart A**). The minority reporting falls were primarily exporting to the United States, other dollar-denominated destinations or the Republic of Ireland. Exports of goods were slightly stronger than those of services. There were no major differences in export conditions as reported by small and large firms.

Chart A Export values over the past six months

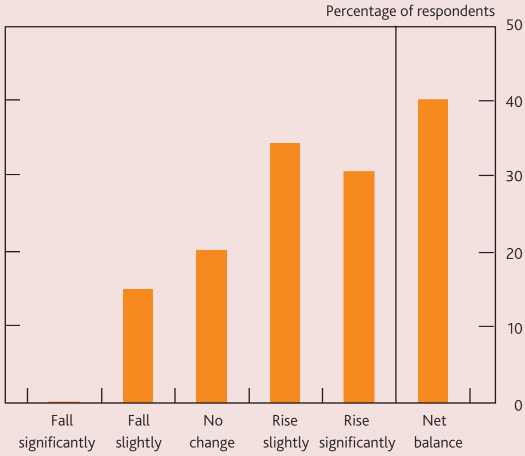


Note: The net balance is calculated by giving weights of 0.5 for a 'slightly' response and 1.0 for a 'significantly' response.

An even stronger pattern emerged when contacts were asked about expectations for the next six months, with very few expecting a significant fall in exports (**Chart B**). Goods exporters were again more positive than those in the service sector.

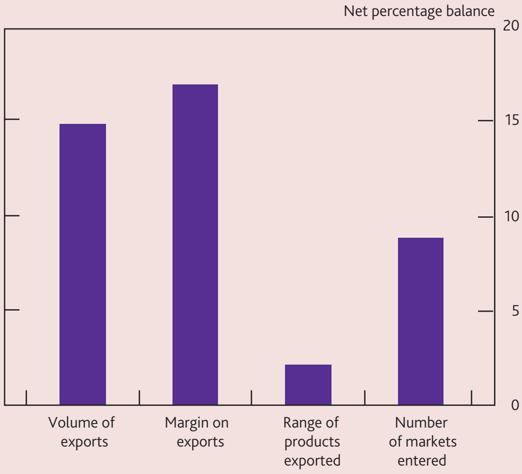
Respondents were also asked how the depreciation of sterling was affecting or expected to affect export sales. The strongest effect was an improvement in margins, marginally ahead of an increase in export volumes (**Chart C**). The range of products exported and the number of markets entered had also increased, though to a lesser extent.

Chart B Export values over the next six months



Note: The net balance is calculated by giving weights of 0.5 for a 'slightly' response and 1.0 for a 'significantly' response.

Chart C Effect of sterling's depreciation on exports



Given the significant depreciation of sterling over the past year, a rather larger proportion of the responses might have been expected in higher volumes. Contacts suggested this might be delayed because of the long-term nature of many export contracts and the use of hedging arrangements that were already in place — thereby delaying the benefit of a weaker exchange rate.