BANK OF ENGLAND

Agents' summary of business conditions

March 2008

- Consumption growth eased, driven by slower growth in the value of retail spending.
- The easing in demand for housing continued, and house price inflation fell further.
- Investment intentions fell in both the services and manufacturing sectors. Tighter credit conditions continued to weigh on investment intentions, mainly through their effect on uncertainty about demand.
- Demand for exports remained robust, as did forward orders.
- Growth in manufacturing edged down, while that in construction and service sector output slowed further.
- Labour demand softened and recruitment difficulties became less pronounced.
- Capacity pressures lessened and were expected to ease further.
- There was little change in pay settlements and growth in total labour costs remained well contained.
- Annual input price inflation rose sharply and annual output price inflation increased as manufacturers sought to restore margins. (See box on the Agents' cost pass-through survey.)
- Annual consumer price inflation increased, driven by increases in the 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 over 700 businesses in the period between **late January and late February**. 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.

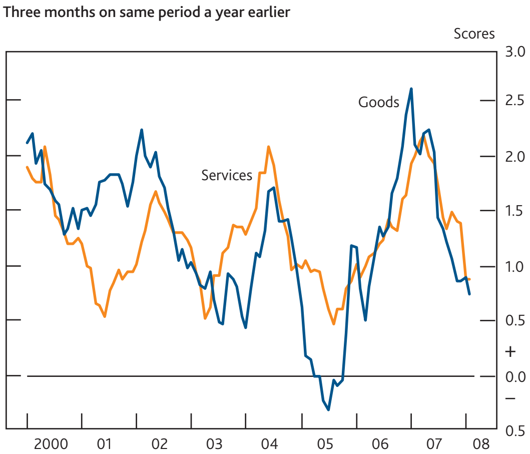
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

Agents reported that overall consumption growth slowed further in February, with growing evidence of households reining in discretionary spending on goods and services (**Chart 1**).

Chart 1 Consumption spending



The Agents' score for retail sales of goods resumed its downward trend as the stimulus to demand from unusually extensive discounting around the Christmas period had waned. Housing-related spending remained weak, and sales of fashion and leisure goods had slowed sharply. There were also further reports of weak spending by age groups most exposed to mortgage debt. In contrast, spending on electronics and food remained firm. Discounting was still prevalent, especially for non-food items.

The Agents' score for spending on consumer services was unchanged in February, but was well down on its level in recent months as households reduced their spending on services provided by tourism operators, hotels, clubs and restaurants.

Housing market

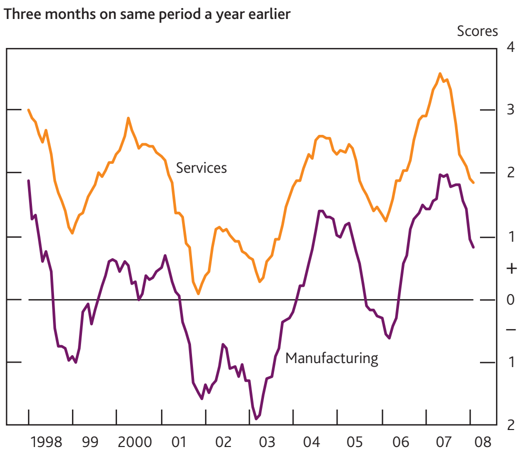
The weakness in housing demand persisted in February. In the market for established housing, credit conditions had become more constrained as lenders set higher loan to valuation ratios. This, along with uncertainty about the economic outlook, was weighing on demand. Estate agencies reported that enquiries and instructions remained subdued. Sale periods continued to lengthen and the cancellation of sales rose. Vendors were commonly accepting sizable discounts on asking prices for houses, which was one factor behind the fall in price inflation for established homes.

Demand for new housing also continued to weaken, as access to finance became more difficult and potential buyers deferred decisions in anticipation of price falls. House builders were keen to shed unsold stock and were discounting heavily. Reflecting this, price inflation for new homes slowed further. However, some contacts thought that demand for new housing may have reached its trough.

Investment

Investment intentions ticked down in February, having eased for much of the past year (**Chart 2**). Recent financial market turmoil had weighed on investment intentions, compounding the effects of earlier increases in Bank Rate. The direct effects remained concentrated in the commercial property and finance sectors, and for highly geared companies seeking to refinance their debt. Most contacts were still not affected by changes to the cost or availability of credit. But more contacts were concerned about the possible effects of tighter credit conditions on both domestic and global growth. Consequently, more companies were deferring or scaling down their investment plans even if their access to finance was unchanged.

Chart 2 Investment intentions over the next twelve months



Overseas trade

External demand remained robust, with weaker demand from the United States continuing to be offset by strength in the volume of sales to Europe, the Middle East, China, India and Africa. The depreciation of sterling had also enhanced the margins for exporters to these destinations. And external demand was expected to remain buoyant in the near term, given the strength in export orders and the depreciation of sterling. Some UK exporters were benefiting from their ability to supply economies (such as Middle Eastern countries and India) that had adopted British standards in aspects of production, with many of these economies remaining in a rapid growth phase.

Demand by UK companies for intermediate imports also remained solid. But there were reports of a slowing in imports of some consumer goods, consistent with the slowdown in household spending.

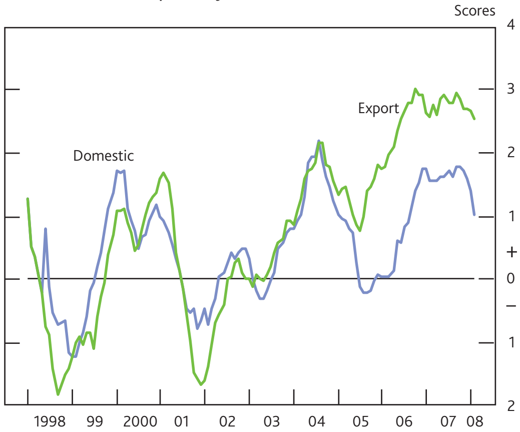
Output

Manufacturing

Total output growth in manufacturing slowed in February, but remained firm (**Chart 3**). External demand was still the key driver of growth, and export orders remained elevated. However, production for domestic markets eased noticeably in the month. This was particularly so for manufacturers of building materials and consumer goods. Domestic orders pointed to a further slowing in production for local markets.

Chart 3 Manufacturing output

Three months on same period a year earlier



Construction

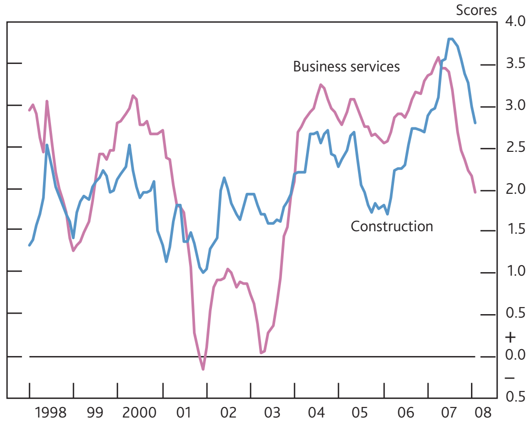
Growth in construction output eased further in February (**Chart 4**), driven by slower private sector house building. The overall pace of construction growth, however, remained high, supported by strength in non-residential construction. And with large amounts of non-residential work already pre-committed, construction activity was set to remain robust in the near term. But more commercial projects were now under review due to the effects of recent financial turmoil, and there was a general reduction in the appetite for speculative building. Consequently, some contacts were revising down their expectations for output growth beyond mid-2008.

Services

The Agents' score for business services output edged down in February to its lowest level in four years (**Chart 4**). A slowdown in demand for business services from its previous rapid pace had been under way since last April, but had been amplified by financial events. This slowing was still most evident in demand for professional and financial services, which fell abruptly following the onset of financial turmoil. But in the past two months, there had also been a reduction in demand for other business services (such as logistics and business catering), suggesting a broader slowing in the sector and possible spillover effects from tighter credit conditions. Consistent with this, many business service contacts had become more pessimistic about the outlook.

Chart 4 Sectoral output

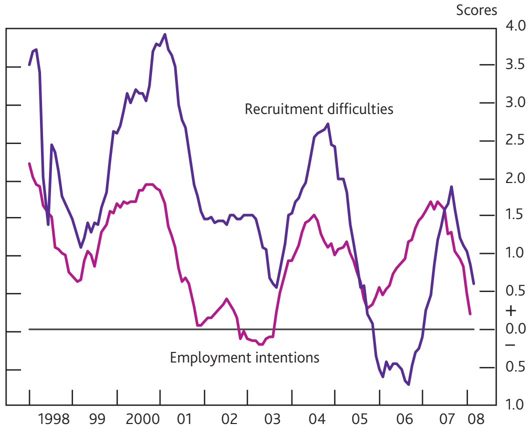
Three months on same period a year earlier



Employment

Given the slowdown in activity, growth in labour demand softened a little in February. Some contacts in sectors where the moderation in activity had been most pronounced reported reducing the number of hours of paid work. Others reported an increased tendency to leave existing vacancies unfilled. Looking ahead, employers had become more cautious about adding to their workforce. Reflecting this, the Agents' score for employment intentions over the next six months fell in February (**Chart 5**). The fall in intentions was concentrated in the business and consumer services sectors. But it was also evident in residential construction and, to a lesser extent, manufacturing where efforts to enhance productivity and contain growth in variable costs were weighing on labour demand.

Chart 5 Labour market(a)



(a) Recruitment difficulties relative to normal; employment intentions (average across sectors) over next six months.

In keeping with the easing in labour demand, recruitment difficulties were less prevalent in February than in mid-2007. In part this reflected a reduction in labour turnover as employees became less confident about seeking alternative positions. Some employers had also become more active in hoarding skilled labour, given the persistence of structural shortages of a range of professionals and skilled trades people.

Capacity utilisation

Contacts reported that capacity pressures were expected to ease over the next six months. This reflected the combined impact of additions to capacity over the past year or two along with the recent projected slowing in activity. Capacity pressures were expected to ease most in the services sector, where a pronounced slowdown in activity was already under way, and in manufacturing and construction.

Costs and prices

Labour costs

Agents reported that across-the-board pay settlements remained stable in February. Consistent with the results from the Agents' latest pay survey, recently negotiated settlements were little changed from those in the previous year; this was despite relatively high RPI inflation and the resurgence of energy costs. Companies also reported that growth in total labour costs had eased since mid last year, due to slower growth in the variable component of pay. But looking ahead, a slight pickup in labour cost growth was expected.

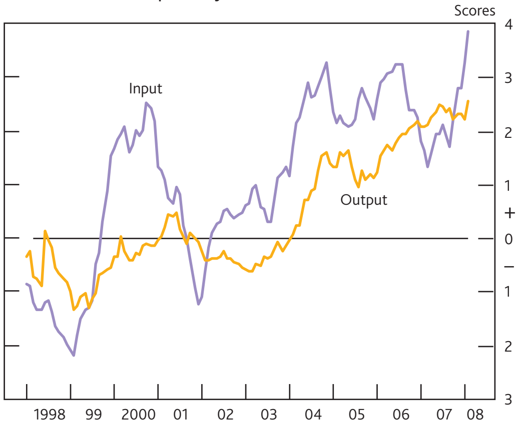
Input and output prices

Input price inflation jumped again in February (**Chart 6**). This was due to further substantial increases in the world prices of energy, oil derivatives, building materials and food inputs. In addition, contacts continued to report increases in the cost of importing finished and intermediate goods from China and India. These higher input prices reflected increases in world prices, and increasingly the effects of the depreciation of sterling.

The Agents' score for manufacturing output prices increased in February. Following sharp increases in input costs in recent months, and a consequent compression of margins, manufacturers had become more active in passing on cost increases. (For more details see the box on cost pass-through.) Food and beverage manufacturers had experienced the greatest success in securing price rises. However, higher prices were sometimes being imposed at the expense of market share as companies sought to restore margins to more sustainable levels.

Chart 6 Manufacturers' input and output prices[(a)]

Three months on same period a year earlier



(a) Manufacturers' non-labour input and output prices.

Business-to-business service price inflation also rose in February having eased for much of the past year. Contacts in specialist business services reportedly increased prices in response to earlier wage pressures, while providers of transport services had become more successful in passing on higher fuel costs.

Consumer prices

The Agents' score for annual goods price inflation ticked up again in February, reflecting further increases in the prices of energy and food. Annual service price inflation also increased, driven by higher transport and utilities prices. Consequently, overall consumer price inflation was higher.

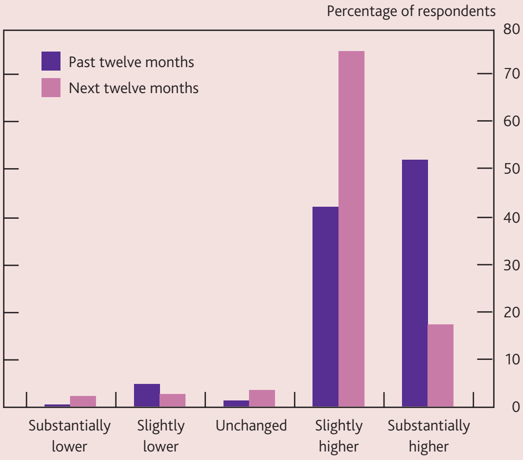
The near-term outlook was for further upward pressure on consumer price inflation. With higher contract prices being awarded to suppliers, some large retailers were becoming more active in passing on commodity-related cost increases to consumers. And the cost of final imports was anticipated by contacts to increase further. So the relative prices of various classes of goods in the CPI were set to rise. But contacts were also keen to offset higher price inflation for some products with lower price inflation elsewhere. Consistent with this, when asked about their average product price, the majority of retailers who responded to the Agents' survey on cost pass-through indicated that they would not be passing on recent cost increases in the near term.

Agents' cost pass-through survey

Given the acceleration of growth in input costs in recent months, prospects for inflation will be influenced by the extent to which these cost increases are passed on to prices. To investigate this issue, the Agents conducted a survey of around 200 of their contacts across all key sectors in the economy. The findings are summarised in this box.

Most respondents reported that their variable costs were higher than a year ago, and more than half reported that these costs were substantially higher (**Chart A**). Looking ahead, some further increases in variable costs were expected, albeit at a moderate pace.

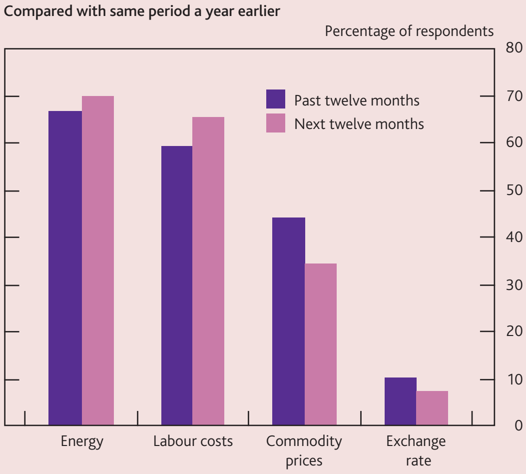
Chart A Variable costs



Respondents indicated that the cost of energy, labour and commodities had been the key drivers of total cost increases over the past year, and were expected to remain so over the year ahead (**Chart B**). This was most evident for energy and labour (the latter dominating most companies' cost base so that even modest increases can drive materially higher total costs). However, the impetus to growth in total costs from increases in commodity prices was expected to become less pronounced in the year ahead.

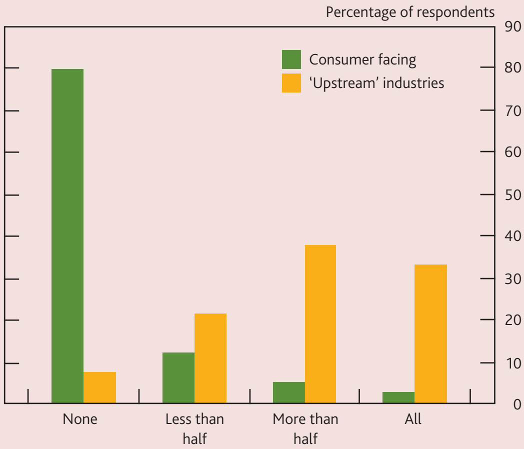
Chart B Drivers of cost increases

Compared with same period a year earlier



Given the significant increases in input costs that had occurred, and remained in prospect, respondents were asked how much would be passed on to their prices. A distinction was made between those consumer-facing respondents whose prices directly enter the CPI, and all other respondents whose prices are 'upstream' producer prices. As shown in **Chart C**, most consumer-facing respondents did not expect to pass on cost increases to their customers within the next twelve months. In contrast, most other respondents did. Of these, more than 50% expected to pass on at least half of the cost increase they had experienced.

Chart C Expected extent of cost pass-through within next twelve months



Note: Contacts could nominate more than one cost so that results sum to more than 100%.

In terms of the timing of pass-through, the bulk of respondents in upstream industries intending to pass on cost increases expected to do so by mid-year (**Chart D**). Of those few consumer-facing respondents intending to pass on cost increases, most already had done so, or were expecting to do so in the next few months.

Chart D Speed of pass-through