BANK OF ENGLAND

Agents' summary of business conditions

September 2008

- Consumption growth eased reflecting weaker retail sales and consumer services.
- The deceleration in housing demand continued.
- Investment intentions declined sharply. With regard to credit conditions, the cost of finance rose and availability diminished.
- Inventories of consumer durables increased.
- Demand for exports weakened slightly but was still relatively strong.
- Growth in domestically orientated manufacturing fell and there was further deceleration in construction and services output.
- Labour demand softened and recruitment difficulties eased.
- Capacity pressures continued to fall.
- Growth in total labour costs remained well contained.
- Annual input price inflation and output price inflation remained elevated.
- Annual consumer price inflation was steady.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with over 600 contacts in the period between late July and late August. 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.

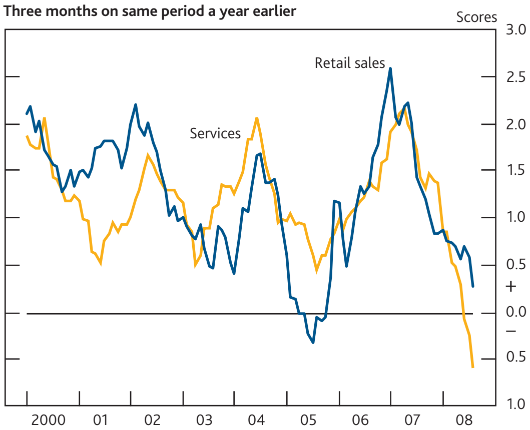
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

The Agents' scores for retail sales and consumer services both declined (**Chart 1**).

Chart 1 Consumption values



The score for the value of retail sales fell in August, having been broadly flat in recent months. With little perceived change in goods price inflation in the month, the Agents reported a corresponding decline in the growth of retail sales volumes.

Consumers continued to rein in their discretionary spending, especially for big-ticket household items such as carpets and furniture. Growth in sales volumes of electrical goods — which until recently had been comparatively buoyant — declined sharply. Demand contracted even for some low-priced items such as greeting cards, newspapers and magazines.

Demand for new and used cars declined significantly. Dealers attributed that to several factors, including waning consumer confidence and increased finance costs for car buyers. Also, recent sharp falls in resale values had discouraged many potential buyers from part-exchanging their used vehicles for new cars.

The Agents' score for spending on consumer services continued to decline, and had fallen by much more than the score for retail sales since their respective peaks in early 2007. Where possible, households had been cutting discretionary spending, for example by making less use of mobile phones and switching from taxis to public transport. Non-essential servicing and repair of motor vehicles had been delayed. Pubs and restaurants reported a further weakening in sales, with some contacts noting that the poor summer weather and TV coverage of the Olympics had encouraged consumers to stay at home. Demand for housing-related services such as conveyancing and removals contracted further.

Housing market

The number of transactions for established homes continued to decelerate. The number of transactions had fallen by around 50%–60% on a year earlier and was increasingly confined to forced sales arising from job relocations, probate and repossessions. The collapse in transactions by first-time buyers had increased rental demand. But the supply of rental property had also risen, leaving rents little changed. For example, with little demand for new housing, house builders were increasingly renting out unsold properties (see below). Investor demand in the buy-to-let market had declined sharply in recent months. But there were as yet still few reports of forced sales or financial distress among investors.

Investment

Agents' scores for investment intentions declined, with the score for the service sector falling sharply.

An increasing number of firms had deferred or cancelled investment, mostly reflecting deteriorating business confidence in the short-term economic outlook and a growing amount of spare capacity. For example, retailers had scaled back plans to refurbish stores and open new ones. With relatively few firms looking to expand capacity, most had focused their capital spending on raising efficiency — for example by upgrading IT systems and power generating equipment — and legislative compliance.

There were comparatively few reports of companies deferring capital spending on account of financing difficulties. But some contacts were more cautious in planning future investment in case credit conditions deteriorated further. Some banks had repriced loans to small and medium-sized enterprises (SMEs) based on current market interest rates such as Libor rather than Bank Rate. The value of collateral, especially property, was being scrutinised more carefully and loan to value ratios had been reduced, reflecting the risk of further falls in residential and commercial property prices. Some non-bank contacts were concerned that their banks would be unwilling to increase their lending facilities should the need arise. That had engendered a more cautious stance with regard to investment intentions, cash flow and the amount of trade credit extended to customers. Firms reported a further increase in delays receiving payment from debtors. But there were few reports of any significant rise in bad debts.

Inventories

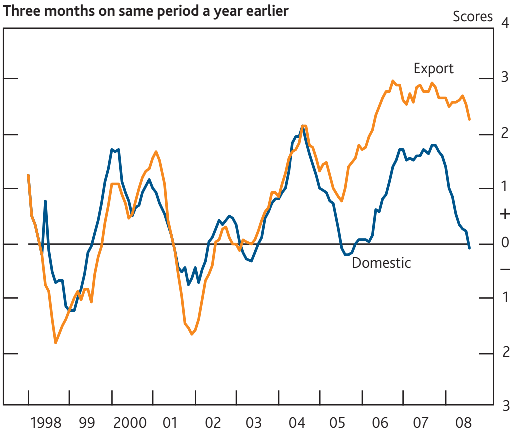
Retailers and distributors reported significant, unanticipated stockbuilding of a variety of consumer durables, especially new and used cars, furniture and TVs. Looking forward, retailers planned to reduce orders and hold less stock than in previous years in the run-up to Christmas. Inventory accumulation had also been problematic for house builders, who had attempted to improve cash flow by trying to let out completed properties, offering shared equity schemes to prospective buyers and increasing sales to housing associations.

Exports and imports

External demand growth fell slightly in August (**Chart 2**). Even so, the Agents reported that export growth remained substantially more robust than other components of aggregate demand. Euro-area and US markets were a little weaker on the month. By contrast, buoyant demand growth continued in emerging markets for intermediate and capital goods, often used in energy and infrastructure projects. Demand remained particularly strong for engineering consultancy and project management services, for instance for the construction of petrochemical refineries.

Import growth was reported to have slowed, mostly reflecting weaker growth in domestic demand. There were also increasing reports of UK manufacturers gaining share in domestic markets at the expense of Far Eastern suppliers, largely reflecting customer dissatisfaction with the latter's product quality, delivery delays and rising prices.

Chart 2 Manufacturing output



Output

Services

The Agents' score for business services output declined in August. Within business services, the score for professional and financial services was broadly unchanged, but other business services weakened. In professional and financial services, many accountancy firms had shifted resources away from corporate finance and transactions work towards business recovery and outsourcing. In the legal sector, the continued sharp fall in demand for conveyancing and property-related services had been offset by increased activity in law firms' insolvency, litigation and employment departments. Corporate demand for recruitment, advertising and marketing services weakened. In other business services, corporate discretionary spending continued to ease for a variety of services including travel, hotels and conferencing.

Logistics companies reported weaker demand growth, mostly reflecting the slowdown in consumption and house building.

Manufacturing

Manufacturing output growth declined in August (**Chart 2**). Weaker production for domestic markets mostly reflected further contraction in demand from the construction industry for products such as bricks. Newspapers reported a sharp fall in advertising income which had reduced value added. By contrast, car production was steady despite weaker demand. Manufacturers of equipment used in aerospace, energy production and commercial waste disposal continued to report buoyant activity and strong domestic order books.

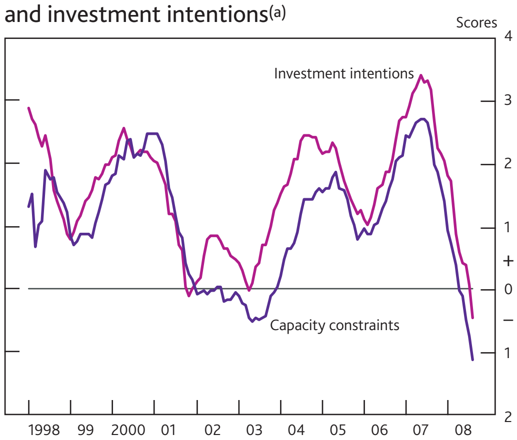
Construction

Construction output growth slowed further. The volume of house building continued to contract. Work had ceased on many uncompleted properties, which were being mothballed in the absence of confirmed purchasers. New housing starts were at very low levels. Activity in the commercial property market eased further. However, output continued to be supported by the relatively high volume of work in progress, reflecting the long lead times between starting and completing developments. There was a steady volume of public sector commissioned construction.

Capacity utilisation

Capacity constraints in manufacturing and services declined in August. Overall, contacts reported that the slowdown in demand had been quicker than anticipated and the amount of spare capacity was greater than normal. That had contributed to the recent sharp fall in firms' investment intentions (**Chart 3**). Actions taken so far to reduce spare capacity had largely been incremental — for example most firms had not made cuts in their workforce commensurate with an anticipation of a further weakening in demand growth. Even so, a sizable minority of firms — especially those SMEs with

Chart 3 Capacity constraints over the next six months and investment intentions[a]



(a) The aggregate scores for capacity constraints and investment intentions are weighted averages of the respective scores for manufacturing and services.

low profit margins and limited access to external finance — had responded more speedily to the slowdown by aggressively reducing capacity, for example by cutting staff and sub-letting unwanted office space.

Employment

Labour demand continued to soften in August. Many firms had implemented a freeze on recruitment recently. Reports of redundancies were more common and had spread to a broader range of industries such as retailing and newspaper publishing. Investment banks had recently implemented a further round of labour shedding and more job cuts were expected soon in the sector. Across the economy as a whole, recruitment difficulties declined, although vacancies remained hard to fill for a few skills such as engineering and accountancy. In recent months contacts had noted a much better supply of suitable indigenous workers available to fill lesser-skilled jobs, but migrants were somewhat less easy to find.

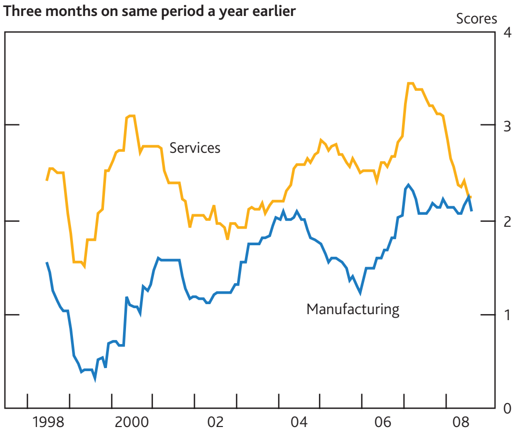
Costs and prices

Labour costs

The Agents' scores for the growth of labour costs were little changed in August. Over the past year the manufacturing score had been broadly flat. But the score for the service sector had declined steadily, mostly reflecting lower commission and other performance-related payments (**Chart 4**).

Chart 4 Labour costs

Three months on same period a year earlier



The Agents had little news on wage settlements this month as comparatively few contacts had annual pay reviews in July and August. Looking forward, the majority of firms anticipated that their next annual pay settlement would be broadly unchanged compared with their previous award. For many contacts, the recent weakening in demand growth and rising non-wage costs had weighed heavily on profitability and they were unwilling to countenance larger increases given the uncertain outlook. While some planned to increase their awards, mostly on account of the rise in RPI inflation, there was a broadly similar number of firms looking to give a smaller pay rise and a growing number anticipated a pay freeze.

Input and output prices

The Agents' score for manufacturers' input price inflation was unchanged in August. Spot prices of most commodities had fallen over the past month, especially for oil. However, contacts continued to report rising costs of manufactured materials such as plastics and packaging, reflecting lags in the supply chain between changes in input and output prices. Looking forward, many firms were concerned about expected further increases in the prices of steel and energy as contracts came up for renewal.

The cost of imported finished and intermediate goods accelerated a little further. That partly reflected increasing cost pressures in emerging markets and partly the recent weakness of sterling.

The Agents' score for manufacturing output price inflation remained elevated. Overall, manufacturers had not fully recovered previous sharp increases in their material costs and they continued to pass these on to customers. Contacts expected further increases in their prices in the next few months. However, the scope to make those increases stick was reducing as the economy slowed, and some expected a much tougher climate for negotiating price rises.

The score for business-to-business services price inflation eased slightly this month. There was an increasing number of reports that the slowdown in demand for business services was reflected in weaker pricing, for example advertising companies had started to discount their charges for advertising space more heavily. By contrast, many haulage companies, including those with fuel escalator clauses, had not yet passed on the recent fall in fuel prices to their customers and instead had recovered some of the margin erosion suffered when fuel prices had been rising.

Consumer prices

The scores for retail goods and services price inflation were little changed in August. For retail goods, higher energy prices were broadly offset by lower prices of clothing, electrical goods, furniture and motor vehicles (especially used cars). Annual food price inflation was little changed on the month but was expected to ease going forward due to recent commodity price falls for cereals etc and the dropping out of the annual comparison of retail food price increases a year earlier. In the service sector, Agents' reports suggested that retail price inflation may have started to level out, largely reflecting the slowdown in consumer demand. Prices had fallen in August for motor insurance premia and for some property-related financial services.