BANK OF ENGLAND

Agents' summary of business conditions

March 2009

- Retail sales values were down relative to the same period a year earlier. But demand had not contracted as sharply following the New Year sales as many retailers had feared.
- Investment intentions remained weak, primarily because of the depressed outlook for demand and the high level of uncertainty surrounding future prospects.
- Many contacts had reported shrinking export volumes. Weakness in world demand had outweighed any gains to competitiveness arising from sterling's depreciation.
- Manufacturing output had continued to contract as firms ran down stocks. Construction and services output had also fallen relative to the same period a year earlier.
- Credit conditions remained a major concern for many firms.
- Labour demand had continued to shrink. Many firms had cut average hours, and there were widespread reports of actual and planned cuts to headcount. Growth in per capita labour costs had slowed.
- On average, there had been little change in the rate of inflation in materials prices. A special survey of the Agents' contacts showed that there were significant differences between trends in the prices of energy, imported components and domestically sourced components (see box).
- Inflation in domestic output prices had eased further. The special survey on cost pass-through suggested that suppliers were encountering resistance to pass-through of any increases in costs, while being pressured to pass on any cuts in costs.
- Inflation in imported finished goods prices remained elevated. There were some signs of pass-through to retail food prices, but less widespread evidence for other goods prices.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with contacts in the period between late January and late February 2009.
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

Contacts had continued to report that retail sales values were down relative to the same period a year earlier. And many retailers had maintained deep discounting to stimulate demand. However, sales had not contracted as sharply following the New Year sales as many retailers had feared. Indeed, some contacts felt that the rate of contraction in non-food sales had eased during late January — reflected in a tickup in the Agents' score (**Chart 1**). However, in many parts of the United Kingdom, severe weather conditions had had an adverse impact on footfall during early February. Looking forward, few non-food retailers expected a material recovery in demand in the near term. That, together with concerns over availability of working capital, had led them to order less stock than normal for the time of year.

Chart 1 Consumer spending

Three months on same period a year earlier

Demand for consumer services was contracting more rapidly than retail goods sales. Many pubs and restaurants had seen very weak spending, while demand for property-related and financial services had also fallen sharply. There was some evidence of switching from foreign towards domestic holidays, in the wake of sterling's depreciation.

Housing market

While the volume of housing transactions had remained at very low levels, reports of growth in enquiries and viewings had become considerably more prevalent. There were now some signs that increases in buyer interest had led to a tickup in sales. However, the recent increase in enquiries and viewings had been limited to households and investors that had substantial liquid assets or housing equity. The dearth of mortgage availability at higher loan to value ratios had continued to exclude many first-time buyers from the market. Many estate agents felt that these financing constraints, coupled with widespread fear of unemployment, would preclude any substantive recovery in activity over the near term.

Business investment

Investment intentions remained weak. As in recent months, the majority of contacts had either cut capital spending plans or deferred previously approved projects. While some consumer-facing firms planned to maintain spending on refurbishment, capital expenditure plans were more typically limited to projects with a quick pay-off or that were necessary to meet regulatory requirements.

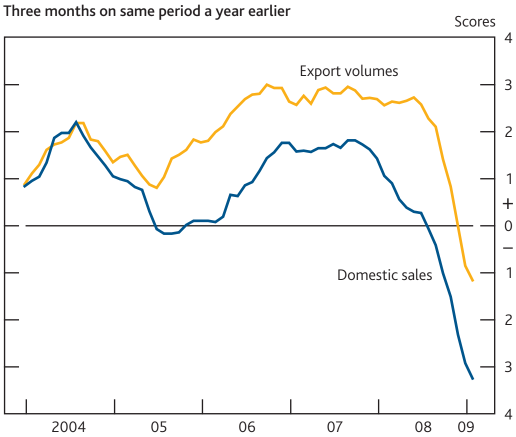
The depressed outlook for demand, coupled with substantial spare capacity, was often described as the prime driver of cutbacks in capital expenditure. The high level of uncertainty over future prospects was also widely cited as a factor leading to deferral of major spending decisions. Concerns over availability of working capital and project finance also remained important for many firms.

External demand

External demand was still seen to be stronger than domestic demand for manufactured goods. But many contacts reported shrinkage in export volumes, motivating further cuts to the Agents' score (**Chart 2**). Weakness in world demand had continued to outweigh any impact of sterling's recent depreciation. That depreciation had led to improvements in competitiveness for some firms — particularly those for which labour or domestically sourced components accounted for a large part of costs. But for many others, the rising cost of imported materials had limited the scope to cut foreign currency prices.

Chart 2 Manufacturing output

Three months on same period a year earlier



Import volumes had continued to contract sharply: as demand for consumer and capital goods had fallen, destocking had led to reduced orders for imported components, and sterling's recent depreciation had raised import prices. The rising cost of imported finished goods had led some retailers to switch to domestic suppliers. And, for companies earlier in the supply chain, there were some further reports of substitution from imported inputs towards domestically produced alternatives.

Inventories

There were widespread reports of destocking by manufacturers. Stocks were being run down fairly aggressively in those subsectors that had seen the most acute falls in demand during late 2008 — that is, the automotive, construction and capital goods sectors. Many contacts in these sectors continued to report excess stocks; particularly those at the early stages of the supply chain. But this was not surprising given the scale of excess stocks towards the end of 2008. Indeed, some contacts felt that their stock overhang was being unwound faster than they had previously expected.

Output

Business services

Turnover had fallen further for firms in a wide range of business services subsectors. Spending on haulage and distribution had fallen sharply. There were further reports of reductions in firms' non-contractual (discretionary) spending — for example on business travel. Commercial letting activity had remained moribund, with reports of deferrals to planned office moves as firms cut back on capital spending. And weakening labour demand had led to reductions in recruitment agencies' fee income.

For some time, demand for 'countercyclical' services such as litigation and insolvency work, had been the main element of growth in the business services sector. But for many auditing and legal practices, growth in these areas had been offset by shrinkage in demand for acquisitions-related, tax advisory and other work. Falling workloads had led some large professional services providers to cut headcount and make reductions to average hours.

Manufacturing

There was little change to the broad picture of substantial falls in manufacturing output (**Chart 2**). However, the aggregate picture masks material differences between subsectors. Output had collapsed across the automotive, construction-related and capital goods supply chains. Other sizable subsectors, such as aerospace and food processing, had not seen such a sharp change in demand. But even in those areas, growth in orders had slowed.

Construction

The level of construction activity had continued to contract. The sharp decline in private activity had more than offset continued growth in public sector demand. Private house-building activity remained much lower than at the start of 2008 — reflecting the weakness in housing demand and an overhang of stocks of new flats and houses. Commercial property activity had also contracted, and the pipeline of new projects was negligible. There had been further retail closures, leading to an excess of retail space in some parts of the United Kingdom. While some developers were still going ahead with planning applications, local authorities had seen a considerable reduction in planning activity.

Credit conditions

Concerns over the availability of working capital remained a major concern for many firms.

Trade credit

Senior management was focusing more acutely than normal on interfirm credit. The general trend was towards increasing debtor days — the time taken to receive payment for goods and services provided. But there were exceptions to this trend. In particular, there were reports of demands for upfront payments from customers for whom trade credit insurance cover had been withdrawn. Insolvencies had continued to rise. But so far, bad debts were rarely reported as having reached problematic levels for suppliers.

Bank finance

There were widespread reports that the cost of existing bank loans and facilities had not fallen in line with Bank Rate. Spreads on these loans and facilities had been widened and a wide range of fees had been increased or introduced.

The flow of new lending had slowed. In part, that was due to lower demand. Capital expenditure plans had been cut and some firms were deleveraging to avoid breaching covenants. More generally, firms were wary of approaching banks for finance for fear of triggering an unfavourable review of existing terms. In addition to slowing demand for finance, a number of contacts felt that banks had tightened the criteria applied to requests for new lending. That reflected both a reduced appetite for risk and perceptions that the risks attached to corporate lending had increased.

Employment

The broad picture remained one of shrinking demand for labour in the wake of falls in aggregate demand and output. Many firms had cut average hours. In part, that had occurred through reductions in overtime and cuts to shifts. Some firms had also sought to inject flexibility into hours through changes to working practices, such as introduction of short-time working. Freezes on recruitment of permanent staff were commonplace. And, as in recent months, a significant number of contacts had made cuts to permanent staffing levels. Many contacts had contingency plans to cut staffing if demand did not improve.

Costs and prices

Labour costs

Inflation in per capita labour costs had slowed further in recent months, reflected in reductions in the Agents' scores (**Chart 3**).

In part, that was the result of cuts in average hours — moves to shorter working weeks and cuts to expensive night and weekend shifts had had a substantial impact on labour costs for some firms. There were also widespread reports of lower bonus payments or suspension of bonus schemes.

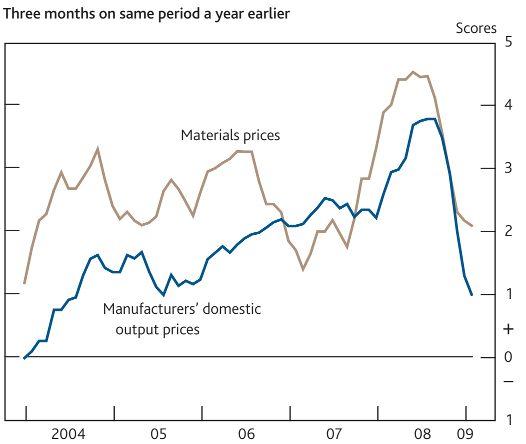
Chart 3 Labour costs per head

Regular pay pressures had also eased. As in recent months, many contacts felt that elevated concerns over job security had increased employees' willingness to accept lower settlements. The Agents had continued to hear widespread reports of plans for wage freezes. And a growing minority of contacts intended to impose pay cuts.

Producer prices

On average, there had been little change in the rate of inflation in materials prices (**Chart 4**). The results of a special survey on cost pass-through are reported in the box. That survey suggested that there were significant differences between trends in the prices of energy, imported components and domestically sourced components. Inflation in the price of many domestically produced components had eased in the wake of weak demand. But many contacts were now reporting sharp increases in the price of imported components, following sterling's recent depreciation. And, despite recent falls in wholesale gas prices and global oil prices, the Agents had continued to hear reports that energy bills were rising, as long-term fixed price contracts expired. The net effect of these changes to energy, imported and domestically sourced component prices varied across respondents to the survey — depending on the structure of their cost bases.

Chart 4 Manufacturers' input and output prices



Further down the supply chain, there were widespread reports that weakening demand had shifted the balance of negotiating power from suppliers towards purchasers, leading to pressure on suppliers' margins. These reports were consistent with responses to the special survey on cost pass-through which suggested that suppliers were encountering resistance to pass-through of any increase in costs, while being pressured to pass on any cuts. Weak demand had also led to a reduction in inflation in business services prices.

Consumer prices

Sterling's recent depreciation had led to increases in the wholesale price of a wide range of imported finished goods. Increases in wholesale prices were perhaps most prevalent for imported food and wine, but there had also been reports of increases in clothing, electrical goods and car prices. There were some signs of pass-through to retail food prices. But there was less widespread evidence of pass-through to other goods prices. There, the picture had continued to be dominated by promotional activity, leading to further reductions in the Agents' scores for retail goods prices (**Chart 5**).

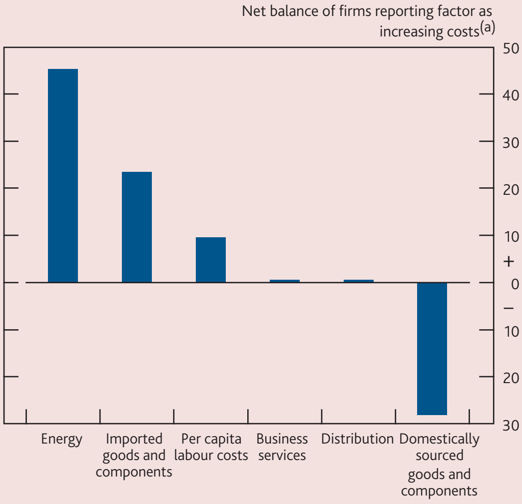
Chart 5 Retail goods and imported finished goods prices

Agents' survey on cost pass-through

While sterling has depreciated significantly over the past twelve months, falling global demand has led to downward pressure on both global commodity prices and suppliers' margins. To gauge the net impact on firms' costs, the Agents conducted a survey of around 250 of their contacts, across all sectors of the economy. The survey updated a similar exercise conducted in February 2008. All figures reported are weighted by turnover.

Respondents were asked which factors had most affected their variable costs over the past six months. For some time, contacts had been reporting that their energy bills were rising as long-term fixed price contracts expired. That was borne out by responses to the survey, as energy costs were the most widely reported upward pressure on costs (**Chart A**). While the cost of imported goods and components was also widely reported to have risen — as might have been expected in the wake of sterling's depreciation — many respondents noted that domestically sourced goods and components had become cheaper.

Chart A Factors most affecting variable costs over the past six months



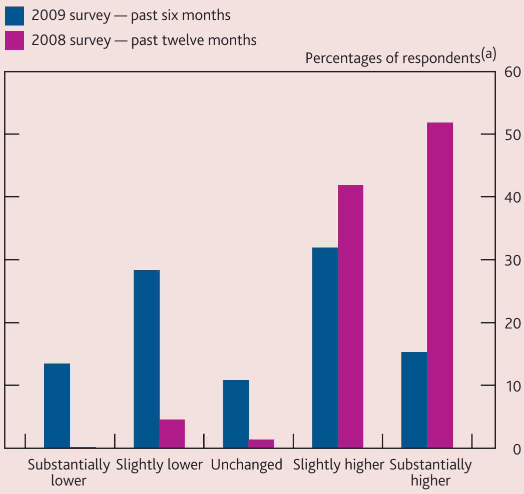
(a) Weighted by turnover, respondents could select more than one option.

The survey suggested that the net impact of these various changes in costs had varied markedly across firms (**Chart B**). That diversity of experience across respondents to the 2009 survey contrasted with the results of the 2008 survey, in which the majority of respondents had reported substantially increased costs. In the 2009 survey, there was tentative evidence that retailers and manufacturers of consumer goods had experienced greater upward pressure on costs than average.

Looking forward, more respondents expected costs to fall over the next six months than expected them to rise. That suggested that any further impact of sterling's depreciation on imported component prices was expected to be offset by easing of other costs.

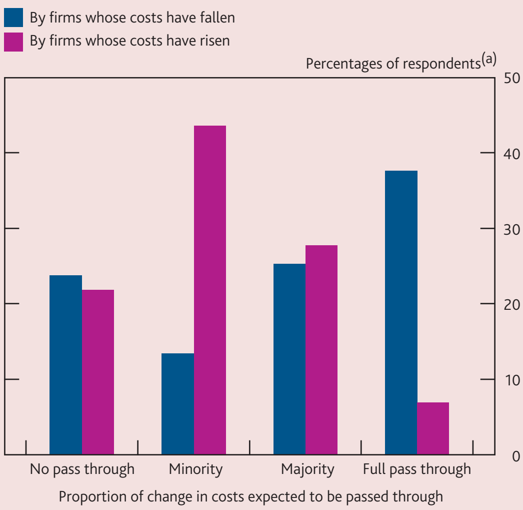
The survey suggested that pass-through of any falls in firms' costs was expected to be more complete than pass-through of any increases in costs. The majority of respondents whose average variable costs had fallen expected to pass on most of the falls (**Chart C**) — indeed, 50% had already cut prices. By contrast, most of those respondents whose costs had risen expected to pass less than half of any increases on to customers. This picture appeared consistent with more general reports from contacts that weakening demand had shifted the balance of negotiating power from suppliers towards purchasers, leading to pressure on suppliers' margins.

Chart B Change in variable costs



(a) Weighted by turnover.

Chart C Degree to which changes in variable costs are expected to be passed through



(a) Weighted by turnover.