BANK OF ENGLAND

Agents' summary of business conditions

August 2006

- Consumer spending growth was steady, at or slightly above historical average rates. But many retailers remained cautious about prospects for the rest of the year.
- The housing market recovery continued and optimism of house builders improved.
- Growth of exports and imports rose further.
- Investment intentions increased. That partly reflected manufacturers' need to invest in energy-saving equipment to improve cost competitiveness.
- Manufacturing production continued to pick up gradually, with a slight strengthening in domestic as well as overseas markets.
- Construction output growth was steady.
- Professional and financial services activity remained buoyant but output growth in other business services such as advertising weakened a little.
- Employment intentions remained slightly positive while slack in the labour market may have increased fractionally.
- Capacity pressures rose slightly in both manufacturing and services.
- There were few signs of any general increase in pay pressure.
- Input price inflation remained high, reflecting higher prices of energy, some metals and imported goods.
- Manufacturing output price inflation also stayed high and there was further pass-through to consumer goods prices.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with around 750 businesses in the period between late June 2006 and late July 2006. It provides information on the state of business conditions, from firms 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 firm 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.

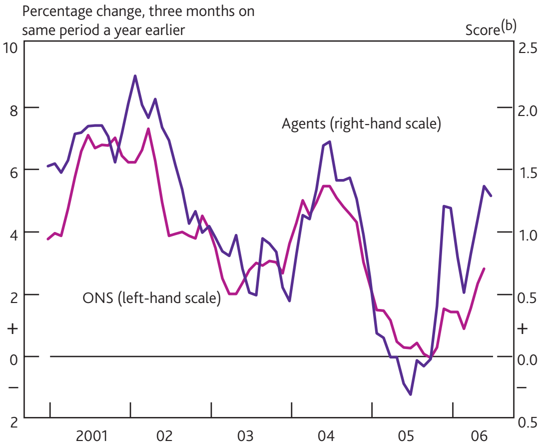
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the *Inflation Report*, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm**

Demand

Consumption and housing

Consumer demand growth stabilised in July, at or slightly above historical average rates. Demand for electrical goods remained strong and the hotter weather stimulated sales of summer fashions and goods for outdoor leisure activities. By contrast, contacts generally reported subdued demand for new cars and white goods. In addition, there were further reports of increased purchases of nearly new cars at the expense of reduced demand for new cars, on value for money grounds.

Chart 1 Retail sales values(a)



(a) For more information on the Agents' scores, see Ellis, C and Pike, T (2005), 'Introducing the Agents' scores', *Bank of England Quarterly Bulletin*, Winter, pages 424–30, available at www.bankofengland.co.uk/publications/quarterlybulletin/qb050401.pdf.
(b) A score of zero indicates that sales or turnover were unchanged in the latest three months compared to a year earlier. A positive (negative) score indicates sales or turnover were higher (lower) than a year earlier. For more information see Ellis and Pike (2005).

Looking ahead, many retailers remained cautious about trading prospects for the rest of the year. That reflected perceived budgetary pressures on households due to the squeeze on real income growth from higher energy and fuel prices, increased personal taxes and tightening credit conditions. Some contacts were also concerned about the possibility of interest rates being increased.

Consumer services growth was little changed in July. Legal and financial services provided to consumers had benefited from the revival in the housing market and by more active wealth management (including tax planning) by upper income groups. But leisure services — including bars, restaurants, hotels and pubs — generally reported weaker demand. An anticipated surge after the World Cup in bookings of overseas holidays with travel operators had not materialised. That was attributed in part to the prolonged spell of warm weather in the United Kingdom.

The steady recovery in housing market activity continued. Overall, the market was viewed as having returned to normal levels of activity. Prices rose modestly but were not expected to accelerate, reflecting affordability problems, especially for potential first-time buyers. Nevertheless, demand for lower-priced housing had remained strong, and many estate agents were concerned by declining stocks of those properties as sales outpaced new instructions. Some regions reported further signs of revival in the buy-to-let market.

House builders were upbeat about prospects for the rest of the year, with increasing sales reservations, housing starts and completions. Some large builders had stepped up volumes in order to offset the loss of profits arising from a change in the mix of house building towards lower priced houses where demand was strongest but margins were smaller. Persistent difficulties in securing planning permission had intensified competition between developers for new sites.

Exports and imports

Export growth continued to pick up with strengthening demand from the euro area, especially France and Germany. Buoyant sectors included defence, aerospace, health care and the manufacture of electrical equipment used in power generation. Growth in exports of goods remained strongest in emerging markets such as Eastern Europe, India and China. The service sector also benefited from growth in these regions, with for example increased demand for construction, surveying and engineering services. There were some reports that exports to the Middle East were curtailed due to the deteriorating security situation there.

Turning to imports, the current focus on cost cutting to alleviate the squeeze on manufacturers' margins had given a further fillip to overseas sourcing, at the expense of domestic output. Ports cited renewed growth in imports from India and China after a brief slowdown in Q1. That chimed with other reports from contacts that the Chinese economy accelerated in Q2. Import penetration also increased for services, for example financial services continued to outsource back-office and customer-service operations to India, and hauliers based in Eastern Europe gained market share in the United Kingdom due to lower costs of labour and fuel.

Investment

Manufacturing investment intentions strengthened a little further. To some extent, that reflected a more positive outlook for demand, with some firms looking to increase capacity. But more often contacts cited the need to reduce energy bills. Many firms were concerned that energy costs could remain higher in the medium term, causing some to accept longer pay-back periods of up to five years on investments that saved energy. Service sector investment intentions also edged higher. Supermarkets and other large retailers continued to invest heavily in new floor space and warehousing, and in the refurbishment of existing premises to improve competitiveness. And investment in transport infrastructure rose, with ports expanding to cope with increased trade volumes while airports and railways planned for rising passenger numbers.

But the news on investment was not uniformly positive. For those firms whose margins were most under pressure from higher energy costs, capital expenditure was often being cut back to improve cash flow. Existing assets were being used more intensively, an example being the subdued demand for new trucks by road hauliers.

Output

Primary production

There were concerns that the very dry weather recently would reduce yields of cereals and some vegetables compared with 2005. But with generally firmer prices for cattle and arable crops, farmers' optimism had improved a little. The growth of global supply of bio-fuels had increased demand and prices of wheat and oil-seed rape. But prices of sugar beet had fallen sharply since the change in EU subsidy arrangements. The outlook for dairy farmers remained poor owing to continued low milk prices.

Manufacturing

Manufacturing output rose further, with slightly improved demand in domestic as well as overseas markets. The main sources of stronger domestic demand were the construction and aerospace industries and users of energy-efficient capital equipment. Some food and drink processors also reported improved domestic sales, with the hot weather boosting demand for soft drinks, prepared salads etc.

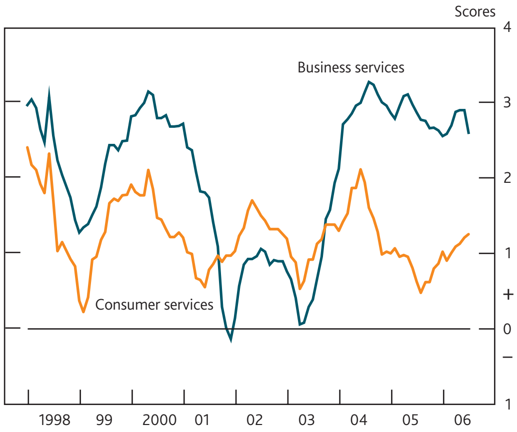
Construction

Construction output growth remained steady, at slightly above normal rates. Growth in public sector demand remained strong, but had slowed, with contacts noting reduced orders from the NHS. Offsetting that, house building and privately financed infrastructure projects accelerated.

Services

Professional and financial services activity continued to grow strongly in July. Banks, building societies, accountants and solicitors all reported strong growth in activity. That was helped by the housing market, regulatory changes in various areas of business (including pensions, accounting standards, the environment and health and safety), growing mergers and acquisitions activity and greater demand for tax planning advice by households. By contrast, demand for other business services decelerated slightly in July. That was partly due to companies' efforts to cut costs in the face of a continued squeeze on their margins. Most notably affected was the demand for advertising. Overall, growth in consumer services was little changed. Stronger growth in consumer demand for

Chart 2 Services turnover



professional and financial services was offset by weaker demand for leisure services (see above).

Employment

Contacts' employment intentions over the next six months were little changed in July. While the rate of job loss in manufacturing continued to slow, employment prospects in the private services sector may have eased slightly. Large retailers further reduced labour usage, in part by better matching of the hours worked by part-time staff to their peak hours of trading. Job creation in the public sector continued despite redundancies in the NHS. Overall, recruitment difficulties if anything had eased further. That largely reflected the growing availability of lower paid workers from the accession countries. But skill shortages amongst professions such as accountants and solicitors had increased.

Capacity utilisation

Capacity pressures rose slightly. The degree of spare capacity in manufacturing diminished further due to the increased demand seen in recent months. But most businesses retained some flexibility to increase capacity where necessary, for example by using agency staff during peak periods. Capacity pressures in the services sector also picked up slightly. Those pressures were most pronounced for professional and financial services, reflecting a lack of skilled staff.

Costs and prices

Pay

Only a relatively small number of companies were reported to have reviewed pay over the past month. Overall, average earnings growth in those companies was little changed as a result of these reviews. Many firms, including some in professional services, had agreed pay rises for the majority of their staff in recent months that were generally around last

Chart 3 Consumer prices for goods and services

year's levels, or were lower where company performance had deteriorated. The growth of overtime and bonus payments in sectors with skill shortages continued to increase as capacity constraints tightened a little.

Input prices

Input price inflation stayed high. In addition to the rising cost of electricity, more contacts noted that steel prices had accelerated. Prices of foodstuffs also increased. That was partly due to tighter global markets — world demand for cereals had risen due to increased production of bio-fuels and there had been import restrictions on beef from parts of South America. Prices of imported manufactures continued to accelerate. Contacts reported that inflationary pressures were mounting in China and some had switched to Indian suppliers. These included importers of engineered goods and textiles.

Output and consumer prices

Price inflation of manufactured goods continued to rise. But in the majority of cases not all of manufacturers' higher costs could be passed on to their customers and margins remained under downward pressure. Business services price inflation was little changed. Many companies in that sector experienced less impact from recent energy and fuel price increases on their overall costs.

Consumer goods price inflation picked up further in July. Strengthening demand allowed many retailers to pass on to consumers the higher prices charged by their suppliers. That included higher prices of fresh and processed foods. Consumer services price inflation was little changed. Greater competitive pressures for budget airlines and holidays served to offset the effects of higher energy and fuel costs.