Bank of England
Agents' summary of business conditions

June 2006

- **Consumer spending growth** picked up.
- The **housing market** recovery continued, with demand outpacing supply.
- **Export sales** accelerated again; **import growth** was less pronounced.
- **Investment intentions** rose: the pace of decline in UK manufacturing investment eased, and services companies expected their investment spending to accelerate.
- Alongside strong export sales, domestic **manufacturing production** picked up.
- **Construction output** grew steadily.
- **Business services** turnover was strong, particularly in the professional and financial sector.
- **Employment intentions** strengthened, with business services recruiting vigorously, but there was still slack in the labour market.
- The degree of **spare capacity** in the manufacturing sector narrowed; capacity pressures in the services sector were unchanged.
- There were few signs of **pay pressures**, or any second-round effects from higher energy prices.
- **Input price inflation** stayed high, reflecting the impact of energy prices.
- **Output price inflation** rose; there was limited pass-through to **consumer prices**.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with over 900 businesses in the period between late April 2006 and late May 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.

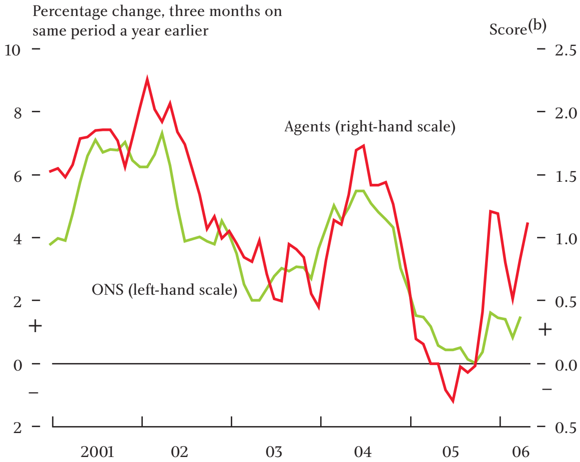
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, *obtained from: www.bankofengland.co.uk/publications/inflationreport/index.htm.*

DEMAND

Consumption and housing

Consumer spending growth picked up in May. But the picture was mixed: while some contacts reported a modest rise in sales over Easter, others reported weaker demand. Overall retail sales picked up slightly, due in part to the late timing of Easter, warmer weather, and high demand for specific products — notably beer and high-specification televisions — ahead of the football World Cup. Abstracting from these factors, spending remained a little soft compared with recent years, although well above last year's lows. Retail contacts remained cautious about the outlook for sales over the remainder of 2006. For example, demand for DIY products and other household goods was still fairly weak: the tentative signs of an increase in spending did not match the extent of the recovery in housing market activity.

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).

While overall retail sales growth was a little higher, growth in spending on consumer services was unchanged in May. Once again demand was polarised, with restaurant and pub chains reporting weak trading while spending on budget airlines was very strong. Leisure attractions benefited from the warmer weather over Easter, but holiday bookings were slow, partly due to the World Cup.

The recovery in housing market activity gathered pace, with estate agents reporting further improvements in demand after the lull in 2005. However, this was exacerbating the shortage of available stock for sale. Contacts noted that, as well as pushing up asking and selling prices, this was discouraging some homeowners from putting their property on the market, because of the increasing difficulty in finding their next home.

Housebuilding activity was rising in response to better sales, but was lagging behind the recovery in housing transactions. In some areas, the rate of new builds was still lower than in 2005. And while the use of incentives to sell stock had declined they were still available in a number of instances. Planning approval was delaying many projects, and was becoming more of a concern as builders tried to increase production.

Exports and imports

Export sales accelerated again, with UK companies reporting strong demand from Asia, the United States and the Middle East. The revival in European demand also gained impetus, with UK companies reporting higher orders from their French and German counterparts. UK engineering companies reported the strongest demand, particularly in the aerospace and chemical sectors. But more generally manufacturers were seeing stronger demand from abroad than in their domestic markets (see later).

UK imports also rose in May, but the pace of growth was more modest than for UK exports. While many companies were continuing to source materials and components from overseas, the relative weakness in imports of consumer goods continued. Some port contacts even noted that import volumes were lower than a year ago.

Investment

Contacts' investment intentions picked up. Manufacturing firms were scaling back on investment in the United Kingdom, but the pace of decline eased again. What UK investment was planned would focus on cutting costs and improving productivity following the recent squeeze in margins resulting from energy price rises: indeed, some current investment was aimed at cutting energy costs. While service sector firms were investing to cut costs too, some sectors were also investing in new capacity. In retailing, there were renewed reports of larger retailers investing in new floor space (alongside refurbishing existing sites), and banks were also looking to increase their presence on the high street. Telecoms companies continued to invest heavily, as did utility firms, and demand for IT investment remained strong.

OUTPUT

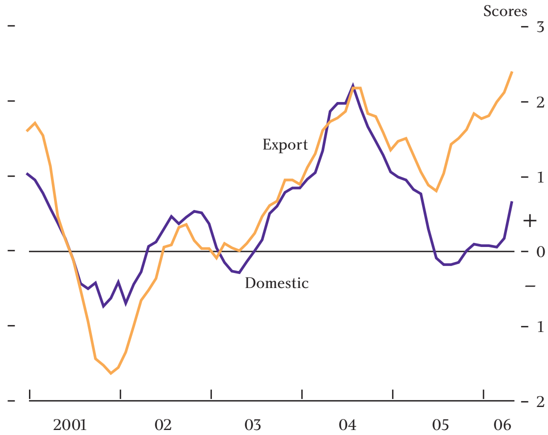
Primary production

Agricultural contacts reported some recent firming in prices: that had improved confidence if not production, which was little changed. Given recent rises in energy prices, coal-fired power stations were producing energy at close to full capacity. But North Sea oil and gas production weakened following recent rises.

Manufacturing

Manufacturing production rose, with output for both domestic and export markets rising. Export demand strengthened again (Chart 2), with the score at its highest since 1997. Domestic output growth also picked up, with demand improving across a range of goods, reflecting the recent improvements in business investment and consumer demand. Overall, demand was strongest for engineering and pharmaceutical firms, with printing and automotive production continuing to move overseas.

Chart 2
Manufacturing output



Construction

Construction output growth was broadly steady in May. Government-sponsored work was still buoying demand, but there were some reports of a slowdown in public sector spending. Offsetting that, commercial construction activity gathered pace. The expansion in the retail sector was a key source of demand; and speculative demand for new office developments remained strong. The recovery in housing market activity had led to a rise in new housing starts, although the rise in building activity was patchy.

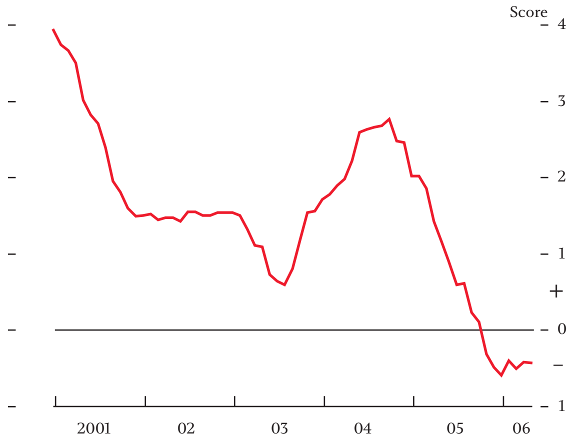
Services

Once again business services turnover outshone other sectors of the economy, with high and stable growth. The strong demand for professional and financial services was unabated, and reports from contacts from across the regions were uniformly positive. The buoyant demand for professional services reflected both the need to comply with new regulations and tax legislation, and also strong credit demand from certain sectors such as commercial property projects and M&A activity. The pace of demand for these services had a knock-on impact on some other business services, such as taxi and courier firms. But generally demand for other business services was less buoyant than demand for professional and financial services. Demand for consumer services was weaker still, but broadly stable.

EMPLOYMENT

Contacts' employment intentions over the next six months picked up across all major sectors, to varying degrees. The rate of lay-offs in manufacturing eased a little, consumer services companies were now expecting a modest increase in headcount, and business services firms were actively trying to recruit in the face of strong demand. But while the outlook for private sector employment improved, the state of the labour market was unchanged, with contacts still reporting a significant degree of slack (Chart 3). That reflected further inward migration, and also a slowing in public sector recruitment.

Chart 3
Recruitment difficulties(a)



(a) Skill shortages before January 2005.

CAPACITY UTILISATION

The degree of spare capacity in the manufacturing sector narrowed slightly, reflecting the stronger demand seen by UK companies. But there was still enough spare capacity to meet expected demand, and manufacturers were also able to 'flex' capacity if necessary. Capacity pressures in the services sector were unchanged: these were most pressing in professional and financial services, due to a lack of skilled staff. However, in the same way that some manufacturers were able to shift capacity overseas, some larger professional services companies were also increasing capacity temporarily — for example by flying in staff from overseas offices during busy periods.

COSTS AND PRICES

Pay

No significant pay pressures were reported. Settlements were at or below last year's levels, and increases in overall pay bills were fairly similar to a year ago. Contacts reported very few instances of workers demanding higher pay increases following the recent rises in petrol and domestic utility bills — indeed, many contacts noted that workers were aware that firms' margins were also being squeezed, with some unions even offering pay cuts to preserve employment. There were isolated instances of large pay rises, but these reflected particular skill shortages.

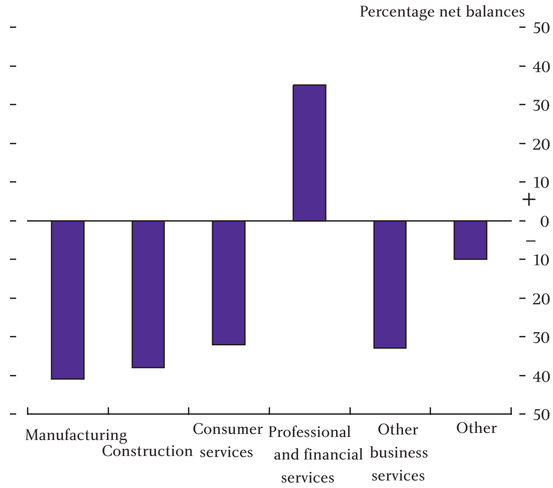
Input prices

Input price inflation remained high. The direct upward pressure on costs from energy prices continued to feed through as supply contracts were renewed. Energy costs were still the biggest concern for most businesses, and were encouraging contacts to investigate ways to improve energy efficiency and to source materials increasingly from abroad. The prices of imported components were also rising, and at an increasing pace. Manufacturers were most affected by the rise in energy costs, with many services companies — particularly business services firms — noting that energy costs were insignificant compared with the cost of labour, which was rising at a much more subdued pace (see above). Aside from the impact of energy (and metals) prices, other cost pressures were subdued.

Output and consumer prices

Manufacturing output price inflation stayed high, as the pass-through of higher energy costs to output prices continued. There were some signs that strengthening demand was making it easier for firms to pass on the cost increases, although this was more prevalent in the service sector — where energy costs were a relatively small proportion of total costs in the first place — than in manufacturing. Even those manufacturers with energy surcharges in place were finding it hard to enforce the full recovery of costs.

Chart 4
Profit margins(a)



(a) Net balances of firms reporting that that margins had risen or fallen. Individual responses have been weighted by turnover.

During May, the Agents carried out a survey of their contacts regarding their profit margins. The survey covered around 250 companies with a total turnover of £36 billion. The results suggested that most contacts had seen margins fall slightly over the past twelve months; the main exceptions were professional and financial services companies, where margins had risen (Chart 4). In response to lower margins, most contacts were likely to increase productivity and/or reduce employment to compensate. But many contacts simply said they would have to accept a lower profit margin, at least in part. In contrast, few contacts said they would reduce investment or increase their selling prices in order to regain profitability.

Most of the increase in energy costs was still being absorbed by manufacturers' margins. And some of the price increases posted by manufacturers were being absorbed in the distribution sector. As such, the impact on consumer goods prices was still fairly small, although inflation did pick up. Consumer services price inflation also rose a little as firms passed on energy costs. But overall, contacts saw little evidence that underlying inflation (ie excluding energy price effects) was increasing.