BANK OF ENGLAND

# Agents' summary of business conditions

November 2006

- Consumer spending growth was steady; sales of household durable goods picked up, but car sales weakened.
- Activity in the housing market was little changed.
- Export sales accelerated yet again; import growth remained strong.
- Investment intentions rose to their highest level for 18 months.
- Manufacturing output accelerated, as domestic demand strengthened.
- Construction output grew strongly.
- Service sector activity accelerated; professional and financial services were particularly strong.
- The labour market tightened a little, but there was still a degree of slack overall.
- Capacity pressures increased; pressures in the service sector were the highest for five years.
- There was little evidence of higher pay settlements, but contacts were cautious about the upcoming pay round.
- Input price inflation eased a little, reflecting lower energy prices.
- Consumer price inflation was broadly unchanged.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with over 1,000 businesses in the period between late September and late October 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

Overall, consumer demand growth was steady in October. Retail sales growth picked up slightly, driven by strong sales of items such as high-specification televisions and other audio-visual products. There were also reports that demand for some other durable goods was rising. Sales of low-value items were robust, with the main weakness again centred in 'middle market' clothing, continuing the polarisation of spending seen during this year. Overall, confidence among retailers probably improved over the month, with some reports of strong early sales of seasonal items.

In contrast, private demand for new cars showed no sign of picking up, with some exceptions among high-value models. The seasonal boost from the new registration plate in September had been weaker than last year, and most motor traders were downbeat about the prospects for sales of new cars.

Consumer services growth was broadly unchanged in October. The recent strength of domestic tourism continued, and there were also signs that foreign visitor numbers were picking up. But pubs, clubs and restaurants continued to report weakening demand, particularly those serving young and low-income customer groups.

### Housing

Activity in the housing market was little changed. While estate agents have enjoyed the usual seasonal pickup in activity following the summer lull, underlying demand in some regions softened. Despite this, the market remains relatively tight, particularly for less expensive properties, where shortages of homes for sale abound. However, this tightness was only having a limited upward impact on selling prices, with many contacts reporting modest house price inflation.

House builders were enjoying steady demand for new homes, particularly for lower-cost units; these were frequently bought off-plan, before the homes had actually been built. More generally demand remained steady, although the use of incentives to sell completed new housing stock was still widespread.

### Exports and imports

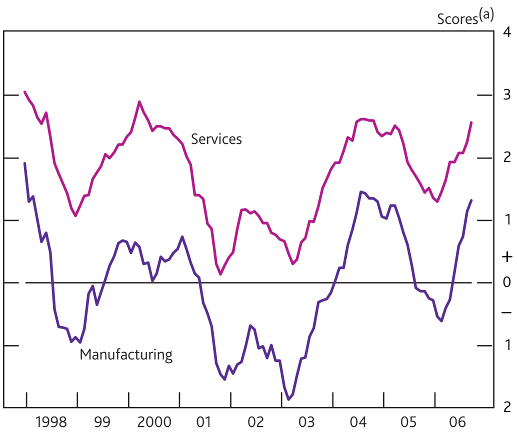
Export sales accelerated in October, continuing to underpin the improvement in manufacturing output. Once again, strong growth was seen across the Agency network. Demand from Europe continued to improve, and exports to the Far East remained strong. Despite some concerns among contacts about the outlook for the US economy, the impact on UK exports had so far been minimal.

Despite steady consumption growth, there were some reports that stocking by retailers for the pre-Christmas period was still fairly cautious, exacerbating the recent weakness of consumer imports. However, imports of raw materials and intermediate goods continued apace, and contacts were extending the out-sourcing of services activities abroad, such as IT and back-office work.

### Investment

Investment intentions rose in October, reaching their highest levels for 18 months (**Chart 1**). Many companies were continuing to invest in energy-efficiency projects, given the high level of energy prices. But there was also more focus on expanding capacity in the face of strong demand. In particular, while many manufacturing companies were locating new capacity abroad, an increasing number were also investing in new equipment or extending facilities for their UK operations. Professional services firms were investing heavily in IT in response to capacity constraints (skill shortages), in an attempt to raise output per worker. Retailers were also investing in new and refurbished premises, and several hotel chains were expecting to invest significantly more over the next year than they have over the past year.

**Chart 1** Investment intentions



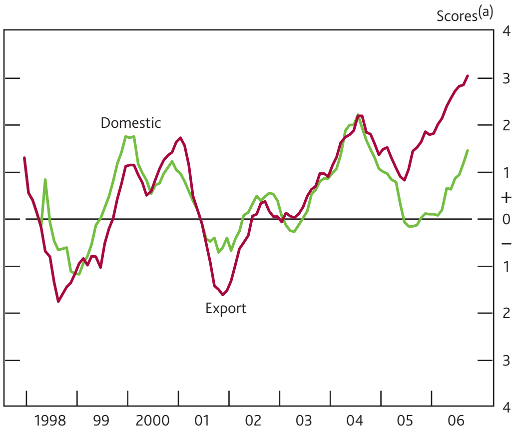

(a) A score of zero indicates that investment over the next twelve months was expected to be unchanged, compared with the past twelve months. A positive (negative) score indicates that investment was expected to be higher (lower) than a year earlier. For more information see Ellis, C and Pike, T (2005), 'Introducing the Agents' scores', *Bank of England Quarterly Bulletin*, Winter, pages 424–30.

## Output

### Manufacturing

Manufacturing production picked up in the face of strong demand, reflecting an acceleration in both exports (see above) and production for the domestic market (**Chart 2**). High-tech and niche manufacturers were performing the strongest, with producers of more commoditised items increasingly focusing on assembly of parts sourced overseas, rather than producing those items themselves.

Chart 2 Manufacturing output




(a) A score of zero indicates that output over the past three months was unchanged compared with the same period a year earlier. A positive (negative) score indicates that output was higher (lower) than a year earlier.

### Construction

The expansion in construction output continued. Public sector spending was a key driver of output growth, with further education work and an increasing emphasis on infrastructure development helping to buoy order books. Private sector demand was also strong across a variety of work, including civil engineering, retail, city offices and utilities.

### Services

Professional and financial services activity accelerated in October, continuing the very strong expansion seen in recent months. Demand was very high for taxation, regulatory and investment advice, corporate banking and commercial property activities. The strength of demand growth in these sectors was also spilling over into other service sectors, where demand also rose. Business demand for hotels was strengthening, as was corporate demand for outsourcing of back-office work and infrastructure management. However, some areas of weakness remained, notably traditional advertising: spending budgets were still tight, and the shift to internet-advertising continued. And performance was mixed in other sectors, such as wholesaling and haulage. Consumer services growth was broadly unchanged (see earlier).

## Employment

Contacts' intentions for employment growth over the next six months were broadly unchanged. Employment in manufacturing was expected to remain broadly stable, while consumer services companies expected a modest increase in headcount. The strongest demand was again from business services firms, where a lack of skilled labour was the main capacity constraint many contacts were facing. Perhaps reflecting this, the use of migrant labour remained widespread, and there were further reports of migrants filling higher-skilled roles. The supply of labour at the lower end of the market was still generally sufficient to meet demand. However, there were some signs that skill shortages at the higher end of the market may have intensified, particularly in business services. So, on balance, the degree of slack in the labour market may have diminished a little.

## Capacity utilisation

Capacity utilisation increased further. This was particularly true in the service sector, where pressures were the highest for five years. A lack of skilled staff in the business services sector was the primary constraint, and contacts were increasingly looking to migrants to fill specific skill shortages. As a result of these constraints, companies were more selective about the work they undertook, and were prepared to outsource activity where necessary. However, the impact of these capacity constraints on the selling prices of business services was still fairly subdued (see later). In the manufacturing sector, capacity pressures picked up a little, reflecting the pickup in demand growth.

## Costs and prices

### Pay

As yet, there was no widespread evidence of large pay increases: most settlements remained around the 3% mark. There were exceptions, notably in financial services, where skill shortages and strong profitability were leading to high pay increases. More generally, contacts were cautious about the upcoming pay round, citing the pickup in RPI inflation and the recent increase in the National Minimum Wage, which had narrowed pay differentials at the lower end of the wage distribution. However, while negotiations were expected to be tougher this year than last year, many contacts were still under margin pressure and employees were aware of that.

### Input prices

Input price inflation eased again in October. While the prices of material inputs were still higher than a year ago, the recent fall in energy prices was relieving part of the pressure on contacts' margins. However, many companies were tied into fixed-term contracts, rather than buying energy on the spot market. So, just as the full impact of the rises in energy prices had taken time to appear, the recent decline in prices would not be fully passed on to companies for some time. Similarly, the prices of energy-related inputs, such as plastics and chemicals, were lagging the decline in oil prices. The prices of imported finished goods continued to rise, although at a more modest pace than other input costs.

### Output and consumer prices

Manufacturing output price inflation crept up again in October, as the recent buoyancy in demand made it easier for companies to pass on more of their increased input costs to customers. However, in most instances contacts had still only passed on a limited proportion of the increase in costs in higher prices.

Although the pressure on capacity in the business services sector had been both prolonged and increasing over the past year, the rise in business to business service price inflation had been relatively modest (**Chart 3**). In part, that reflected companies 'flexing' capacity, where it was possible to do so. Contacts also reported that other factors had affected price setting, including longer-term considerations, rather than just current capacity pressures.

**Chart 3** Capacity pressure and business services inflation(a)


(a) Between January 2005 and October 2006.
(b) A score of zero indicates that prices over the past three months were unchanged compared with the same period a year earlier. A positive (negative) score indicates that prices was higher (lower) than a year earlier.
(c) Constraints over the next six months. Before January 2005, this score reflected companies' current situation, rather than being forward-looking.

Consumer price inflation was broadly unchanged in October, with little sign of widespread inflationary pressure. Higher energy prices continued to boost headline inflation although petrol prices had fallen back recently.