BANK OF ENGLAND

Agents' summary of business conditions

October 2006

- Consumer spending growth was steady.
- The housing market recovery continued. Supply rose to match demand and house price inflation stabilised.
- Export growth continued to strengthen modestly.
- Investment intentions rose a little further.
- Manufacturing production growth increased, with a marked pickup evident in domestic demand.
- Construction output growth also ticked up.
- Service sector output growth was steady.
- Employment intentions rose and skill shortages intensified.
- Capacity pressures rose slightly.
- Pay pressures were generally little changed, but were expected to grow next year.
- Input price inflation eased back, reflecting lower prices of oil and some metals.
- Manufacturing output price inflation was steady. Consumer price inflation eased slightly.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with over 700 businesses in the period between late August 2006 and late September 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**

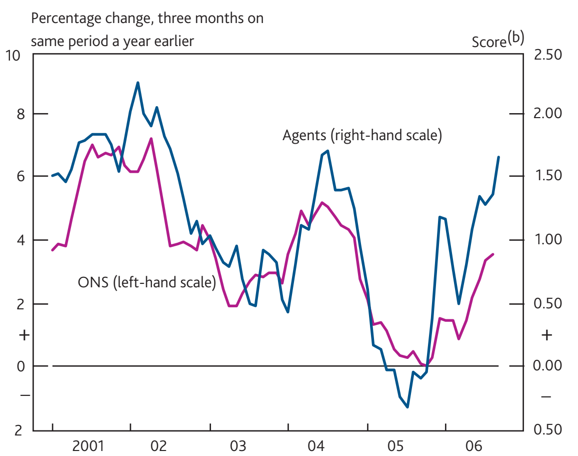
Demand

Consumption and housing

Overall, the annual growth rate of consumer demand in September was little changed compared with the previous month. Retail sales accelerated slightly. But new car sales were lower than a year earlier and growth of consumer spending on services eased a little.

Spending on durable goods (other than cars) continued to strengthen slightly. There was a modest pickup in demand for housing-related goods such as furniture, and sustained strong growth in sales of high-tech electronics including flat-screen TVs. The squeeze on household discretionary spending had benefited discount, 'value' retailers, dealers of used and nearly-new cars, and internet retailers which continued to gain market share. Up-market retailers also reported relatively strong demand growth. That chimed with new car sales in September. Total new car sales were reported to be down on a year ago. But sales of prestige marques had held up rather better. Looking ahead, some retailers were apprehensive about prospects between now and Christmas and had cut back on stocks.

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).

Reports of consumer demand for services were marginally weaker compared with the previous month, with reduced growth of spending on leisure activities, including restaurants and gaming. Travel operators and airports also reported weaker than expected demand. But that at least partly reflected the continued impact of the security alert on 10 August, and was mostly offset by a sizable boost to the domestic tourism industry. Legal and financial services continued to benefit from the strengthening housing market, though there was a further slowdown in the demand for unsecured credit.

The housing market continued to strengthen. Most Agencies reported further increases in demand. That was despite a persistent shortage of first-time buyers and a slight slowdown in investor demand in the buy-to-let market. But an increased number of estate agents had also noted a pickup in new instructions. House price inflation stopped rising. By contrast, in a few regions — most notably Northern Ireland and Scotland — the shortage of supply remained acute. In Northern Ireland, investor demand was particularly buoyant and annual house price inflation remained at around 25%.

House builders remained confident about demand prospects. Rising demand, especially for low to mid-priced properties, had reduced stocks of unsold new houses and some contacts were more willing to build speculatively to replenish stocks.

Exports and imports

Exports accelerated a little further. Some Agencies noted a slight slowdown in US demand. But that was counterbalanced by a pickup in sales to the euro area, especially France and Germany. The strongest demand remained for capital goods and construction materials, partly based on the surge in global capital expenditure in the oil, gas and mining industries. Exports of luxury consumer goods had also picked up. Overall, growth of imports continued to match or exceed that of exports. That mostly reflected an acceleration in imports of consumer goods and manufactured components, especially from countries that priced in dollars.

Investment

Investment intentions continued a steady revival. A more optimistic mood among manufacturers was reflected in their plans to raise the amount of capital spending in the year ahead. In some industries, most notably aerospace, higher capital spending was planned to address growing capacity constraints. But, more often, investment was focused on improving productivity and reducing energy consumption, in order to raise cost competitiveness. In the service sector, the pickup in investment intentions remained more modest. The growth in corporate demand for new office space, warehousing and retail premises had been steady. In the wholesale and retail sector, national chains continued to open new stores as they sought to gain market share from independent retailers. By contrast, investment had been cut back by some High Street pub chains, bars and restaurants that mostly targeted younger adults.

Output

Primary production

North Sea oil and gas production continued to decline. Output was being constrained by acute shortages of skilled staff and equipment, especially rigs, which were often being assigned to projects in other parts of the world.

Manufacturing

Manufacturing output growth rose further. Activity was buoyed by a marked pickup in domestic demand and continued solid growth in exports. Some manufacturers reported that legislative changes had stimulated domestic demand. For example, demand for new trucks had increased ahead of new EU emissions controls in October. And some firms had accumulated stocks of steel, and manufactures with a high steel content, in anticipation of further steel price increases.

Construction

Construction output continued its steady acceleration since the start of the year. Large contractors continued to report full order books from public sector projects. In the private sector, utilities companies reported increased spending on electricity transmission, water and sewerage infrastructure and nuclear decommissioning work. There was also continued steady growth in the construction of shopping centres and city centre offices.

Services

Output growth in the service sector was steady in September. Professional and financial services activity continued to accelerate slightly. That was offset by a slight easing in growth of consumer services (see above).

Accountants noted that compliance work emanating from Sarbanes Oxley legislation in the United States had probably peaked, but that corporate mergers and acquisitions activity had become stronger. Lawyers reported an increase in property-related activity. Generally, the pipeline of work for contacts in professional and financial services suggested that activity would remain strong at least until the new year. In other business services such as advertising and promotion and corporate hospitality, growth remained subdued. The squeeze on corporate margins continued to limit clients' discretionary spending on those services. And some consultancy firms had seen less work commissioned from local authorities. By contrast, there was stronger demand for telecommunications services, partly reflecting greater take-up of technological innovations such as broadband and voice over internet protocol (VOIP).

Employment

Contacts' employment intentions over the next six months rose further in September. That appeared to reflect growing business confidence in the economic outlook. Recruitment difficulties also increased. While there remained some slack in the market for unskilled workers, many firms reported that it had become more difficult to find skilled and semi-skilled staff to fill vacancies across a broad range of occupations.

Capacity utilisation

Capacity utilisation increased slightly, although apart from professional and financial services, most firms continued to have an adequate amount of capacity so that growth was not yet being constrained. Where skill shortages were a constraint on activity, some firms were able to find short-term solutions by increased use of agency and temporary staff or by outsourcing and offshoring work.

Costs and prices

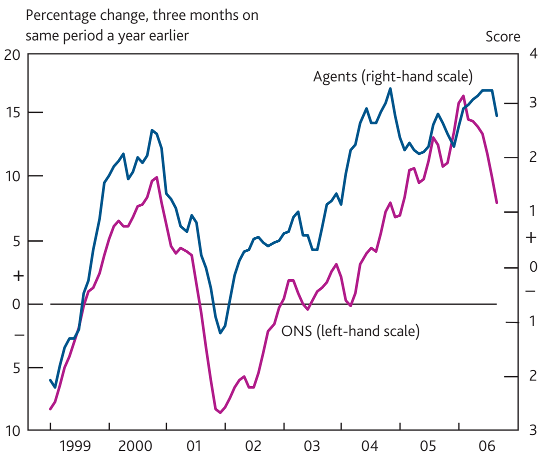
Pay

Pay settlements remained at around 3% and overall wage inflation was stable in most sectors. Industries with relatively high earnings levels tended to report increased pay pressure, reflecting growing problems in recruiting and retaining staff. In industries where pay levels were relatively low, such as retail, some contacts were concerned that the 5.9% increase in the National Minimum Wage on 1 October would add to labour costs at a time when their margins were already tight. Looking ahead, some employers expected to concede larger pay increases in 2007, mostly reflecting their firms' current profitable trading and a tightening labour market. That was especially the case in financial services.

Input prices

Input price inflation eased, mostly reflecting significantly lower prices of oil, gas and some metals. Lower oil prices had started to feed through into lower prices of plastics and basic chemicals. But many firms purchased utilities at fixed prices on annual contracts and had yet to benefit from lower wholesale gas prices. Overall, costs of imported finished goods continued to accelerate moderately, though inflationary pressures were ameliorated by the weaker dollar. There were more reports of increased inflationary pressure in low-cost economies, including China.

Chart 2 Input costs



Output prices

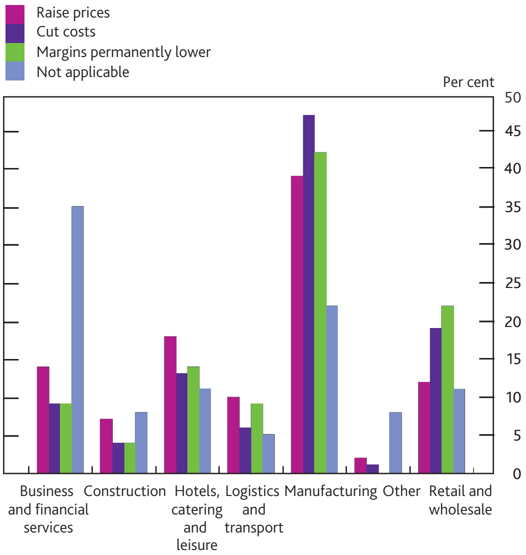
Manufacturers' output price inflation was little changed in September. A growing number of manufacturers reported that they were able to raise prices, though typically still not sufficiently to maintain margins. In many cases, those increases were confined to covering higher costs of materials — for which the rate of price inflation had eased recently (see above).

Agents' price-setting survey

During August and September the Agencies carried out a survey of their contacts regarding price setting. The survey covered around 300 companies with a total turnover of about £45 billion. Overall, contacts reported that they reviewed and changed prices quite often, with about half changing prices at least five times a year. But the frequency of price changes varied greatly between sectors. Retailers changed their prices very often. By contrast, manufacturers changed their prices less frequently, with most changing them just once a year. For a majority of firms the frequency of price changes had risen over the past decade. That partly reflected increased competitive pressures and technological advances such as the internet.

Many contacts reported that prices were usually set flexibly, for example they often varied according to the customer and the overall level of demand. Regarding the current squeeze on margins, nearly two thirds of firms had responded by cutting costs and roughly half had increased prices (Chart 3). About a quarter of respondents reported that margins were likely to remain lower, even after remedial measures.

Chart 3 Agents' price-setting survey[a]



(a) Firms were asked: 'If margins have been squeezed in the recent past, how do you plan to address this?'

Consumer prices

The Agencies judged that consumer goods price inflation was broadly unchanged in September. Higher prices of utilities and seasonal foods were broadly offset by lower petrol prices. Most consumer goods prices continued to fall steadily. Consumer services price inflation eased a little. That largely reflected greater competition and over capacity in a few specific services including air travel, foreign holidays and household insurance. But car insurance premia were expected to rise in the months ahead.