BANK OF ENGLAND

Agents' summary of business conditions

September 2006

- Consumer spending growth remained reasonably firm.
- The recovery in housing market transactions continued. The recent interest rate increase was not expected to dampen demand.
- Export growth strengthened modestly, with signs of further recovery in euro-area demand.
- Investment intentions rose a little further.
- The level of manufacturing output continued to increase, with strengthening demand in domestic as well as overseas markets.
- Construction output growth ticked up.
- Service sector output growth was steady.
- Employment intentions rose, but there remained some slack in the labour market.
- Capacity pressures rose slightly in both manufacturing and services.
- Pay pressures remained benign except in a few areas of specific skill shortages. But future pay negotiations were expected to be tougher.
- Input price inflation levelled out, helped by a weaker dollar against the pound and lower fuel prices.
- Manufacturing output price inflation continued to rise modestly 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 700 businesses in the period between late July 2006 and late August 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.

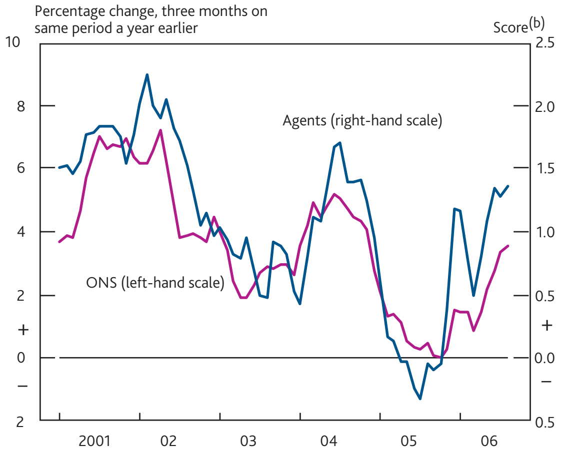
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the *Inflation Report*, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm**

Demand

Consumption and housing

Consumer demand growth in August was little changed compared with the previous month and remained reasonably firm. An increase in mortgage equity withdrawal had supported consumption growth and was also being used by households to reduce their unsecured debt. It was too early to judge whether the interest rate increase on 3 August would have any adverse effect on consumer sentiment. Notwithstanding that, retailers believed that consumer confidence remained fragile. Discretionary spending on bigger ticket items such as white goods and furniture remained weak, though demand had ticked up slightly in the latest month. And early orders for new cars with a September registration plate suggested that sales volumes would be down slightly on last year. Dealers continued to report that the market for used cars was holding up rather better than that for new cars.

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 mixed, but overall pointed to reasonably steady growth. The hot summer weather and the recent disruption to air travel may have given a temporary boost to the domestic tourist industry and leisure attractions. Legal and financial services continued to benefit from the strengthening housing market. By contrast, spending at bars and restaurants was reported to be below expectations in some areas, in part due to a credit squeeze on indebted young adults.

The steady recovery in the housing market continued and the number of sales was higher than usual for the summer. Lower-priced properties remained the easiest to sell. But with a shortage of cash buyers, housing chains were relatively long, which had slowed the rate of completions. Overall, annual house price inflation had not yet risen decisively, despite fairly strong demand and a scarcity of stock. Estate agents generally expected current levels of demand to continue in the rest of the year. Buy-to-let activity strengthened, with more investor demand for lower-priced property, in part for rental to migrant workers. Construction of new houses continued to gather pace with strong demand for social housing.

Exports and imports

There was no loss of momentum in exports. Strong US demand continued, there was a further recovery in sales to the euro area and export growth to Eastern Europe, India and China remained buoyant. Some contacts reported that demand from the Middle East had accelerated, possibly reflecting the increase in oil revenues there. Suppliers of capital goods to energy-related businesses had seen particularly strong growth recently, reflecting the surge in global investment in the oil, gas and petrochemicals industries. That also benefited some business services, such as the design and project management of plant construction. The recent depreciation of the dollar had not significantly affected export volumes to date, though it had caused concern for a number of exporters. The growth of imports of components and finished goods continued to rise. Many companies increasingly sourced from lower-cost developing economies rather than the United Kingdom, to help mitigate margin pressures.

Investment

Investment intentions strengthened a little further, though by less than seen in recent months. Overall, business confidence was conducive to stronger growth in investment. However, some companies that had funds available to invest were delaying new capital expenditure, partly on account of perceptions of greater uncertainty about the global economic outlook and geopolitical risks. In manufacturing, the continued pickup in investment intentions largely reflected the need to improve cost competitiveness by reducing inputs of labour, materials and energy. Consequently firms emphasised the need for greater automation and mechanisation and the purchase of energy-efficient machinery. Infrastructure investment by utilities companies was accelerating. In the service sector, demand for office space had strengthened as capacity constraints tightened. Larger retailers continued to invest in new outlets and the refurbishment of existing stores.

Output

Primary production

Farmers reported that the hot and dry weather in July had significantly reduced crop yields in the United Kingdom and on the continent. Lower yields and stocks globally had increased cereals prices by around 10% compared with a year ago. Meat prices had also risen, partly reflecting increased demand since the lifting of the export ban on UK beef, and partly reflecting restrictions on imports from South America.

Manufacturing

The level of manufacturing output rose again. Overseas demand continued to strengthen. That in turn stimulated manufacturers' domestic sales of intermediate and capital goods to exporters. In addition to continued strong growth in aerospace and pharmaceuticals, firms that reported a pickup in growth included suppliers of capital goods to the oil and gas, power generation and construction industries. Firms in niche markets serving high-income consumers — for example private boat builders — reported exceptional levels of demand, much of which emanated from the emerging economies.

Construction

Construction output growth increased slightly. Strong public sector demand continued for social housing, schools and nurseries. There was increased investor demand for commercial property, including new warehousing and workshop premises, partly from overseas where there the United Kingdom was seen as offering attractive returns. Some contacts were concerned that these robust investment flows were not matched by a corresponding increase in end-user demand for commercial property so that yields had fallen.

Services

Output growth in the service sector was little changed in August. Growth in consumer services was steady (see above). Professional and financial services output growth remained very strong. That was assisted by a firmer tone to global equity markets in recent months, which among other things had increased households' demand for services related to the management of savings and tax planning. The picture for other business services remained patchy. Media contacts noted declining advertising spending in newspapers, TV and radio, which had not been fully offset by increased advertising on the internet. Hotels reported only slow growth in spending on corporate events, while logistics companies continued to suffer from strong foreign competition. But software companies had seen stronger growth, partly on account of firms looking to improve their management information and the development of their intranet and internet sites. And businesses providing services to the oil and gas industry, such as marine surveys and the design of refineries, reported record order books stretching some years into the future.

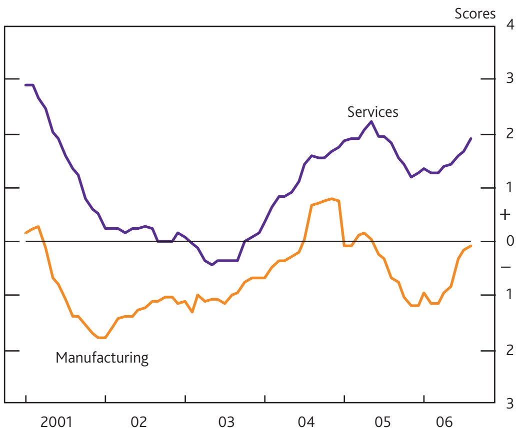
Employment

Contacts' employment intentions over the next six months rose marginally in August, consistent with slightly stronger reports of demand and output growth. Even so, the availability of labour was generally viewed to be more than adequate to meet this increased demand. That largely reflected the growing availability and use of workers from the accession countries. More employers were willing to tap into the pool of migrant workers to address labour shortages, and job advertising on the internet had enabled companies to access foreign labour more easily. However, skill shortages remained in certain specific areas, notably in occupations such as accountancy and law.

Capacity utilisation

Capacity utilisation increased slightly. Manufacturers mostly had an adequate amount of capacity. In part that reflected investment and other measures aimed at increasing labour productivity (see above). Some service sector firms continued to report that activity was significantly constrained by skill shortages, notably in professional and financial services, information technology, electrical engineering and construction project management. But the picture was mixed, with increased spare capacity for some services such as insurance. That partly reflected new entrants from overseas.

Chart 2 Capacity constraints



Costs and prices

Pay

Pay settlements remained at or below those of last year. But increasing bonus and overtime payments resulted in a small acceleration in average earnings, particularly in those firms with more acute skill shortages. The cost of funding pension fund deficits remained a key concern for many employers and was putting downward pressure on pay in these sectors. Looking ahead, a growing number of firms expected tougher negotiations in their next annual pay review. That was largely due to the increase in RPI inflation, which was used as the starting point for many pay negotiations.

Input prices

Input price inflation remained high, though it had levelled out. The dollar's weakness against sterling had helped to subdue inflationary pressures.

Steel and other metals prices continued to increase. In the construction sector the cost of building materials had accelerated, with particular pressure on the prices of timber products owing to supply constraints in Scandinavia. And prices of arable crops continued to rise due to low yields in the United Kingdom and Europe. By contrast, the cost of fuel had eased and sea freight charges for outbound cargo to the Far East had fallen due to increased shipping capacity.

Output and consumer prices

Manufacturers' output price inflation continued to rise modestly. It was slightly easier for manufacturers to pass on higher costs, including those that supplied the larger supermarkets. But manufacturers' profit margins continued to be squeezed and the recovery in margins was expected to be drawn out. Business services inflation edged higher. With demand growth outstripping supply, some professional services found it relatively easy to pass on higher labour costs to their clients.

Consumer goods price inflation picked up further in August. That largely reflected higher prices of utilities and fresh food. Both were expected to increase further in the short term. Abstracting from those increases however, the Agents reported that there were few signs of more widespread inflationary pressure for consumer goods. Consumer services price inflation was little changed. Increased capacity for some consumer services, including insurance, hotels and leisure attractions, may have dented contacts' ability to pass on higher costs. In the transport sector, bus companies had passed on higher fuel costs to their customers. But regulatory restrictions had delayed what were anticipated to be larger than usual increases in rail ticket prices.

Chart 3 Manufacturers' prices