BANK OF ENGLAND

Agents' summary of business conditions

April 2007

- Consumption growth stabilised, having slowed in the previous month.
- Demand for housing remained firm, though house price inflation was slightly weaker.
- Investment intentions persisted at high levels, especially in the service sector.
- Demand for exports remained buoyant, despite the continued high value of sterling.
- Growth in manufacturing output picked up, boosted by external demand.
- Output growth in both the construction and service sectors continued to strengthen.
- Employment intentions increased, driven largely by demand for labour in the service sector. And recruitment difficulties increased, with skill shortages becoming more broad-based across types of labour in some regions.
- Capacity pressures remained high, particularly in the construction and service sectors.
- Growth in across-the-board pay settlements increased modestly, though increases in other forms of remuneration became more pronounced, consistent with greater recruitment difficulties.
- In contrast, growth in materials costs slowed further, so that input price inflation eased again. However, output price inflation remained stable as firms rebuilt margins.
- Consumer price inflation also remained steady at its recent relatively high rate.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with around 850 businesses in the period between **late February and late March**. 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.

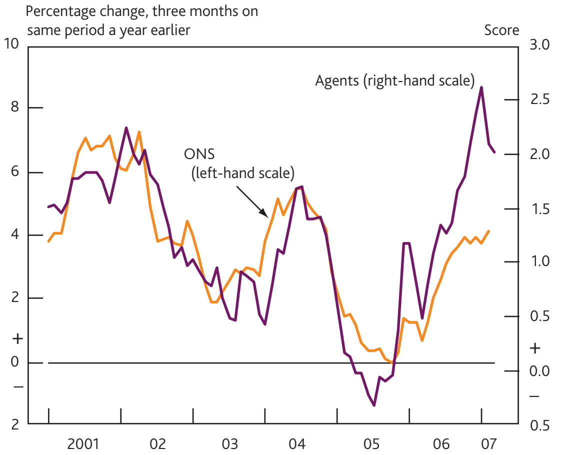
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

Most Agents reported that growth in the value of retail sales stabilised in March at a firm pace, having slowed noticeably in February (**Chart 1**).

Chart 1 Retail sales



Recent patterns of spending were maintained in March, with demand remaining strongest for high-tech electronics and weakest for clothing, footwear and some consumer durables (such as furniture). In most regions, private car sales also remained subdued. In contrast, demand for consumer services retained broad-based strength, with particularly healthy demand for tourism-related services. This supported continued strength in consumption overall.

Looking ahead, retailers were cautious about the outlook, referring to recent increases in interest rates and council taxes as factors weighing on disposable income. They noted that some lower-income households were showing signs of financial stress, and that this could restrain sales growth in the period ahead.

Housing market

Overall, demand for housing remained firm, despite recent increases in interest rates. In the market for established housing, strong demand and a lack of new instructions fuelled further house price inflation, though prices rose at a less rapid pace than in recent months.

High house prices and recent interest rate rises continued to erode affordability. Consequently, rental demand remained strong, boosted by demand from both would-be buyers and immigrants. But with yields in the buy-to-let market still low, investor demand was subdued in most regions, though remained strong in London.

Demand for new housing was less buoyant than for established homes. And with a shortage of land available with planning permission, builders had difficulty adding to the dwelling stock. Faced with limited scope to pass on cost increases to potential buyers, builders' margins remained tight, and increases in prices of new dwellings were again slower than those for established homes.

Overseas trade

External demand for both goods and services remained strong, and was said to be outstripping growth in domestic demand. Furthermore, strength in exports was evident to a broad range of destinations. While exporters had experienced a loss of price competitiveness arising from the continued high value of sterling, this was so far largely reflected in reduced margins, with orders remaining resilient. Demand for imports also remained high, consistent with robust domestic spending and the relatively high value of the pound.

Investment

Investment intentions strengthened further. This was particularly so in the service sector, where the Agents' score reached its highest level since the series began in mid 1997. Service sector firms continued to invest in additional capacity to meet current high levels of demand. Investment intentions in the manufacturing sector remained much higher than a year ago, reflecting a continued focus on enhancing productivity and competitiveness. Strength in construction activity was aslo stimulating investment, as were regulatory requirements, especially in the transport and utility sectors.

Output

Primary production

Agricultural production was assisted by generally mild weather and favourable growing conditions. Livestock producers benefited from a strengthening of both domestic and external demand for meat, along with rising land prices. Grain plantings increased in response to continued high world prices for grain.

Manufacturing

Manufacturing output growth ticked up in March, owing largely to strength in export demand. Domestic demand for manufactures was less strong, though remained well up on levels of recent years. Despite the trend rise in import penetration, many domestically oriented manufacturers were reportedly adapting to increased international competition by engaging in higher value-added production. Others were benefiting from the current exceptional strength in construction activity and energy investment.

Construction

Output growth rose in March to its fastest rate since the Agents began recording scores in mid 1997, with mild weather facilitating faster progress on a range of projects. Activity was supported by public and private infrastructure projects, along with high levels of demand for new retail and commercial space. Forward orders were plentiful, with even stronger growth in construction output inhibited by capacity constraints, particularly the shortage of managerial staff.

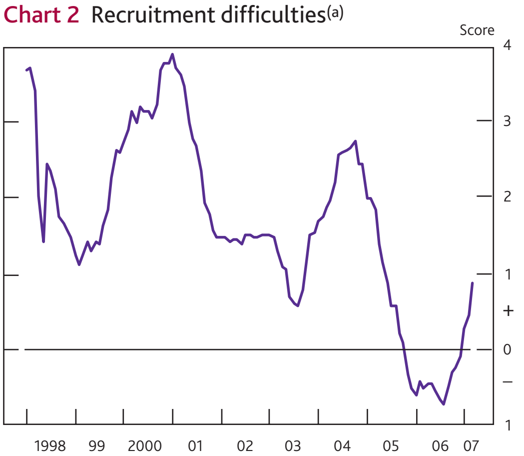
Services

Growth in service sector output continued at a rapid pace, and the Agents' score for business services was at its highest in the decade for which scores have been compiled. While strength in business services was again dominated by demand for professional and financial services, output growth in 'Other business services' also firmed, reflecting greater demand for ICT services and logistics. And demand for consumer services continued to increase.

Employment

Employment intentions rose further in March. This largely reflected the growing strength in demand for labour in the service sector, while labour demand in the manufacturing sector remained close to recent levels. Demand for skilled labour continued to outstrip supply, particularly in the business service and construction industries, so that recruitment difficulties became more pronounced (**Chart 2**). But even in the markets for unskilled workers, where labour is more plentiful, some Agents reported that recruitment difficulties had also increased.

Chart 2 Recruitment difficulties[(a)]



Note: Skill shortages before January 2005.

(a) Relative to normal. Agents are asked to place a value on their assessment of the degree of difficulty on a scale from -5 to +5 consistent with their reports.

Capacity utilisation

Consistent with growing recruitment difficulties, capacity pressures remained high, especially in the business service and construction sectors, and were expected to remain so over the next six months. And while manufacturers were generally not capacity constrained, there were more reports of capacity utilisation being at above normal levels.

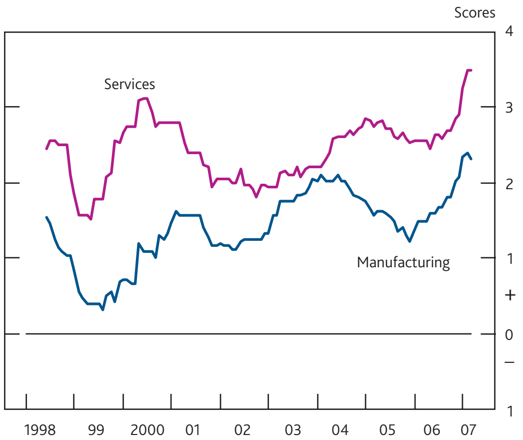
Most firms were responding to capacity constraints by increasing their investment and the average hours worked by their staff, though it was also common to hear reports of firms outsourcing work to overseas offices or importing labour. These responses did not, however, avoid the need for other actions: some firms were turning away lower-margin work, while others, particularly business service firms, were increasing prices.

Costs and prices

Labour costs

The Agents' scores for labour costs in the manufacturing and service sectors remained elevated (**Chart 3**). Pressures were most pronounced in the service sector, consistent with its greater recruitment difficulties. However, labour costs in the manufacturing sector had also increased significantly over the past year. Across the economy as a whole, Agents observed that growth in labour costs was somewhat stronger than suggested by the official data.

Chart 3 Labour costs per employee

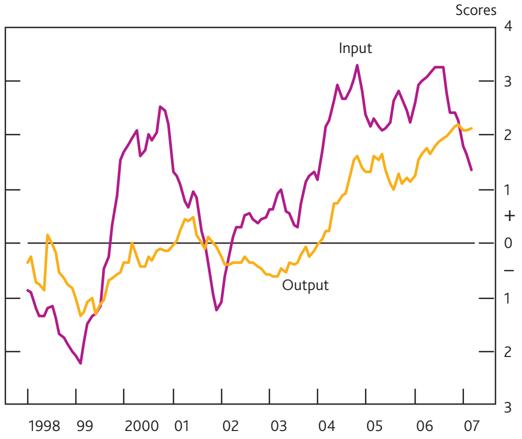


With basic pay settlements having increased only modestly, much of the reported increase in labour costs was attributed to other forms of employee compensation. Incentive payments were being applied to a larger share of the workforce, and were aimed at enhancing a firm's ability to attract and retain labour without permanently increasing the level of labour costs. Firms were also increasing pension payments, health insurance and providing additional leave benefits.

Input and output prices

Input cost inflation eased further in March (**Chart 4**). Much of this slowdown reflected slower growth in the cost of

Chart 4 Input and output prices



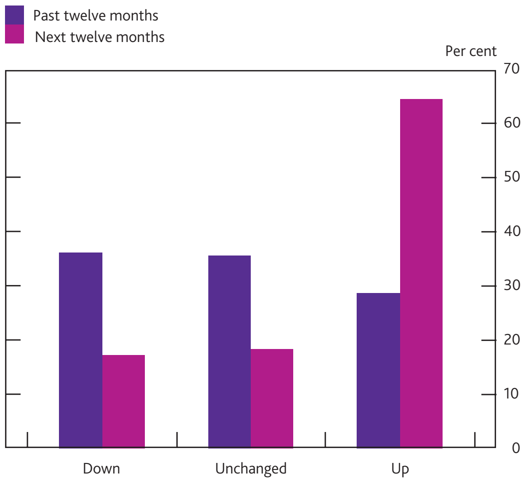
Note: Manufacturers' output prices.

commodities and the recent strength of sterling, which had lowered the domestic price of imported inputs. Falls in the cost of energy were also significant for many firms. Nonetheless, given lags in contract renegotiation, some firms reported that they were yet to enjoy the benefits of recent reductions in spot energy prices.

The score for manufacturing output price inflation was unchanged in March, having been static at a high level for some months (also **Chart 4**). With the effects of earlier cost shocks now abating, manufacturers appeared to be holding on to recent cost reductions to rebuild margins. Business to business service price inflation also remained steady, but at a higher rate than inflation in the manufacturing sector, reflecting higher wage outcomes and greater pricing power in this buoyant sector.

Given recent evidence of margin rebuilding, the Agents conducted a survey of 230 consumer-oriented firms in the manufacturing, service and retail sectors to examine the issue more closely. Firms were asked to describe the extent to which their unit costs and prices had changed over the past year, and the extent to which they were expected to change over the year ahead. They were also asked to report on the direction of change in their margins over the past year, and the expected change in the year ahead. The survey revealed expectations of a clear fall in cost inflation over the next twelve months. Many firms did not intend to pass on cost reductions in full so that margins could be rebuilt, should demand conditions allow. Consequently, a large net balance of respondents expected margins to increase in the coming year (**Chart 5**).

Chart 5 Change in gross profit margins



Consumer prices

Consumer price inflation for both goods and services remained relatively high in March. Consumer service price inflation largely reflected rising labour costs. Goods price inflation stemmed from the earlier sharp increase in output prices. Looking ahead, however, contacts expected that consumer price inflation would fall back, given the stabilisation of output price inflation, flat or falling import prices and intense competition among major retailers. The extent to which slower consumer price inflation would results was, however, said to be sensitive to the timing and degree of margin rebuilding by both suppliers and retailers of final consumer goods and services.