BANK OF ENGLAND

Agents' summary of business conditions

December 2007

- Growth in the value of consumer spending eased further, though growth in sales volumes remained more resilient, supported by discounting.
- The easing in demand for housing accelerated in most regions; house price inflation also fell.
- Investment intentions fell again, though they had been pared back ahead of the recent financial turmoil. The Agents conducted a survey on credit conditions (see box), and found that a small majority of companies were not affected by tighter credit conditions. Of those affected, it was most common for companies to take no action or to change financial arrangements. But around one third of companies were changing investment plans.
- Total demand for exports remained firm.
- Growth in manufacturing output was solid. Growth in construction, while very strong, eased noticeably, and service sector activity slowed sharply.
- Employment intentions and recruitment difficulties eased, reflecting softer demand in the service sector.
- Capacity pressures lessened in service industries, but persisted elsewhere.
- Growth in total labour costs remained well contained. The outlook was for slightly higher growth in settlements but an easing in the variable component of earnings.
- Annual input price inflation jumped higher in the month, while output price inflation was little changed.
- Annual consumer price inflation ticked up, driven by higher prices of fuel and food.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with nearly 700 businesses in the period between **late October and late November**. It provides information on the state of business conditions, from companies 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 company 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.

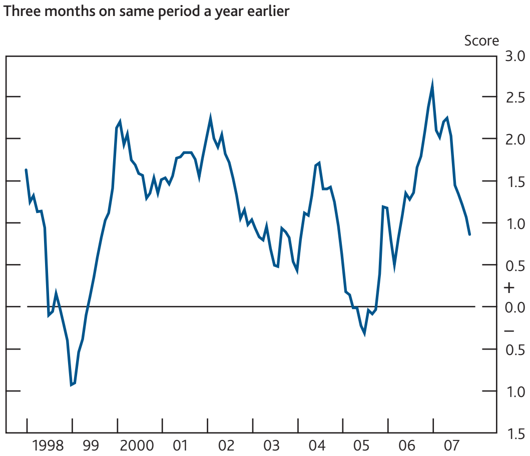
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

The Agents' score for the value of retail sales fell slightly further in November, and was well down on its level in the first half of the year. However, most of the easing in spending growth occurred ahead of the recent financial market turmoil (**Chart 1**).

Chart 1 Retail sales values



Agents continued to report subdued growth in discretionary spending. Softer spending was most evident for housing-related expenditures, consistent with the easing in housing demand. And there were further reports of weak sales for product lines typically purchased by those middle-income groups facing increased interest costs. Spending on consumer services also remained subdued in most parts of the United Kingdom, but had stabilised in recent months.

Price discounting remained prevalent, as retailers sought to stimulate demand and reduce unwanted inventories. Consequently, growth in the volume of sales remained stronger than sales values, particularly for clothing. Nonetheless, retailers expressed concern about the outlook for consumer spending, and some had revised down their expectations for the first quarter of 2008.

Housing market

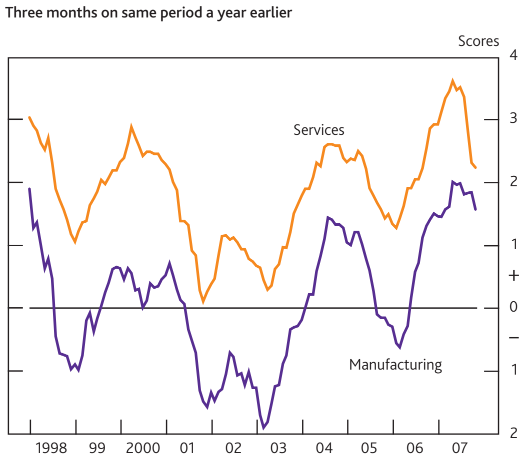
The slowdown in housing demand accelerated in November. In the market for established housing, estate agencies reported lower levels of enquiries, and claimed that some potential buyers were deferring decisions until anticipated reductions in interest rates were realised. Others were being deterred by tighter credit conditions. And given recent reductions in house price expectations, there were fewer new instructions. Overall market conditions were described as unseasonably weak across the United Kingdom, with sale periods lengthening and vendors accepting discounts on sale prices. Consequently, price inflation for established homes eased further.

In the market for new housing, demand continued to weaken. Contacts attributed this to the cumulative effect of increases in Bank Rate and uncertainty stemming from financial market turmoil. Discounts and incentives were being used more actively to secure sales, so that price inflation for new homes slowed further. The reduction in overall building activity was modest, however, owing to the volume of pre-committed work. But given recent sharp falls in commitments to build, a slowdown in housing construction was expected next year.

Investment

Investment intentions fell in November for the fourth consecutive month, and were well below their peak in May. This reduction was largely driven by developments in the service sector; manufacturers' investment intentions edged down but remained firm (**Chart 2**). An easing in investment intentions had already been under way in response to earlier increases in Bank Rate. However, that easing had been reinforced by recent financial turmoil, especially the associated weakening in demand for commercial property development. While a small majority of contacts interviewed still reported no adverse effects from tighter credit conditions, a growing share was now being affected, mainly in the business and consumer services sectors. Most affected companies were taking no action at this stage, or were seeking to alter the timing and nature of their external finance. But around one third were now reducing or deferring planned investment. For more details, see the box on the Agents' survey.

Chart 2 Investment intentions over the next twelve months



Overseas trade

External demand remained buoyant overall, as the fall in US demand was offset by strength in demand elsewhere. The accession economies of Europe, the Middle East and emerging economies in Asia and Africa all remained sources of strong demand. By product, demand remained strongest for business services and capital goods.

Demand by UK companies for intermediate imports remained high. But, there were reports of a modest slowing in imports of consumption goods, consistent with the easing in retail spending and reductions in desired inventories of retailers.

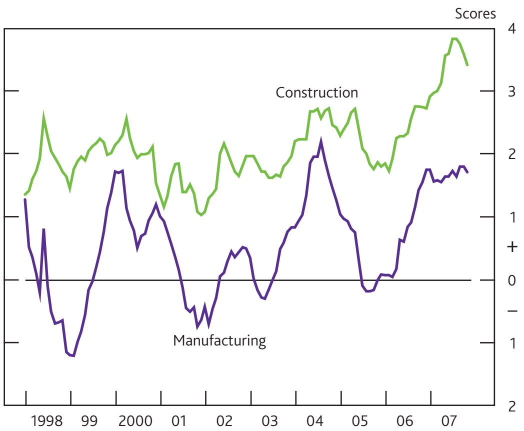
Output

Manufacturing

Manufacturing output growth remained solid in November (**Chart 3**), buoyed by strong external demand for manufactured exports, especially high-value capital goods. Production for domestic markets also remained firm, particularly for manufacturers supplying the non-residential construction sector. UK manufacturers reported generally favourable prospects, with many having secured niche export markets.

Chart 3 Manufacturing and construction

Three months on same period a year earlier



Construction

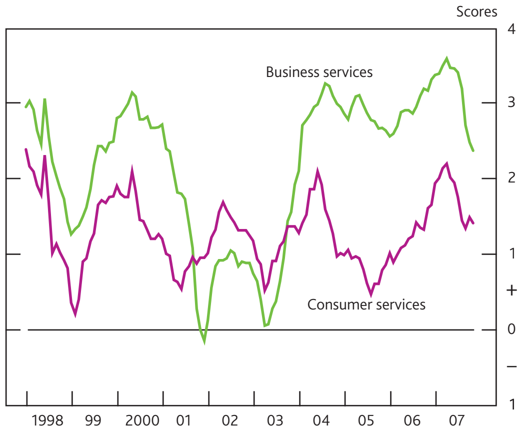
Growth in construction output remained strong, though had eased from its recent exceptional pace (**Chart 3**). There remained large amounts of pre-committed work across a broad range of construction activities. This was temporarily insulating the sector from the fall in demand for commercial property development that had followed the recent financial turmoil. But looking ahead, contacts' forecasts for growth in construction output had been revised down.

Services

Service sector output growth slowed further in November (**Chart 4**). The slowdown was concentrated in professional and business services, though demand for other business services had also eased. The slowdown in growth in professional and business services had become evident earlier in the year but had been amplified by recent financial turmoil.

Chart 4 Service sector output

Three months on same period a year earlier



Employment

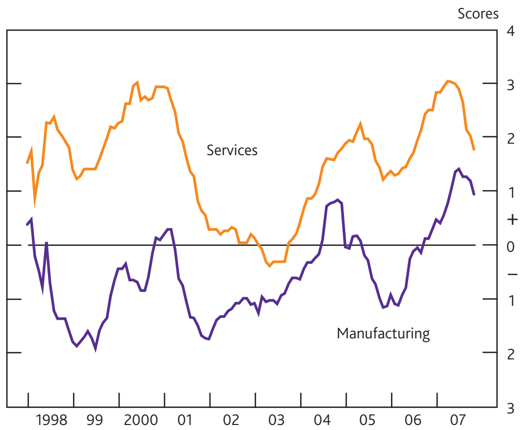
Consistent with the slowdown in activity, employment intentions eased again in November. This outcome was largely driven by the business services sector, where the slowing in activity had been most pronounced. However, slightly weaker employment intentions were also evident in other sectors, notably consumer services and manufacturing. Some contacts attributed the reduction in hiring intentions to uncertainty about demand. There was also further evidence of a modest easing in recruitment difficulties, mainly in business services. In contrast, recruitment difficulties persisted for professionals in the manufacturing and construction industries, where structural skill shortages were evident.

Capacity utilisation

Contacts reported that capacity pressures were expected to ease over the next six months, though would remain higher than the average of recent years (**Chart 5**). The anticipated easing was partly due to recent additions to capacity. But it also reflected expectations of a slowing in activity, which would make it easier for companies to meet demand with

Chart 5 Capacity constraints over the next six months

Relative to normal



existing resources. Capacity pressures were expected to ease most in the service sector.

Costs and prices

Labour costs

Agents reported that growth in across-the-board pay settlements remained stable in November. And the Agents' score for total labour cost growth was little changed in the month, remaining well below its level at the beginning of the year. While overall earnings growth appeared well contained, contacts continued to highlight the dispersion of wage outcomes across occupational groups, with rapid wage growth still evident for various classes of skilled labour.

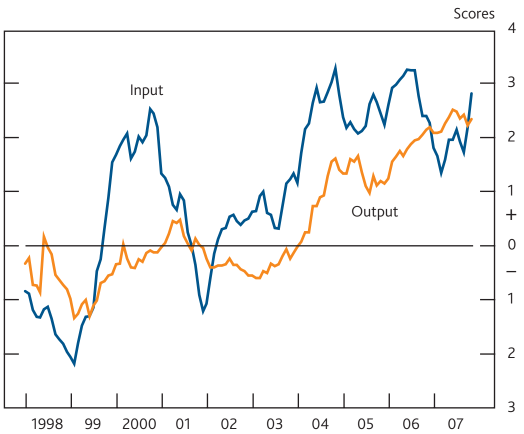
Looking ahead, contacts expected settlements in January to be somewhat higher in response to recent increases in RPI inflation. However, growth in the variable component of pay was expected to fall. Reductions in commission-based earnings and bonuses were expected to be most evident in the service sector. In fact, some contacts reported that growth in commission-based earnings had already slowed, given reduced residential property transactions and the easing in the value of consumer spending.

Input and output prices

Input price inflation had rebounded in the past two months (**Chart 6**). This owed to sharp increases in the prices of energy, oil derivatives, metals, building materials and food inputs. These costs increased despite the strength of sterling against the US dollar, and reflected higher world prices. With the surge in oil prices, many contacts were also faced with fuel surcharges on their transport costs. But a theme of discussions with contacts was the rising cost of importing finished and intermediate goods from China. This was said to reflect underlying inflationary pressure in China along with China's recent removal of exporters' tax concessions.

Chart 6 Manufacturers' input and output prices[(a)]

Three months on same period a year earlier



(a) Manufacturers' non-labour input and output prices.

The score for manufacturing output prices was little changed again in November. With input price inflation displaying renewed strength, manufacturers' margins were reported to be under greater pressure. Consistent with this, the Agents' score for manufacturers' pre-tax profitability fell in November. In part, margin compression reflected lags in the adjustment of output prices to cost shocks. Some contacts reported an intention to pass on higher costs. While competitive pressures were limiting the extent of pass-through, it was expected that manufacturers of food products would have greater pricing power, should retailers be concerned about securing longer-term supplies.

The score for business-to-business service price inflation was unchanged again in November, but was clearly lower than in the middle of the year. The moderation in service price inflation reflected increased commoditisation of commonly provided services, but also the effects of the easing in demand.

Consumer prices

The Agents' score for annual goods price inflation picked up in November reflecting higher prices for fuel and food. With annual service price inflation little changed, overall consumer price inflation also ticked up.

The increase in food prices was in direct response to the rising input costs faced by suppliers. Price increases had been most pronounced for dairy and cereal products, and further rises were in prospect. In contrast, discounting remained prevalent for non-food items as retailers sought to stimulate demand and avoid unwanted stocks. However, some contacts emphasised that the current phase of deep discounting was drawing to a close as retailers sought to arrest the erosion of their margins.

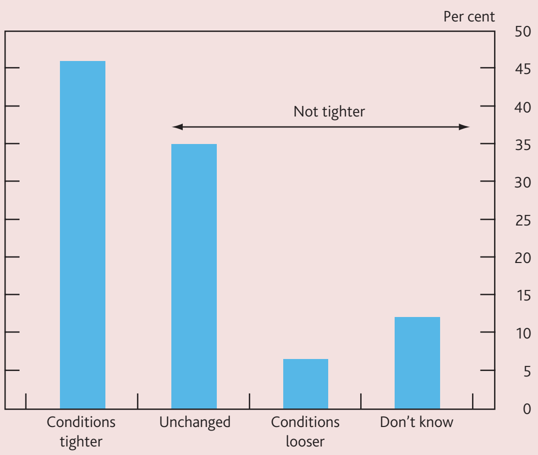
Agents' credit conditions survey

In recent months, credit conditions have been a focus of Agents' interviews with contacts. In November, Agents conducted a formal survey of 260 companies to explore credit issues in more detail. The sample covered companies from all key sectors of the economy and a range of firm sizes. (Results were weighted by turnover.) This box summarises the main results from the survey.

Many companies interviewed were relying on internal finance, and so were not directly affected by tighter credit conditions. Of those reliant on external finance, banks and capital markets were the main sources of finance, with the latter being important for large companies. It was also found that most companies had some degree of insulation from tighter credit conditions, as the majority of those accessing external finance had a combination of fixed and floating-rate loans.

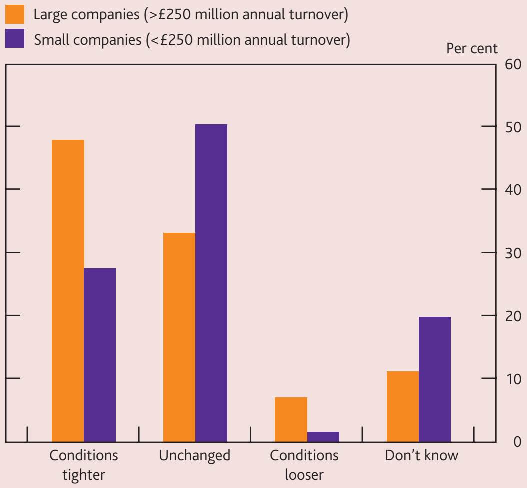
Nearly half of the companies surveyed reported that credit conditions were tighter, this being a larger share of companies than apparent in earlier discussions with Agents' contacts (**Chart B1**). A small majority still reported that credit conditions were not tighter.

Chart B1 Credit conditions



By firm size, a greater share of larger companies (those with more than £250 million annual turnover) experienced tighter credit conditions than did smaller companies (**Chart B2**). A majority of smaller companies reported that credit conditions were unchanged, and a sizable share did not know whether their conditions had changed, as they were yet to seek new finance.

Chart B2 Credit conditions by firm size



When asked about how they might respond to changed credit conditions, nearly half of respondents to the Agents' survey did not intend to take action at this stage. A sizable share indicated that they would alter their financial strategies, with changed investment plans being the third ranked response. Consistent with their access to more diverse sources of finance, a greater share of large companies reported an intention to change financial strategies than did smaller companies.

Chart B3 Expected response to changed credit conditions