BANK OF ENGLAND

Agents' summary of business conditions

February 2007

- Consumer spending was stronger than anticipated over the Christmas period but was more mixed in January.
- Activity in the housing market remained mostly firm, though the outlook was less certain.
- Export growth weakened a little, largely reflecting the stronger pound.
- Investment intentions remained robust, particularly in the service sector.
- Manufacturing output growth eased a little, but confidence was still upbeat.
- Growth in construction output accelerated, helped by the mild weather in January
- Service sector output growth continued to accelerate on a broad front.
- Employment intentions and recruitment difficulties increased, largely in professional and financial services.
- Capacity pressures rose further.
- Pay awards were expected to rise modestly in most sectors in 2007, but by rather less than the increase in retail price inflation over the past year.
- Input price inflation eased again.
- Consumer price inflation increased further.

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 December and late January 2007. 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.

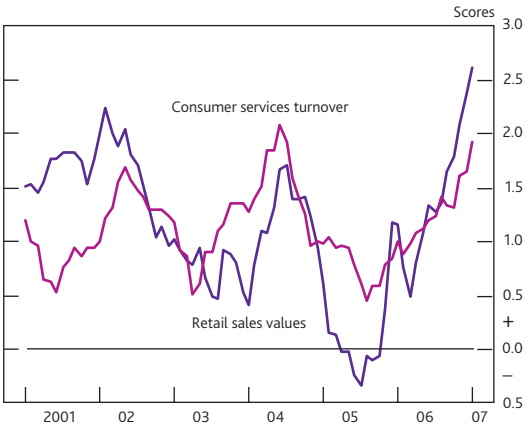
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption and housing

Demand in the Christmas and immediate post-Christmas period was stronger than retailers had anticipated, and their confidence improved. The picture for January as a whole was a little more mixed. Most Agencies indicated that, having allowed for seasonal factors, demand growth in January held up well. But a few Agencies reported a more subdued picture in January, with a fairly sharp falloff in consumer demand. Overall, it appeared that retail sales had not slowed down after Christmas to the same extent as last January; the Agents' score for retail sales therefore rose further (**Chart 1**). Private new car sales in January were down slightly on a year ago. But spending on consumer services accelerated a little, with a rather more uniform picture across the regions than for retail sales.

Chart 1 Retail sales and consumer services turnover



Demand for high-tech electronics, such as flat-screen TVs, remained exceptionally strong in January, with internet retailers reporting especially rapid sales growth. New Year bookings at restaurants, hotels and pubs were comparatively strong, and high numbers of international tourists also boosted consumption of services. In contrast, demand for winter clothing continued to be depressed by the relatively mild weather.

Confidence and activity in the housing market mostly remained firm. While still too early to be sure, the majority of estate agents expected that the January interest rate rise would not damage sentiment unduly, and the market would be underpinned by a continuing shortage of new instructions. Even though estate agents expected that regional differences in house price inflation would persist, on average, house prices were expected to rise in 2007 by around the growth in earnings. But some estate agents were more nervous following the latest Bank Rate increase and anticipated a sharp slowdown in housing demand should interest rates rise much further. Investor demand in the buy-to-let market was a little weaker, consistent with reports that credit availability had tightened. The cost of borrowing had risen by more than rents in recent months, and some buy-to-let investors were faced with increasing cash shortfalls. Some estate agents were concerned that the proposed introduction of Home Information Packs in June in England and Wales would bring forward new instructions into the first half of 2007, but thereafter would raise costs and depress supply in the secondary market.

Optimism among house builders was a little more guarded in January than it had been at the end of 2006. There were some reports that the number of viewings and sales had been lower than normal. In order to stimulate demand, the use of incentives such as inclusive fixtures and fittings remained widespread, as did the offer of part-exchange deals. Building costs and land prices had risen and there was limited scope to pass on these higher costs by raising the prices of new houses, due to the affordability concerns of potential buyers. As a result, house builders' margins continued to be squeezed.

Exports and imports

Export growth weakened slightly in January. That mostly reflected a loss of price competitiveness of manufacturers arising from sterling's recent appreciation, especially in dollar-based markets. While the main impact to date had been a loss of margin on exports, there were now more reports of orders being lost. And there was some perception of a slight easing in the growth of global activity. By contrast, imports may have accelerated a little. Apart from sterling's appreciation, that reflected the recent buoyancy of demand for consumer durables and strong investment.

Investment

The Agents' scores pointed to continued strong investment intentions in January. Service sector firms invested in additional capacity, including offices, warehousing and retail space. Growth of investment by manufacturers remained more subdued, and was mostly focused on efficiency improvements.

Apart from a fairly high level of business confidence and liquidity, other factors said to be boosting investment included increased rates of technological progress and industrial consolidation in some sectors of the economy, and regulatory and environmental requirements. Consolidation in some hard-hit manufacturing sectors such as food processing had spurred investment in more modern plant and machinery. And some of the current surge in investment by power generating companies had been necessary to offset the effects on output from environmental regulations.

Output

Primary production

North Sea output of oil and gas continued to decline. Increases in oil and gas prices in 2006 had extended the economic life of some fields. But that had necessitated increased investment in repair and maintenance for older fields, so that periods of 'down time' were becoming longer.

Manufacturing

Output growth was a little weaker in January, reflecting the slight downturn in the growth of exports. Domestic demand growth was unchanged. Although demand for consumer and investment goods had been fairly strong recently, domestic producers continued to lose market share, partly on account of sterling's appreciation. There were some reports that this had given a renewed fillip to moving capacity overseas. Even so, the confidence of most manufacturers was more upbeat than for some time, largely reflecting the robust pickup in the global economy in 2006 which was expected to continue.

Construction

Output growth rose in January, helped by the spell of mild weather. Forward order books remained strong. There was some nervousness regarding prospects for public sector funded projects in view of anticipated budgetary pressures, and future demand for commercial property due to higher interest rates and low yields. However, a larger number of contacts were concerned about factors holding back supply, in particular shortages of skilled labour and land with planning permission.

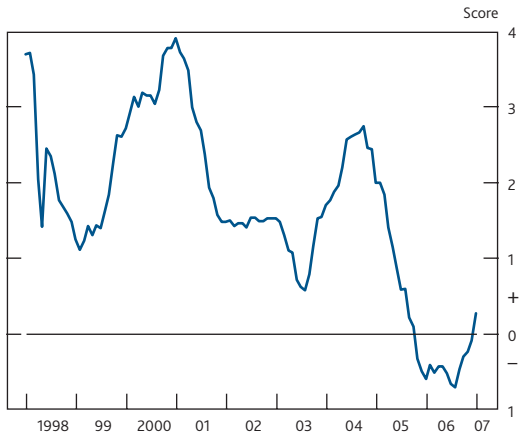
Services

Service sector output continued to accelerate. Within business services, strong demand growth for professional and financial services reflected a wide range of factors including buoyant asset markets, high levels of mergers and acquisitions activity and increased Government regulation and taxation. Accountants and lawyers expected to see good growth of activity continue in 2007. But there were some concerns expressed by City contacts that prices in equity and commercial property markets had risen too high and were vulnerable to further interest rate increases. Privately owned, highly geared businesses were thought to be most at risk. Output growth in 'Other business services' rose slightly, reflecting stronger demand for information, communications and technology-related services, and logistics. Consumer services demand also accelerated (see above).

Employment

Employment intentions increased, largely reflecting the buoyancy of the professional and financial services sector. Growing demand for skilled labour had not been matched by additional supply and recruitment difficulties worsened. While the market for unskilled workers remained adequately supplied, partly reflecting continued inward migration, overall the Agents judged that recruitment difficulties had risen to slightly above normal levels, the first such assessment for fifteen months (**Chart 2**).

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

Capacity pressures rose further (**Chart 3**), particularly in professional and financial services where skill shortages were more severe. Those pressures were typically reflected in firms working their staff more intensively for longer periods; outsourcing work to overseas offices and/or flying in staff from overseas during busy periods; turning away lower-margin work; and increasing prices to balance demand to capacity. Skill shortages in the construction sector — including architects, surveyors, engineers and project managers — had also increased. In manufacturing, contacts had become more adept at flexing capacity when its normal limits were being approached. Sometimes that entailed greater use of temporary (often migrant) labour, and/or outsourcing production overseas.

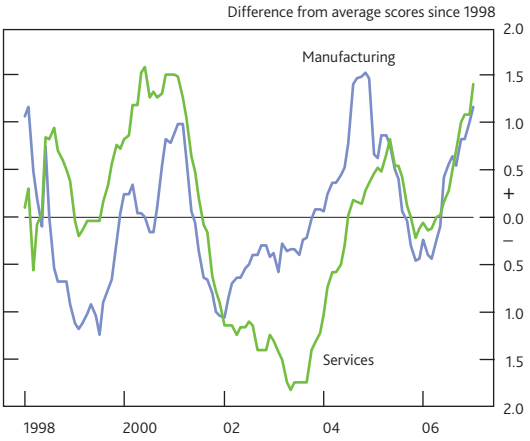
Costs and prices

Pay

Growth of labour costs in manufacturing and the service sectors rose a little further. But overall, most contacts were not unduly concerned about the magnitude of prospective pay increases.

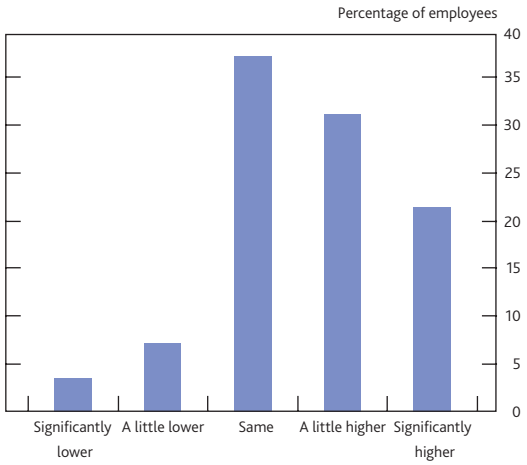
In December 2006 and January 2007 the Agents carried out a survey of their contacts regarding the prospects for pay and

Chart 3 Capacity constraints over the next six months



labour costs during 2007. The survey covered around 460 companies employing a total of over 680,000 workers. A weighted net balance of 16% of firms expected their pay settlement to be higher in 2007 than the previous year. The average expected settlement for 2007 was 3.4%, broadly in line with the level of settlements at the end of 2006, but slightly above the average for 2006 as a whole.(1) Contacts expected the rise in settlements to feed through to an increase in total labour cost growth (**Chart 4**). Respondents suggested that the expected pickup in labour cost growth in 2007 reflected the higher level of inflation and difficulties in the recruitment and retention of staff. But some of this impact was expected to be offset by improvements in labour productivity.

Chart 4 Agents' survey: total expected labour cost growth in 2007(a)



(a) Based on 457 responses to a survey of companies by the Bank of England's regional Agents in December 2006 and January 2007, weighted by respondents' number of employees. The survey asked respondents: 'in the next twelve months, how do you expect the annual percentage change of total labour costs per employee to compare with the previous twelve months?'.

According to the survey, companies planned to continue to make greater use of forms of compensation other than settlements, such as one-off bonus payments.

Input prices

Input price inflation continued to ease. That reflected further falls in the dollar, lower prices of oil, gas and some metals, and much smaller increases in energy costs when annual contracts were renewed. But the full benefit of lower spot energy prices was not expected to be felt for another six months or so. Costs of imported finished goods had also risen at a slower rate. A weaker dollar and lower transport costs more than offset signs of higher inflation for goods produced in emerging economies such as China and India.

Output and consumer prices

Manufacturers' annual rate of output price inflation edged lower in January. Overall, manufacturers were able to pass some of the benefits of lower non-wage costs on to their customers, while still being able to raise margins. Manufacturers reported that they planned to rebuild margins further this year, though in the past that had been thwarted by competitive pressures. Business to business services price inflation increased, reflecting higher wage inflation and in some cases improved margins as firms looked to profit from excess demand.

Consumer goods price inflation increased further. Overall, better-than-expected demand before Christmas had reduced retailers' stocks for clearance in the January sales, and discounting was perhaps slightly less than usual as a result. The exception was clothing and footwear, with retailers reporting heavier discounting this year. Poor global harvests, coupled with growing demand for arable crops from producers of bio-fuels, continued to underpin higher rates of annual food price inflation. Nevertheless, retail food price pressures were expected to ease soon as output recovered. Consumer services price inflation rose slightly, partly due to relatively large increases in rail fares.

(1) See **Table 4.A** on page 34 of the February 2007 *Inflation Report*.