BANK OF ENGLAND

Agents' summary of business conditions

July 2007

- Consumption growth remained firm but eased a little, driven by a slowdown in discretionary spending.
- Demand for housing also eased in most areas outside London.
- In contrast, investment intentions remained robust.
- Demand for exports was again buoyant overall, though less so from the United States.
- Growth in manufacturing remained well supported by external and domestic demand.
- Output in the construction and service sectors maintained a rapid rate of expansion.
- Employment intentions were elevated, with labour demand continuing to be strongest in the service sector. Recruitment difficulties increased in most parts of the United Kingdom.
- Capacity pressures persisted and became more widespread across industries.
- Growth in pay awards remained well contained. And while growth in total labour costs eased, it remained higher than that in regular pay owing to additional leave provisions and other non-wage compensation.
- Annual input price inflation increased again in June, as did output price inflation. There was further evidence of margin rebuilding by manufacturers.
- Annual consumer price inflation ticked down but remained above its average of recent years.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with nearly 800 businesses in the period between **late May and late June**. 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.

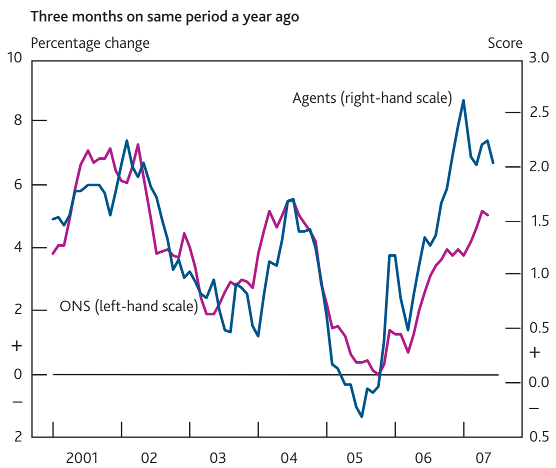
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

The Agents' score for the value of retail sales fell in June, though the overall pace of growth in spending remained firm (**Chart 1**). Reports of a modest easing in sales growth were evident in most regions, and appeared to reflect a slowdown in discretionary spending.

Chart 1 Retail sales values



Most Agents reported an easing in sales of consumer durables (especially furniture and audiovisual equipment) and disappointing sales of new season fashion, with the latter compounded by adverse weather. There were also more reports of softer spending on consumer services, after an extended period of strong growth. Despite the easing in discretionary spending, the overall pace of consumption remained firm, supported by healthy growth in expenditure on staple goods (such as food and basic homewares).

Housing market

Housing demand also eased in June in most areas outside London. In the market for established housing, estate agencies reported a slight fall in transactions growth. At the same time, there was an increase in the number of instructions. In combination, these factors contributed to modest downward pressure on expected price inflation for established homes in some regions.

Demand for new housing also eased in parts of the United Kingdom. With discounts still prevalent, builders' margins remained compressed, and price inflation for new dwellings was lower than for established homes. In contrast, demand for rental accommodation strengthened further, particularly in areas with the greatest employment opportunities, leading to upward pressure on rents. Rental yields, however, remained lower than historical averages.

Overseas trade

External demand for goods and services remained strong overall. The high value of the pound relative to the dollar weighed on margins and orders for firms exporting to the United States and dollar-denominated markets. However, this was offset by strength in demand elsewhere. There was further growth in exports of goods to Europe and the Middle East, while service exports expanded rapidly to eastern Europe, and emerging economies in Asia and Africa. Demand for both final and intermediate imports also remained high, consistent with healthy domestic production and the strength of the currency.

Investment

Investment intentions remained high in June. In the service and manufacturing sectors, Agents' scores were only marginally below their recent peaks. Firms in both sectors continued to report intentions to invest in IT. Engineering investment increased, buoyed by infrastructure projects. And there was also increased investment in buildings and structures, especially in the business service sector where strong demand required expansion of premises, and among major retailers with refurbishment plans.

Output

Primary production

Agricultural producers reported ongoing strong demand for locally grown grains, given disruptions to global supply and the expansion of the biofuels market. In contrast, production decisions about livestock were being affected by the increased share of imported meat in the domestic market.

Manufacturing

Manufacturing output growth remained solid in June. The greatest impetus to growth came from exports, consistent with other reports of strong external demand. Those manufacturers facing intense competition from imports in domestic markets were increasingly engaging in higher value added production, or in activities where they could secure faster and more reliable delivery than foreign producers. And there was ongoing stimulus from the current boom in non-residential construction activity.

Construction

Construction output growth edged higher to its fastest rate since the Agents began recording scores in mid 1997, and capacity pressures intensified. Activity continued to be supported by infrastructure projects, along with demand for new retail, industrial and commercial space. Many contacts reported full order books for the year ahead. More Olympics-related projects were under way, and the clustering of these projects was expected to exacerbate capacity constraints in the year ahead.

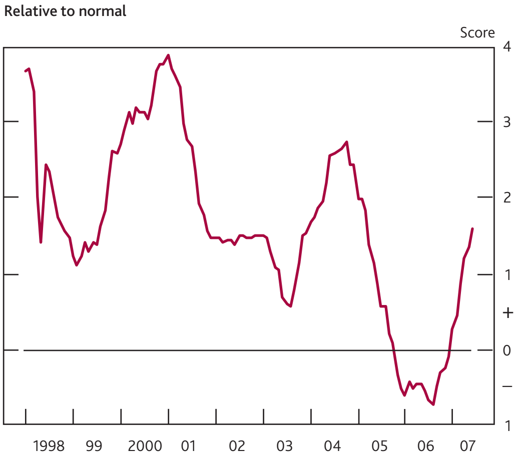
Services

Service sector output continued to expand at a rapid pace, though the rate of growth appeared to have levelled out. Growth in professional and financial services remained strong, boosted by high levels of mergers and acquisitions. Growth in 'Other business services' was also strong, reflecting ongoing buoyant demand for IT services and logistics. However, the Agents' score for consumer services, while high, fell in June, consistent with the reported easing in households' discretionary spending.

Employment

Employment intentions remained elevated. Labour demand was still strongest in the service sector, and employment intentions in manufacturing had stabilised after a sustained period of labour shedding. Demand for skilled labour continued to exceed supply, particularly in the business service and construction industries, so that overall recruitment difficulties climbed further (**Chart 2**), and became more geographically widespread. Migrant labour continued to play an important role in alleviating shortages of less-skilled labour, though there were some reports by businesses that the inflow of migrants was insufficient to meet their needs.

Chart 2 Recruitment difficulties[(a)]

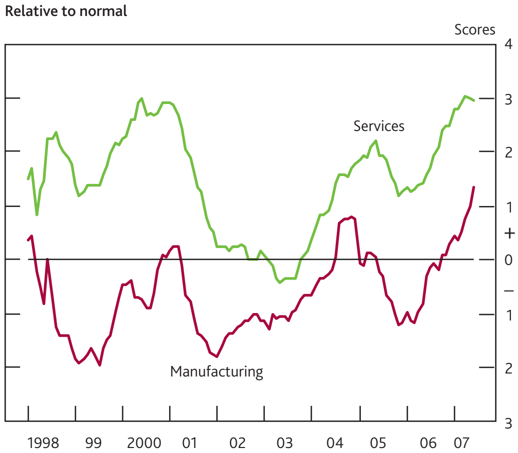


(a) Skill shortages before January 2005.

Capacity utilisation

Consistent with ongoing recruitment difficulties, capacity pressures persisted (**Chart 3**). Driven largely by business service companies, capacity pressures remained greatest in the service sector, and had plateaued at a level close to that at the turn of the decade. But capacity pressures increased in the manufacturing sector, exceeding those during the previous local peak in 2004. Furthermore, capacity remained tightly constrained in the construction sector. This mainly reflected shortages of professional staff, though shortages of materials were also reported.

Chart 3 Capacity constraints expected over the next six months



Costs and prices

Labour costs

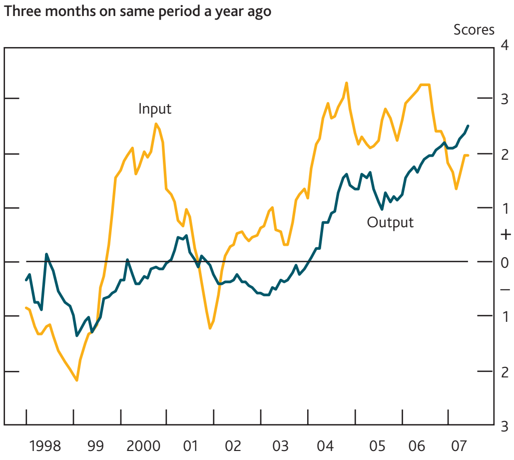
The Agents' scores for labour costs were at a high level in June, though remained below their peak at the beginning of the year. These scores continued to suggest a stronger signal than official data on aggregate earnings growth. This was attributed to reports by firms of increased incentive payments and other forms of employee compensation. And many firms cited the importance of additional leave. Across-the-board pay settlements had edged up only slightly, but were expected by contacts to increase further in the year ahead given tighter labour market conditions.

Input and output prices

Input cost inflation rose again in June (**Chart 4**), with firms reporting renewed increases in the prices of oil, oil derivatives, metals and construction materials. Contacts in the food processing and retail sectors continued to emphasise global demand and supply factors contributing to the rising cost of food inputs.

Against a background of higher input costs, the score for manufacturing output price inflation picked up further in the month, as some firms took advantage of stronger demand to raise prices and recover costs. Scores for manufacturers' input and output prices were consistent with additional margin recovery, continuing the trend evident since the beginning of the year. Furthermore, Agents' scores on pre-tax profitability

Chart 4 Input and output prices(a)



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

had increased for manufacturers in the past six months. Manufacturers reported intentions to continue rebuilding margins to levels prevailing before the 2005–06 energy price shock.

In addition to the increase in prices and margins in the manufacturing sector, business-to-business service price inflation persisted at a high rate, consistent with the relatively high labour cost growth in the sector, and strong demand for business services.

Consumer prices

Goods price inflation eased in June as the effects of the earlier sharp increases in energy prices began to fall out of annual comparisons and recent price cuts took effect. In contrast, service price inflation edged down only marginally to remain at a high rate, leaving overall consumer price inflation elevated. Even though services have had a higher trend rate of price inflation, the sustained strength in service prices over the past year was said by contacts to reflect higher labour costs and robust demand.

Looking ahead, contacts expected that consumer price inflation would fall, driven by cuts in utilities prices, increased penetration of low-cost imports and competition among major retailers. Nonetheless, some contacts expected that these influences would be partly offset by elevated food prices and upward pressure on road transport costs.