BANK OF ENGLAND

Agents' summary of business conditions

June 2007

- Consumption growth remained strong overall, though discretionary spending appeared to ease.
- Demand for housing was firm nationally, but a little more disparate across regions.
- Investment intentions strengthened further.
- Demand for exports remained buoyant overall, though orders were weaker from the United States.
- Growth in manufacturing remained solid, supported by increases in both external and domestic demand.
- Output in the construction and service sectors continued to expand at a strong pace.
- Employment intentions were high, with labour demand strongest in the service sector. And recruitment difficulties became more pronounced in most regions.
- Capacity pressures persisted, especially in the construction and service sectors, but also became more evident in manufacturing.
- Growth in pay awards increased modestly. Other forms of employee compensation continued to drive somewhat stronger annual growth in total labour costs than indicated by official data.
- Annual input price inflation increased again in the month, and output price inflation edged up. And there was more evidence of margin rebuilding.
- Annual consumer price inflation remained relatively high.

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 April and late May**. 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 was little changed in May, with the overall pace of annual growth in spending remaining firm. This relatively strong overall growth rate did, however, mask variations in the performance of key expenditure classes.

Robust growth in spending was evident for staple goods (particularly food and basic homewares). But a number of Agents reported an easing in sales of consumer durables (especially furniture and audiovisual equipment). And there were some reports of a modest slowing in spending on consumer services, after an extended period of strong growth. This was considered by retailers to be an early signal of an easing in discretionary spending, consistent with the effects of tighter monetary policy.

Housing market

Housing demand remained firm nationally, though there were signs that it had eased in some regions. In the market for established housing, estate agencies reported a slight slowdown in transactions growth in the month. There had been a modest increase in the number of new instructions, induced by the (now delayed) introduction of Home Information Packs. The increase in supply of established housing did little to contain house price rises, however, as the level of demand continued to exceed the supply of homes.

Rental demand remained strong and there were further reports of interest by investors in the buy-to-let market. Demand for new housing remained weaker than for established homes, and supply-side issues continued to constrain additions to the dwelling stock. With discounts still prevalent, builders' margins remained tight, and price inflation for new dwellings was again lower than for established homes.

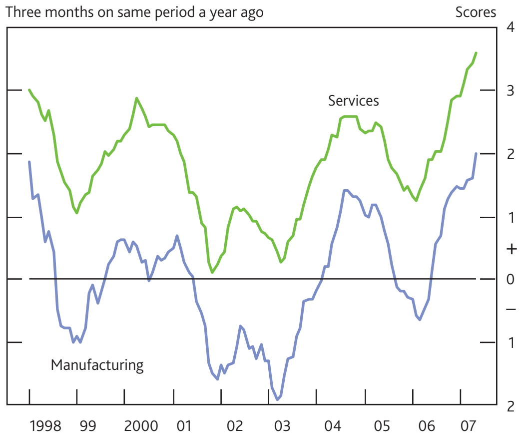
Overseas trade

External demand for both goods and services remained strong. Particular strength was evident in exports of goods to Europe and the Middle East, while service exports were expanding rapidly to emerging economies in Asia and Africa. But a number of contacts reported that the appreciation of sterling against the dollar was now weighing on export orders from the United States. Beyond this market, the rise in sterling over the past year continued to be reflected in lower margins rather than export orders. Demand for imports (both final and intermediate) also remained high, consistent with healthy domestic spending and the high value of the pound. As a result, there were reports of congestion at some UK ports.

Investment

Investment intentions strengthened further. In the service sector, Agents' scores reached their highest level since the series began in mid-1997 (**Chart 1**). And investment intentions in the manufacturing sector were at their highest level in close to a decade, having risen sharply in recent months. Firms were reportedly investing heavily in IT. Those in the service sector had increased IT investment in order to expand capacity, while manufacturers were focusing on IT to enhance productivity and competitiveness. There were also reports of increased investment in buildings and structures, particularly in the service sector where strong demand conditions were requiring expansion of premises.

Chart 1 Investment intentions over the next twelve months



Output

Primary production

Agricultural producers continued to report strong demand for locally grown grains, given weak harvests elsewhere in the world, coupled with expansion of the market for biofuels. Higher grain prices were encouraging some switching of production from livestock to crops.

Manufacturing

Manufacturing output growth remained solid in May, with increases in both external and domestic demand. The impetus to growth from external demand was strongest, with high value-added manufacturers expanding their export markets. Manufacturers competing with imports in domestic markets were also increasing their focus on higher value-added production. Others continued to benefit from the current boom in non-residential construction activity.

Construction

Construction output growth rose in May to its fastest rate since the Agents have recorded scores in mid-1997, and capacity pressures intensified. Activity continued to be supported by infrastructure projects, along with high levels of demand for new retail, warehousing and commercial space. Most contacts expected demand to remain strong over the coming year, so that forward orders were plentiful. However, the clustering of projects associated with the Olympics was expected to exacerbate capacity constraints.

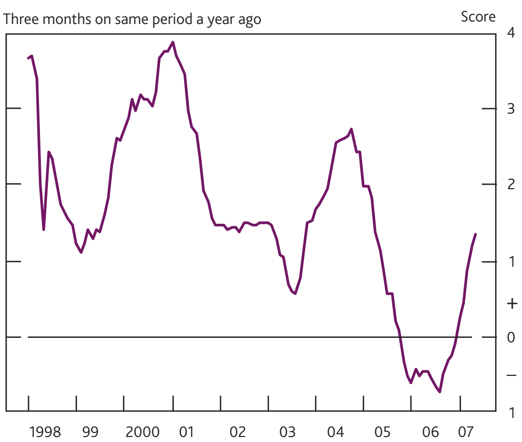
Services

Growth in service sector output also continued at a rapid pace, and the Agents' score for annual growth in the value of business services remained close to its recent high. Growth of professional and financial services remained strong, buoyed by mergers and acquisitions, though there was a modest easing from the exceptional rate seen last month in some regions. Growth in 'Other business services' picked up sharply, reflecting greater demand for IT services and logistics. Growth in consumer services, while high, ticked down in May.

Employment

Employment intentions remained high in May. And while labour demand was still strongest in the service sector, employment intentions in manufacturing were stabilising after a decade of labour shedding. Demand for skilled labour continued to outstrip supply, particularly in the business service and construction industries, so that recruitment difficulties rose further (**Chart 2**), and became more widespread across regions. Migrant labour continued to play an important role in alleviating shortages of less skilled labour. But even here there were reports that it had become more difficult to obtain migrant workers as recruitment from A8 countries slowed and that from the newest accession countries was yet to have an impact.

Chart 2 Recruitment difficulties[(a)]



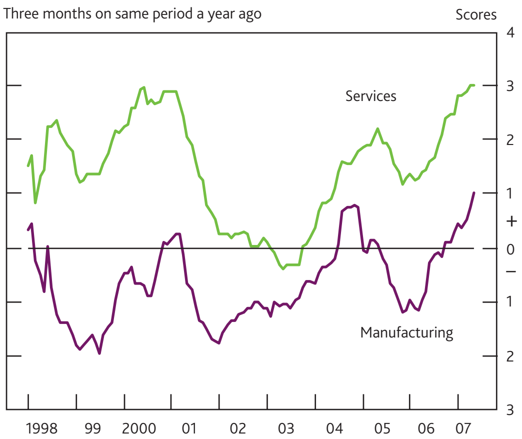
Note: Skill shortages before January 2005.

(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 these recruitment difficulties, capacity pressures persisted (**Chart 3**). Pressures were most acute in the service sector. But they had steadily increased in the manufacturing sector, so that rates of capacity utilisation were now clearly above the 'comfortable' levels that corresponded to a zero score, and exceeded the previous local peak in 2004. Capacity was also tightly constrained in the construction sector, mainly reflecting shortages of professional staff.

Chart 3 Capacity constraints expected over the next six months



Note: Capacity utilisation relative to normal before January 2005.

Most firms were responding to capacity constraints by seeking to increase their capital and labour input, including imported labour. But these efforts were often insufficient to avoid turning away lower-margin work or increasing prices, particularly in business service industries. Firms in both the business services and construction sectors reported expectations that order books were likely to remain full for an extended period.

Costs and prices

Labour costs

The Agents' scores for annual growth in total labour costs per employee remained high in the service sector, but eased further in manufacturing, so that overall labour cost growth was slightly slower. Despite this easing, the Agents' scores for labour costs continued to suggest a somewhat stronger picture than official data on aggregate earnings growth.

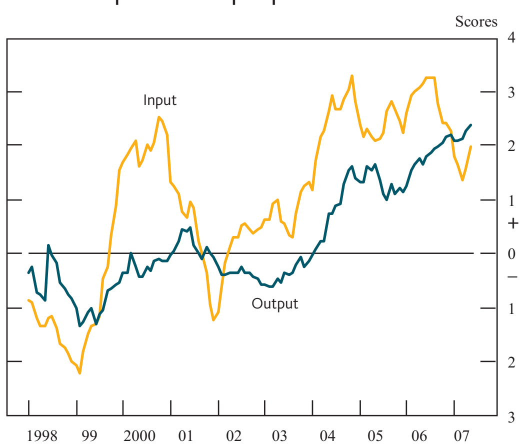
In the service sector, labour cost pressures were geographically widespread, with half the Agents recording scores as high as that for London. This cost pressure was commonly attributed to incentive payments and other forms of employee compensation (such as pension payments, health insurance and additional leave benefits). Across-the-board pay settlements were said to have risen modestly, as firms responded to a perceived tightening in labour market conditions. A number of contacts claimed that the climate for wage bargaining had become more difficult.

Input and output prices

Input cost inflation rose again in May (**Chart 4**), with firms reporting renewed increases in the prices of oil, oil derivatives, metals and construction materials. But many contacts engaged in food processing or retailing also emphasised the rising cost of food inputs, and thought this would be a source of sustained cost pressure. The growing market for bio-fuels was reported as a driver of higher food costs, as crop supplies were diverted from production of food to energy. Climatic events (such as drought in Australia) had also weighed on global supply of key food inputs. And food demand from Asia had been rising rapidly. Manufacturers were reportedly accepting higher prices for food inputs in return for greater security of supply.

The score for manufacturing output price inflation picked up in May, with some firms taking advantage of strong demand to raise prices and recover costs (**Chart 4**). The difference between the Agents' scores for input and output prices suggested that margin recovery in the manufacturing sector had been under way over the past six months or so, after an extended period of margin compression. This was also consistent with Agents' scores on pre-tax profitability, which had increased most clearly for manufacturers in recent months. Manufacturers reported intentions to rebuild margins further this year, but typically indicated a desire for margins to be gradually restored to the level prevailing before the 2005–06 energy price shock, rather than to a higher level. In addition to these developments, annual business-to-business service price inflation persisted at a high rate. This reflected wage outcomes in the service sector, and greater pricing power, given the strong demand for business services.

Chart 4 Input and output prices



Note: Manufacturers' output prices.

Consumer prices

Consumer price inflation remained relatively high in May. Within this, however, goods price inflation had eased as the effects of earlier sharp increases in energy prices began to fall out of annual comparisons and recent price cuts took effect. Service price inflation, on the other hand, persisted at a high rate. While services tend to have a higher trend rate of inflation, the steady pickup in service prices over the past eight months reflected higher labour costs and robust demand.

With upstream inflationary pressures evident in the input and output price prices of producers, an important question was the extent to which they would be reflected in the final prices faced by consumers. During April and May, the Agents conducted a survey of retailers to gauge expected increases in costs, prices and margins over the year ahead. The survey covered 160 retailers, including the largest retailers in the United Kingdom, with a combined turnover of £144 billion. A key finding was that more retailers of consumer services expected prices to rise than expected costs to rise, with higher prices facilitating margin recovery (**Chart 5**). Retailers of goods, on the other hand, did not expect significant price rises, despite being faced with rising costs. Nonetheless, they still anticipated margin recovery, presenting a puzzle. In attempting to explain the puzzle it was found that cost growth was likely to have been overstated, as some respondents reported on the cost of labour and materials, excluding other costs (such as distribution) where savings were being made. But a common theme was that retailers would achieve higher margins through increases in the share of high-margin goods sold and more active use of their buying power to enhance supply-chain efficiencies.

Chart 5 Expected changes for retailers over the next twelve months