BANK OF ENGLAND

Agents' summary of business conditions

March 2007

- Growth in consumer spending eased, but remained firm.
- Overall housing demand was still robust, though the outlook for new home building had become less certain.
- Investment intentions persisted at high levels, particularly in the service sector.
- Demand for exports remained healthy despite sterling's appreciation.
- Growth in manufacturing output eased a little.
- Construction output rose further, supported by both public and private sector projects.
- Service sector output growth continued at a rapid pace.
- Employment intentions increased, driven by demand for labour in the service sector.
- Recruitment difficulties increased, with skill shortages becoming more broad-based.
- Capacity pressures remained high in some sectors, and were greatest in construction and services.
- Growth in labour costs strengthened, consistent with increased recruitment difficulties.
- Growth in materials costs slowed from its earlier rapid pace so that input price inflation eased again.
- Consumer price inflation 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 over 700 businesses in the period between **late January and late February**. 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.

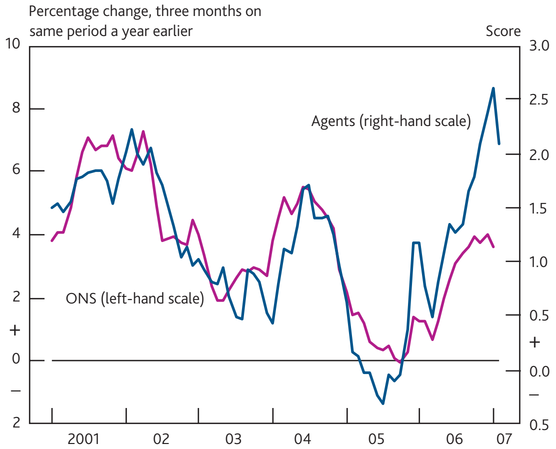
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

Following unexpectedly strong sales in the Christmas period, most Agencies reported that growth in retail spending had slowed somewhat since mid-January, but remained firm (Chart 1).

Chart 1 Retail sales



Most classes of retail spending grew at a slower pace in February than in January, though demand remained strongest for high-tech electronics and was weakest for clothing, footwear and some consumer durables. Private car sales were also soft in February. However, demand for consumer services remained strong, particularly for tourism-related services, supporting the ongoing strength in consumption overall.

Looking ahead, retailers had become slightly more cautious about the outlook. They emphasised that sales were being boosted by those customers purchasing high-value products. Spending by the general customer continued to be held back by high levels of personal indebtedness, and retailers claimed there were more cases of householders seeking individual voluntary arrangements.

Housing

Demand for housing remained robust, despite recent increases in interest rates. With land shortages and planning restrictions inhibiting additions to the housing stock, upward pressure on established housing prices persisted. There were, however, more reports that the pace of house price inflation had begun to ease in regions where the run-up had been most pronounced.

Continued high house prices, combined with recent interest rate rises, had weighed further on affordability. Consequently, rental demand remained strong, boosted by demand from would-be first-home buyers and immigrants. This was reflected in an additional modest increase in rents. Nonetheless, yields in the buy-to-let market remained low relative to the cost of borrowing, so that investor demand was still subdued.

In the market for new housing, house builders were less optimistic this month. The number of viewings remained lower than normal, and builders continued to offer incentives in order to secure sales. Building costs and land prices rose further, and with limited scope to pass on higher costs to potential buyers, builders' margins remained under downward pressure. Reflecting these developments, price inflation for new dwellings was again below that for established homes.

Exports and imports

External demand remained solid, with continued strong growth in the volume of exports to a range of markets. Exporters had experienced a loss of price competitiveness arising from sterling's recent appreciation, especially in dollar-based markets. But so far this had mostly been reflected in lower margins, with limited evidence of falls in orders. Demand for imports remained high. Strength in demand was evident for both intermediate and consumption imports, consistent with the healthy level of domestic spending and sterling's appreciation.

Investment

Investment intentions remained strong. This was particularly so in the service sector, where Agents' scores had risen steadily and were now above those at the turn of the decade. Service sector firms continued to invest in additional capacity, including offices, information systems, warehousing and retail space. Investment intentions in the manufacturing sector, while ticking down in February, remained much higher than a year ago. Manufacturers remained focused on investment that would enhance their productivity and competitiveness.

In addition to generally high levels of business confidence and liquidity, regulatory and environmental requirements continued to spur investment decisions. This was most evident in the energy sector.

Output

Primary production

Agricultural production was little affected by the recent case of avian flu: demand for poultry and poultry products had remained resilient. Both domestic and external demand for other meat products was said to be strengthening, and grain plantings increased in response to continued high world prices for grain.

Manufacturing

Manufacturing output growth eased again in February, but remained at a high level. The recent slowing was evident in both domestic and external markets. Against the background of a trend rise in import penetration, sterling's recent appreciation had further increased demand for imported goods and brought forward plans to move capacity overseas. Nonetheless, positive sentiment was reported by those manufacturers that were adapting to increased international competition, and trading conditions continued to be supported by the strength in global and domestic demand.

Construction

Output growth rose in February to its fastest rate in more than a decade. Mild weather facilitated the advancement of various public sector infrastructure projects. Private sector activity also remained strong, fuelled by retail and commercial projects. Forward orders were plentiful, though faster output growth was impeded by capacity constraints; prominent among these constraints were shortages of skilled labour and insufficient land with planning permission.

Services

Growth in service sector output continued at a rapid pace. The Agents' score for business services rose to its highest level since the series began in mid-1997. Strength in business services was again driven by strong demand for professional and financial services, consistent with buoyant asset markets, high levels of M&A activity and increased regulatory requirements. Accountants and lawyers expected to see continued strong growth in output throughout 2007. Output growth in 'Other business services' remained firm, reflecting greater demand for ICT services and logistics. Demand for consumer services also strengthened.

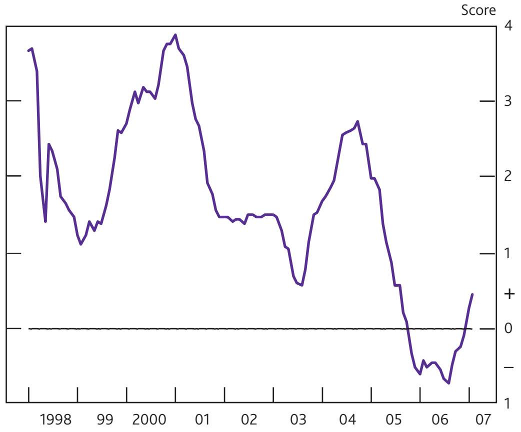
Employment

Employment intentions increased further. This was driven by the strength in demand for labour in the business services sector, while labour demand in the manufacturing sector had stabilised. Demand for skilled labour significantly exceeded its supply in the business service sector, contributing to the rise in overall recruitment difficulties (Chart 2). And even in the market for unskilled workers, where labour supply is more abundant, the Agents reported that recruitment difficulties had also increased.

Capacity utilisation

Consistent with growing recruitment difficulties, capacity pressures remained high (Chart 3). Pressures were particularly marked in the business service sector where skill shortages

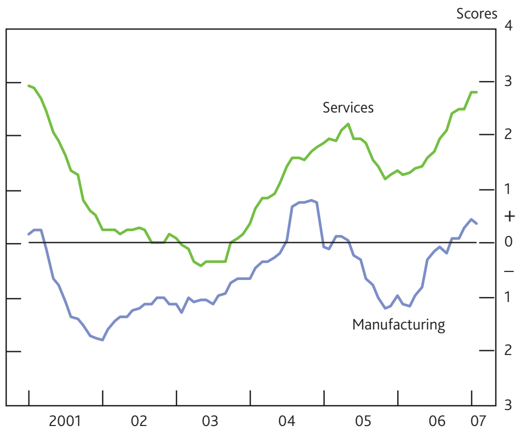
Chart 2 Recruitment difficulties[a]



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.

Chart 3 Capacity constraints over the next six months



Note: Capacity utilisation relative to normal before January 2005.

were more severe. However, capacity pressures were also said to be evident in the construction sector. Manufacturers, on the other hand, were not generally capacity constrained.

Firms were responding to capacity constraints by increasing their investment, increasing the average hours worked by their staff, outsourcing work to overseas offices and importing staff during peak periods. In some cases, firms were turning away lower-margin work. In other cases, firms were more active in increasing prices.

Costs and prices

Pay

Growth in labour costs per employee rose further. The increase was sharpest in the service sector, consistent with the more pronounced difficulties recruiting skilled labour in this sector. However, labour costs in the manufacturing sector had also increased steadily over the past year. Much of the increased growth in labour costs was attributed to greater bonuses and other non-wage remuneration. Across the board, pay awards had only increased moderately. In most sectors, pay awards were expected to be slightly higher in 2007 than in 2006, given growing recruitment difficulties and higher inflation.

Input prices

Material cost inflation eased further. Part of this slowdown reflected the recent strength of sterling, which had lowered the domestic price of imported inputs. Lower world prices of oil, gas and some metals had also helped to contain growth in the cost of inputs. However, given the lags in contract renegotiation, it would be some time before lower spot prices for these key inputs were evident in prices faced by many producers. Indeed, reflecting the earlier sharp run-up in fuel costs, some Agents reported that fuel surcharges remained in place.

Output and consumer prices

Manufacturing output price inflation remained broadly unchanged in February. Manufacturers were passing on only some of the reduction in input costs to their customers, so that margins could be rebuilt. Manufacturers indicated that they planned to rebuild margins further this year, to the extent that competitive pressures would allow. Similarly, business to business service price inflation remained steady, but at a higher rate than inflation in the manufacturing sector. This reflected stronger wage growth in the service sector, and greater pricing power in a climate of strong demand for services.

Consumer price inflation for both goods and services also remained relatively high in February. Consumer service price inflation largely reflected rising labour costs. Goods price inflation continued to reflect the earlier sharp increases in the cost of energy and commodity inputs (Chart 4). However, these input costs were no longer escalating, and sterling's appreciation had reduced the prices of imported final goods. And there had been announced reductions in utilities prices with the prospect that other energy providers will announce similar falls. Consequently, contacts indicated that upstream pressures on goods prices might be less pronounced in the period ahead, especially given continued intense competition among major retailers.

Chart 4 Input and retail prices