BANK OF ENGLAND

Agents' summary of business conditions

May 2007

- Consumption growth picked up, with retail sales boosted by unseasonably warm weather.
- Demand for housing was firm, and there was continued upward pressure on house prices.
- Investment intentions strengthened further, especially in the service sector.
- Demand for exports remained buoyant and exceeded companies' expectations.
- Manufacturing activity remained well supported by external demand.
- Output growth in both the construction and service sectors continued to rise.
- Employment intentions increased, driven largely by demand for labour in the service sector. And recruitment difficulties became more pronounced in most regions.
- Capacity pressures remained high, especially in the construction and service sectors, but also became more evident in manufacturing.
- Growth in pay awards increased only slightly, though increases in other forms of employee compensation continued to drive stronger reported growth in total labour costs than suggested by official data.
- The recent sharp fall in input price inflation was arrested in the month, while output price inflation edged up — consistent with margin rebuilding.
- Consumer price inflation remained elevated.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with nearly 900 businesses in the period between **late March and late April**. 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.**

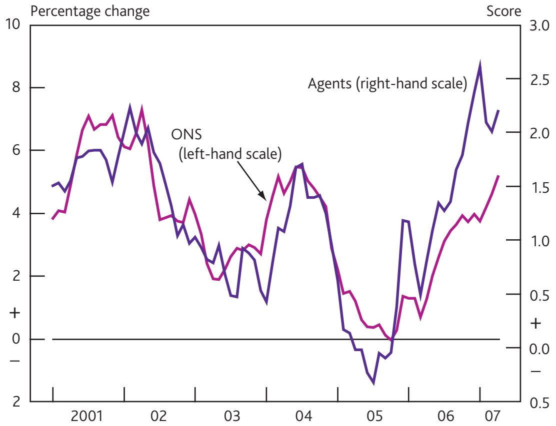
Demand

Consumption

The Agents' score for retail sales picked up in April (**Chart 1**). While the increase was not evident in all regions, most Agents reported that sales had benefited from unseasonably warm weather, particularly during the Easter period.

Chart 1 Retail sales values

Three months on same period a year earlier



Reflecting warmer weather, strong sales were reported for new-season clothing, and goods used in gardening and home renovation. Demand for high-tech electronics remained buoyant. And spending on consumer leisure services was generally strong, further supporting growth in total consumption.

While retailers' sentiment had been boosted by unexpectedly strong sales, they were still cautious about the outlook, given the extent of media speculation about future interest rate rises and reports of tighter lending criteria.

Housing market

Demand for housing remained firm overall. In the market for established housing, demand continued to outstrip the number of instructions so upward pressure on house prices persisted.

The high cost of house purchase continued to stimulate rental demand from would-be buyers, and migrants also boosted demand for rental accommodation. Consequently, there were reports of growing interest by investors in the buy-to-let market, most notably in London and southern regions.

Demand for new housing was again less robust than for established homes. With incentives still prevalent in some regions, price inflation for new dwellings was slower than for established homes and builders' margins remained tight.

Overseas trade

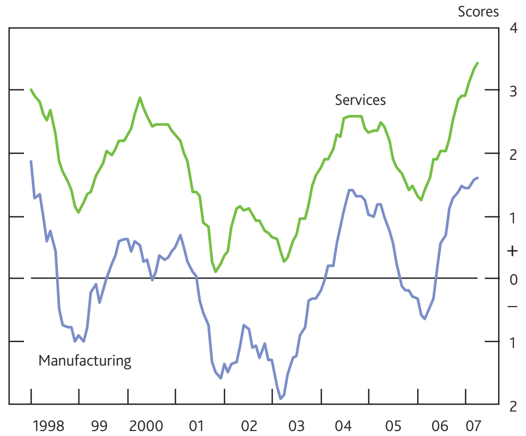
External demand for both goods and services remained strong, and continued to exceed expectations. Strength in exports was evident to a broad range of markets; this included the United States, despite the appreciation of sterling against the dollar. While the high value of sterling had made exporters less competitive, the response of companies had so far been to lower their margins so that orders were little affected. Demand for imports (both final and intermediate) also remained high, consistent with healthy domestic spending and the rise in the value of the pound over the past year.

Investment

Investment intentions strengthened again. In the service sector, Agents' scores continued to climb and were at their highest level since the series began in mid-1997 (**Chart 2**). But investment intentions in the manufacturing sector were also at their highest level in close to a decade, with particular strength in the automotive industry. Across the economy, companies reported they were investing heavily in IT. Those in the service sector had increased IT investment in order to help meet demand, while manufacturers were more heavily focused on IT to enhance productivity and competitiveness. There were also reports of increased investment in buildings and structures, particularly in the service sector where demand conditions were the most buoyant.

Chart 2 Investment intentions over the next year

Three months on same period a year earlier



Output

Primary production

Agricultural producers reported that crops were progressing well and that demand for locally grown cereal remained firm, buoyed by weak harvests elsewhere in the world coupled with expansion of the market for biofuels. Furthermore, rising world prices of timber had also stimulated activity in the forestry industry. Contacts did, however, refer to risks to the near-term outlook for agricultural production stemming from persistent dry conditions.

Manufacturing

Manufacturing output growth remained solid in April, mainly due to strength in external demand. Domestic demand for manufactures was less strong, but greater than levels of recent years. Those manufacturers who are particularly exposed to import competition were increasingly engaging in high value-added production. Others, such as producers of building materials, continued to benefit from the current boom in construction activity.

Construction

Construction output growth rose in April to its fastest rate since the Agents have recorded scores in mid-1997. Activity continued to be supported by public and private infrastructure projects, along with high levels of demand for new retail and commercial space. Forward orders were plentiful, and were beginning to include projects related to the Olympics. Capacity constraints, especially with respect to labour, inhibited even stronger growth in construction.

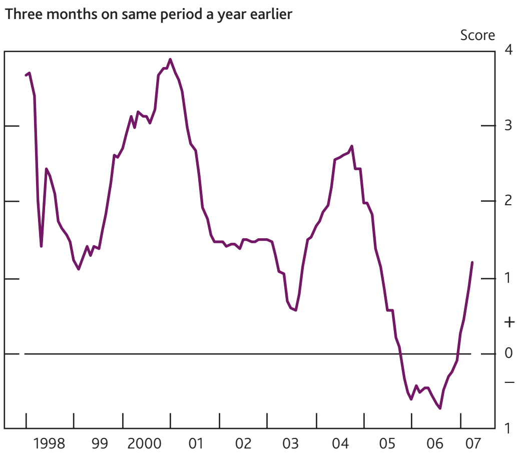
Services

Growth in service sector output also continued at a rapid pace, and the Agents' score for business services reached a record high. The strength in service sector activity was broad-based, both geographically and across industries. While growth remained most rapid for professional and financial services, it also picked up in 'Other business services', reflecting greater demand for IT services and logistics. Similarly, demand for consumer services continued to accelerate.

Employment

Employment intentions remained high in April, notwithstanding the weakening in the official data. As has been evident for some time, labour demand remained strongest in the service sector, though across most industries employment intentions were a touch lower than in the previous month. Demand for skilled labour continued to outstrip supply, particularly in the business service and construction industries, so that recruitment difficulties became more pronounced (**Chart 3**). While there was considerable regional variation in the level of recruitment difficulties, more than half of the Agents reported that it had become harder to find skilled staff over the past few months. Migrant labour

Chart 3 Recruitment difficulties[(a)]



Note: Skill shortages before January 2005.

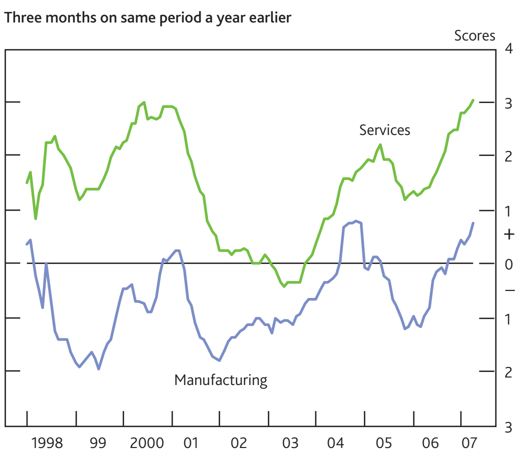
(a) Relative to normal. Agents are asked to place a value on their assessment of the degree of difficulty on a scale from -5 to +5 consistent with their reports.

continued to play an important role in alleviating shortages of less-skilled labour.

Capacity utilisation

Consistent with growing recruitment difficulties, capacity pressures rose further. Capacity utilisation remained most acute in the service sector, but had steadily increased in the manufacturing sector so that rates of capacity utilisation were now clearly above comfortable levels. Capacity was also generally constrained in the construction sector, reflecting shortages of professional staff. Expectations were for capacity pressures to increase over the next six months (**Chart 4**).

Chart 4 Capacity constraints expected over the next six months



Note: Capacity utilisation relative to normal before January 2005.

Most companies were responding to capacity constraints by increasing their investment and labour input. Greater labour input was being achieved through an increase in average hours worked, along with outsourcing work to overseas offices or importing labour. These efforts were often insufficient to avoid turning away lower-margin work or increasing prices, particularly in business service industries.

Costs and prices

Labour costs

The Agents' scores for labour cost growth ticked down in April. Nonetheless, in most regions, growth in labour costs remained well above its long-run average and continued to provide a different signal to official data on aggregate earnings.

Labour cost pressures remained highest in the service sector. Furthermore, these pressures were becoming increasingly widespread, and Agents in a number of regions recorded scores as high as that for London. Much of this cost pressure was attributed to greater bonuses and other forms of employee compensation (such as pension payments, health insurance and additional leave benefits). In contrast, across-the-board pay settlements rose only slightly from their pace of a year ago.

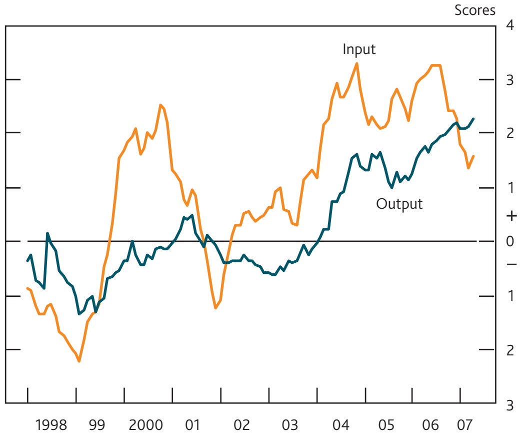
Input and output prices

The recent sharp fall in input cost inflation was arrested in April (**Chart 5**), with many companies reporting renewed increases in the prices of metals and construction materials. However, input cost inflation stayed well down on rates of a year ago, as energy costs continued to ease and the high value of sterling contained import price inflation. Many companies reported that the appreciation of the currency over the past year had offset the effect of rising prices of goods from China.

The score for manufacturing output price inflation picked up slightly in April with some companies reportedly taking advantage of strong demand to raise prices (**Chart 5**). Furthermore, some manufacturers were retaining part of the benefit of the overall fall in input cost inflation, so that margins could be rebuilt. In fact, the difference between the Agents' scores for input and output prices is consistent with margin recovery in the manufacturing sector over the past six months, after an extended period of margin compression. Manufacturers reported plans to rebuild margins further this year, and typically indicated an intention for margins to be gradually restored to the levels prevailing before the run-up in costs since 2004.

Chart 5 Input and output prices

Three months on same period a year earlier



Note: Manufacturers' output prices.

In addition to the edging up of prices and margins in the manufacturing sector, business to business service price inflation persisted at a high rate. This reflected wage outcomes in the service sector, and greater perceived pricing power given the strength in demand for services.

Consumer prices

Consumer price inflation for both goods and services remained relatively high in April. Price inflation for services continued to significantly exceed that for goods; while it is typical for the price of services to have a faster trend rate of increase than that of goods, the recent outcome reflects strength in demand and rising labour costs. Goods price inflation stemmed from the earlier sharp increase in energy and output prices. Looking ahead, contacts expected that consumer price inflation would slow, given cuts in utilities prices, subdued import prices and the effects of competition among major retailers.