BANK OF ENGLAND

Agents' summary of business conditions

November 2007

- Growth in the value of consumer spending eased further, though the volume of sales remained resilient, aided by aggressive discounting.
- Demand for housing also eased further in most regions, as did house price inflation.
- Investment intentions in the service sector fell sharply again in October. They were, however, already being pared back ahead of the recent financial turmoil. So far, tighter credit conditions had not been a major concern for most companies, though posed risks for the investment outlook (see box).
- Demand for exports remained buoyant, despite weaker demand from the United States.
- Growth in manufacturing was solid, and that in construction remained very strong. However, business services activity slowed further.
- Capacity pressures lessened noticeably in service industries, but persisted elsewhere.
- Employment intentions eased, as did recruitment difficulties, largely owing to developments in the business service sector.
- Growth in total labour costs continued to point to stronger earnings growth than official data.
- Annual input price inflation increased in the month, while output price inflation was little changed.
- Annual consumer price inflation fell further, driven by discounting by retailers. Nonetheless, significant increases in some retail food prices were in prospect.

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 September and late October**. 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.**

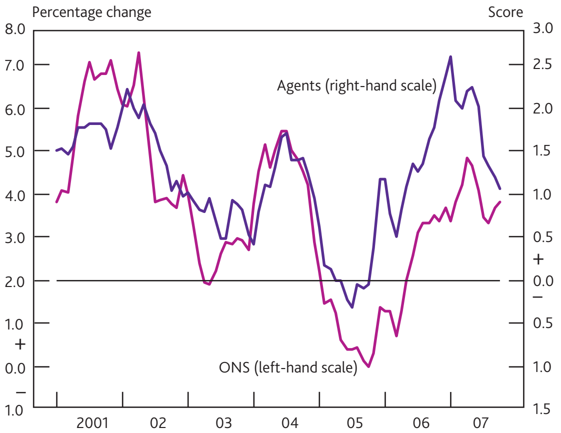
Demand

Consumption

The Agents' score for the value of retail sales fell further in October, continuing a trend which had begun well ahead of the recent financial market turmoil (**Chart 1**). Agents reported that discretionary spending remained subdued, especially for housing-related expenditures, consistent with the easing in housing demand. And there were reports of weaker spending on products typically purchased by middle-income groups who were facing higher interest costs. Spending on consumer services also remained down on rates earlier in the year. Retailers had attempted to stimulate demand and reduce unwanted inventories through aggressive discounting. Consequently, growth in the volume of sales remained resilient and exceeded that for sales values.

Chart 1 Retail sales values

Three months on same period a year earlier



Housing market

Housing demand eased further in October. In the market for established housing, estate agencies reported lower levels of enquiries, and a slowdown in new instructions. Conditions were described as unseasonably weak, both across regions and property types. Sale periods had lengthened, and there was an increase in the share of properties sold at a discount. Consequently, price inflation for established homes eased in most regions, and estate agencies claimed that the prospect of lower City bonuses had weighed on house price expectations, especially in the south.

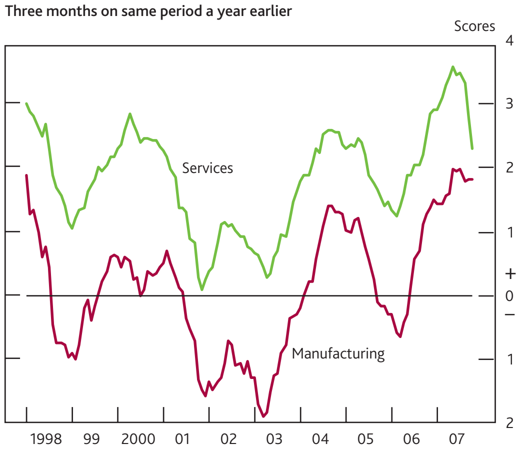
In the market for new housing, demand also remained soft. This had prompted greater use of discounts and incentives to secure sales, so that price inflation for new homes slowed further. But the reduction in overall building activity had so far been modest, given the volume of pre-committed work. Larger builders were yet to be significantly affected by tighter credit conditions, though expressed some concern about the effects of financial turmoil on potential clients' job security.

Investment

Investment intentions fell again in October, for the third successive month. This reduction was driven by a sharp fall in intentions in the service sector; manufacturers' investment intentions remained robust (**Chart 2**). Since May, an easing in investment intentions had been under way in response to increases in Bank Rate, with much of the reduction in intentions predating the recent financial turmoil. So far, the majority of companies reported that tighter credit conditions since August had not inhibited their investment plans. But for a non-trivial minority of companies, it had become difficult to refinance existing debt, or to finance new projects with uncertain cash flow. And some companies were deferring investment decisions given increased uncertainty about the effect of tighter credit conditions on demand. (For details see the box on 'Credit conditions'.)

Chart 2 Investment intentions over the next twelve months

Three months on same period a year earlier



Overseas trade

External demand remained buoyant overall, despite deteriorating conditions for those exporting to the United States. While these exporters were increasingly uncompetitive, given the strength of sterling relative to the dollar, the fall in US demand was being offset by a further strengthening in demand elsewhere. This was most so for exporters to Europe (notably the accession economies), the Middle East and emerging economies in Asia and Africa. By product type, demand was strongest for business services and capital goods.

Demand by UK companies for intermediate imports remained high, given healthy domestic production. But while consumption imports remained firm, there were some reports of retailers reviewing their orders to reduce the risk of unwanted inventories.

Output

Primary production

Livestock production remained hampered by recent disease outbreaks, which had restricted movement of animals. However, dairy production was beginning to expand in response to rising world prices and efforts of retailers to secure supply.

Manufacturing

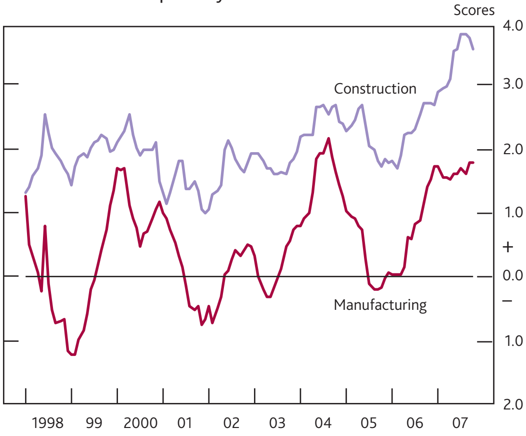
Manufacturing output growth remained strong in October, buoyed by external demand, especially high-value capital goods (**Chart 3**). Domestic production was also firm, particularly among those manufacturers exposed to non-residential construction. Prospects remained good, exceeding expectations for some contacts.

Construction

Growth in construction output remained very strong, though it ticked down from its recent exceptional pace (**Chart 3**). Activity continued to be supported by infrastructure projects, health, education, demand for new industrial and commercial space, and retail refurbishment. For many contacts, order books were full. And capacity constraints remained acute for those in some southern regions, with Olympics-related projects expected to impinge on the availability of resources. The strength in construction activity reflected the large amount of pre-committed work, with output yet to be affected by the downturn in demand for property development stemming from recent financial events.

Chart 3 Manufacturing and construction

Three months on same period a year earlier

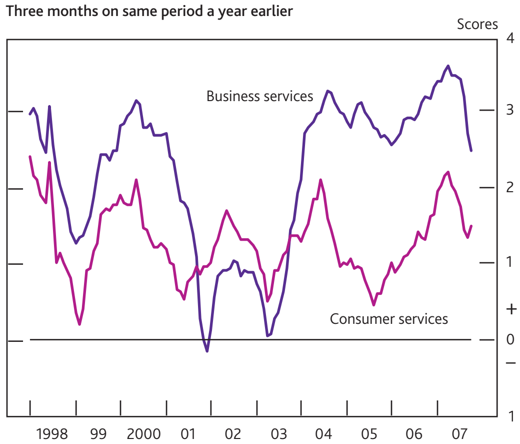


Services

In contrast to the strength in manufacturing and construction, service sector output slowed further in October (**Chart 4**). The slowdown was driven by the main component of the sector — professional and business services — and reflected an easing in demand for services related to large mergers and acquisitions, regulatory standards and property. Following a series of one-off boosts to business service demand in the first half of the decade, a slowdown in growth had become evident earlier in the year. Recent financial turmoil had, however, amplified this trend, with a reduction in activity in financial services and property development weighing on output in the business services sector more generally.

Chart 4 Service sector output

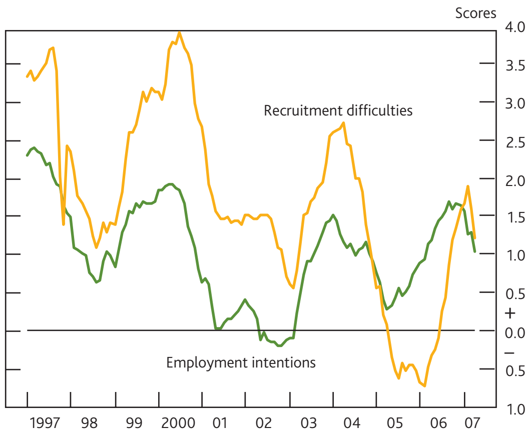
Three months on same period a year earlier



Employment

Employment intentions eased again in October (**Chart 5**). This outcome was driven by weaker employment intentions in the business service sector; intentions elsewhere were for employment to grow at current rates. And for the first time in over a year, there were signs that recruitment difficulties were easing somewhat. This mainly reflected conditions in southern regions where Agents reported less difficulty recruiting business service professionals, consistent with the easing of service sector activity. Recruitment difficulties did, however, persist for other occupations, especially professionals in the manufacturing and construction industries.

Chart 5 Labour market conditions[(a)]

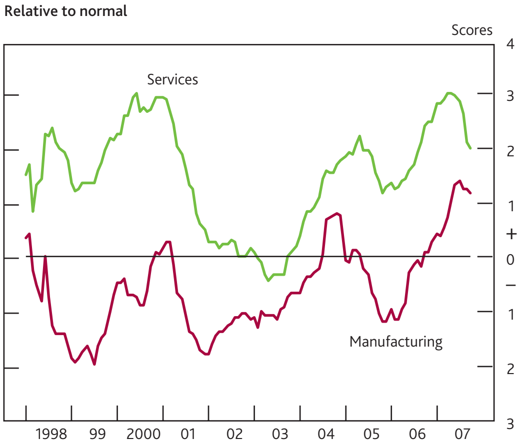


(a) Recruitment difficulties relative to normal; employment intentions (average across sectors) over next six months.

Capacity utilisation

Contacts expected capacity pressures to ease over the next six months, but remain higher than the average of recent years (**Chart 6**). While this anticipated easing partly reflected recent additions to capacity, it also reflected the current slowing in activity, which would make it easier for companies to meet demand with existing resources. Alleviation of capacity pressures was expected to be most apparent in the services sector, where there had been the most pronounced slowdown in demand. Pressures were expected to persist in manufacturing and construction, given ongoing shortages of professional and technical staff and, in some cases, materials.

Chart 6 Capacity constraints over the next six months



Costs and prices

Labour costs

Agents reported that across-the-board pay settlements remained stable in October, and their score for total labour cost growth ticked down to be well below its level at the beginning of the year, reflecting lower required contributions to pension schemes. While the overall picture on earnings growth was benign, it masked growing wage dispersion across occupational groups as companies grappled with those areas of persistent skill shortage. And there were further reports of the impact of requirements to increase paid leave entitlements for temporary staff and those on the national minimum wage. This was said to be significantly increasing unit labour costs in some sectors (notably hospitality, retail and agriculture).

Input and output prices

Input price inflation rebounded in October, driven by higher prices for energy, oil derivatives, metals, building materials and food inputs. These costs increased despite the strength of sterling relative to the US dollar, and reflected sharp rises in world prices. Partly offsetting the higher cost of commodity-based inputs, utility costs declined, though the fall was modest, given the significant lags in renegotiation of contracts for many companies.

The score for manufacturing output price inflation was little changed in October, and had stabilised in recent months. Consequently, with input price inflation displaying renewed strength, manufacturers' margin recovery had slowed. Most manufacturers had only secured partial margin recovery since the episode of rising costs during 2004–06. However, manufacturers of food products, who had experienced visible increases in costs, continued to have greater success in raising prices, especially when retailers were keen to secure longer-term supplies.

The score for business-to-business service price inflation was unchanged in October, having fallen in September. Contacts said this reflected an easing in demand and the effects of increased commoditisation of commonly provided services.

Consumer prices

Agents' scores for annual goods price inflation edged down again in October, partly reflecting the path of utilities prices over the past year. With annual service price inflation unchanged, overall consumer price inflation also fell.

Aggressive discounting had placed downward pressure on retail goods prices. It reflected efforts of retailers to stimulate demand, and intense competition between supermarket chains. Despite recent discounting, most contacts expected that a low point for retail goods price inflation was near. Deep discounting was not expected to be sustained. Contract prices of Chinese imports were increasing, and higher materials costs were beginning to feed through to retail prices of various household items. And some major suppliers of food products reported large increases in their contract prices with supermarkets. While these increases were likely to be absorbed in supermarket margins initially, contacts speculated that by the new year, there could be sizable rises in some retail food prices.

Credit conditions

Agents spoke to nearly 900 companies in October, and explored the extent to which they were affected by tighter credit conditions. This box summarises the main messages from their interviews.

Companies little affected

The majority of companies reported few direct effects of the tightening of credit conditions so far. This was because the greater share of companies interviewed had no need to undertake new borrowing to finance current business plans; they had pre-existing credit lines, access to internal sources of finance or had borrowed long term earlier in the year.

Where new borrowing was required, smaller loans remained linked to Bank Rate and terms were therefore unchanged. And although Libor-linked interest rates on larger loans rose, most borrowers said that this had not yet posed serious problems. Many contacts claimed that financial institutions continued to lend actively for transactions that would generate cash flow, or had risks that were straightforward to assess. Some 'blue chip' companies even reported that they had benefited from a 'flight to quality', while some subsidiaries were borrowing from parent companies without penalty.

Companies most affected

Nonetheless, a non-trivial minority of companies reported that tighter credit conditions were affecting their operations. By firm type, these were mainly:

- highly leveraged firms seeking to refinance their debt (with some contemplating asset sales to meet debt obligations);
- private equity firms unable to access funding on sufficient scale to progress major deals;
- firms seeking syndicated finance; and
- small to medium-sized firms with reduced access to invoice discounting, trade credit and factoring facilities.

By industry, activity in the financial services sector was affected by the cessation of large deals and securitisations. And property development was affected by reduced lending, as investors and financiers took a more cautious view of property valuations.

But so far, the effect of changes in credit conditions on overall investment decisions had been relatively small. To the extent that investment was being inhibited, companies were more likely to be deferring decisions than cancelling them. And when investment was deferred or cancelled, most companies attributed this decision to uncertainty about the effects of financial turmoil on demand rather than the cost or availability of finance.

Nonetheless, there were some early reports of spillovers from those areas affected by tighter credit conditions to other parts of the economy. For example, reduced activity by financial service providers and commercial property developers had reduced demand for accountants and corporate lawyers.

Risks

Contacts emphasised the uncertainty of their current business environment and perceived a number of risks to the outlook. They were concerned that spillovers might become more pronounced, with reduced financial sector activity and commercial property development weighing on demand for a range of professional services. Contacts also predicted there would be job losses in the financial sector, along with more widespread reductions in bonuses, which might remove an impetus to spending on consumer services and residential property. More generally, contacts highlighted the risk of a temporary suspension of decision-making as companies assessed the impact of tighter credit conditions on both domestic and global growth before committing to increases in investment or employment.