BANK OF ENGLAND

Agents' summary of business conditions

October 2007

- Growth in the value of consumer spending slowed further, reflecting aggressive discounting.
- Demand for housing also eased further in most parts of the United Kingdom, though it was too soon to gauge the extent to which this slowing had been amplified by changed credit conditions.
- Investment intentions fell from their earlier high levels, driven by developments in the service sector. These predated recent financial turbulence, which has had limited effect on investment decisions so far.
- Total demand for exports remained generally buoyant.
- Growth in manufacturing was solid, and that in construction remained very strong. However, service sector output growth continued to ease.
- Capacity pressures lessened noticeably in service industries, but persisted elsewhere.
- Employment intentions eased somewhat, largely owing to developments in the service sector. Recruitment difficulties persisted, but became slightly less pronounced.
- Growth in pay awards remained well contained and that in total labour costs eased further.
- Annual input price inflation fell in the month and output price inflation rose, supporting further margin recovery by manufacturers.
- Annual consumer price inflation ticked down. While discounting by major retailers restrained goods price inflation overall, recent floods and rising commodity prices were putting upward pressure on retail food prices.

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 August and late September**. 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.

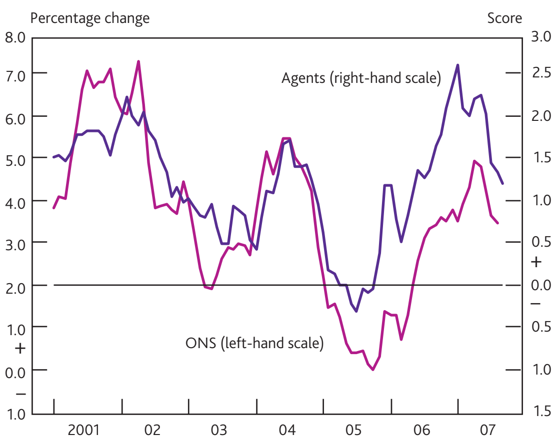
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

The Agents' score for the value of retail sales fell slightly further in September and was well down on levels early in the year (**Chart 1**). Agents reported that growth in discretionary spending remained subdued, especially for housing-related expenditures. There were also widespread reports of weaker spending on consumer services. And while weather conditions were less adverse than in the past few months, they continued to depress clothing sales and those goods and services typically consumed outdoors. Part of the slowdown in the value of sales reflected aggressive discounting as retailers sought to avoid unwanted inventories of summer stock. Consequently, growth in sales volumes was more resilient.

Chart 1 Retail sales values



Housing market

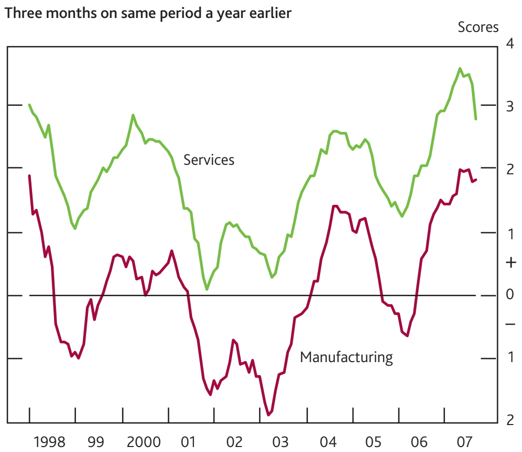
In the market for established housing, estate agencies reported a further easing in demand. This was combined with a slowdown in the growth of new instructions, with the introduction of Home Information Packs now deterring some sellers. Some Agents noted that the slowing in activity had extended to higher-priced properties. Sale periods were lengthening, and estate agencies claimed there had been an increase in the share of properties sold at a discount to the asking price. Consequently, price inflation for established homes eased in most regions.

Demand for new housing had also eased in response to rises in Bank Rate. This had prompted greater use of incentives and discounting, so that price inflation for new homes had slowed. It was too soon to assess the impact of recent financial turbulence on the housing market, though some contacts had reported an associated weakening in sentiment. In contrast, demand for rental accommodation continued to rise in most areas, placing further upward pressure on rents.

Investment

Following an extended period of strength, investment intentions fell quite sharply in September, though remained at a high level. This reduction was driven by developments in the service sector, while investment intentions of manufacturers remained robust (**Chart 2**). In recent months there had been some reports that investment decisions were being reviewed or deferred, given past increases in Bank Rate. This was most evident in the service sector. Importantly, downward revisions to investment intentions predated the current financial turbulence. Few large firms claimed that their investment intentions had yet changed substantially, given generally strong balance sheets and pre-existing lines of credit. Some smaller firms were, however, facing tighter credit conditions. But overall, it remained too early to judge the impact of financial turbulence on investment, with many contacts at this early stage reporting greater concern about its potential effect on demand than the cost of capital.

Chart 2 Investment intentions over the next twelve months



Overseas trade

Given the strength of the global economy, external demand for both capital goods and business services remained buoyant. Difficult conditions for those exporting to the United States (and some dollar-denominated markets) were offset by a further strengthening in demand elsewhere. This was most so for exports of goods and services to Europe (notably the accession economies) and the Middle East. Service exports also continued to expand rapidly to Asia and Africa.

Import demand by UK companies remained high. This included demand for consumption imports, with retailers' concerns about a possible weakening in sales not reflected in their forward orders.

Output

Primary production

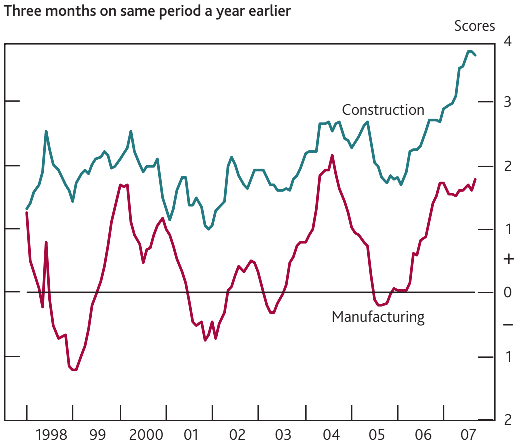
Lower-than-usual yields had weighed on the volume of grain produced, though the value of production remained well supported by high world grain prices. Livestock production had been adversely affected by recent outbreaks of disease, particularly foot and mouth, which had restricted the movement of animals. And there were growing reports of livestock producers exiting the industry.

Manufacturing

Manufacturing output growth remained solid in September (**Chart 3**), supported by strong external demand for manufactured exports, especially high-value capital goods. Production for domestic markets was also firm, particularly among those manufacturers exposed to non-residential construction activity. Prospects remained good, with some contacts reporting a lengthening of order books.

Chart 3 Manufacturing and construction

Three months on same period a year earlier



Construction

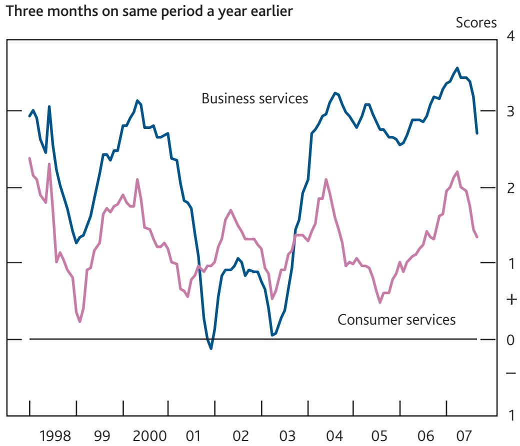
Growth in construction output remained very strong (**Chart 3**). Activity continued to be supported by infrastructure projects, health and education, and demand for new retail, industrial and commercial space. And for many contacts, order books were full for an extended period. Contacts, especially in the south, claimed that the industry was close to full capacity, with Olympics-related projects expected to exacerbate capacity pressures.

Services

In contrast to the strength in manufacturing and construction, service sector output slowed further in September (**Chart 4**). Following a protracted period of very strong growth, the effects of earlier one-off boosts to demand were beginning to wane. This was most evident in the demand for professional and business services where Agents' scores had fallen steadily since April, with a sharp decline recorded in September. This reflected an easing in demand for services related to mergers and acquisitions, accounting standards and property. Scores for 'other' business services had also fallen, but more modestly. And the Agents' score for consumer services fell noticeably further in September, consistent with the easing in household spending. The slowing in service sector growth was under way ahead of recent financial turbulence, and Agents reported that it was too soon to identify how much of the recent easing was credit related.

Chart 4 Service sector output

Three months on same period a year earlier

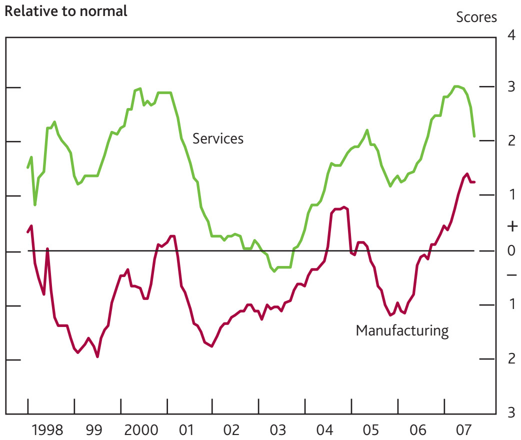


Capacity utilisation

Capacity pressures remained higher than the average of recent years, though were expected to ease somewhat over the next six months (**Chart 5**). In part this reflected additions to capacity from recent investment decisions. But it also reflected the current slowing in activity, which would make it easier for companies to meet demand with existing resources. This was expected to be most apparent in the consumer

Chart 5 Capacity constraints over the next six months

Relative to normal

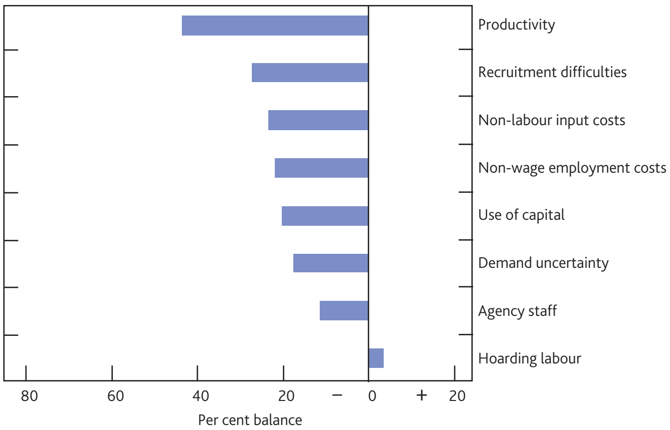


services sector. In contrast, pressures were expected to persist in business services, manufacturing and construction, where companies were most affected by shortages of professional staff and, in some cases, materials and equipment.

Employment

Despite elevated levels of capacity utilisation, growth in employment had been relatively modest. The Agents conducted a special survey of around 600 firms (accounting for 1 million employees) to investigate this puzzle further. The results indicated that several factors had inhibited employment growth over the past year. Prominent among these were improvements in productivity, heightened recruitment difficulties, and raised materials and non-wage labour costs (**Chart 6**).

Chart 6 Factors inhibiting employment growth



Looking ahead, companies' employment intentions eased in September, driven by developments in the service sector. Despite this easing in overall labour demand, recruitment difficulties persisted, reflecting a structural shortage of skilled labour in the business service, manufacturing and construction industries. These difficulties were being compounded by increased rates of staff turnover, particularly in business services and construction. In contrast, there were few shortages of less-skilled labour, given the large pool of migrant workers.

Costs and prices

Labour costs

The Agents' score for total labour cost growth was little changed in September, but was well below its level at the beginning of the year. Agents also reported that across-the-board pay settlements remained stable.

This benign picture of aggregate wage growth masked significant wage dispersion across occupational groups as companies grappled with skill shortages. And some forms of compensation designed to attract and retain workers (such as more generous leave entitlements), raised unit labour costs but were not captured in official measures of earnings.

Input and output prices

Input price inflation eased a little in September, reflecting falls in the prices of energy, base metals and steel products. And the strength of sterling continued to have a disinflationary effect on the cost of imported semi-finished goods. In the month, these factors offset the ongoing increases in other commodity prices (notably food inputs, oil, oil derivatives, and timber), along with rising freight charges.

Manufacturing output price inflation was little changed in September, and well up on its level of a year ago. Consequently, inflation of output prices continued to outstrip that for input prices, supporting further margin recovery by manufacturers. This outcome was consistent with reports by some companies of increased pricing power. Also reflective of margin recovery, the Agents' scores on manufacturers' pre-tax profitability jumped higher in the month, having increased steadily over the past year.

Business-to-business service price inflation fell in September. Contacts attributed this fall to a combination of an easing in demand and increased competition in the tendering for 'commoditised' services.

Consumer prices

Annual goods price inflation edged down again in September, partly reflecting the path of utilities prices over the past year. Annual service price inflation was unchanged, so that overall consumer price inflation also fell.

The unusually high degree of discounting this summer had placed downward pressure on retail goods prices. Discounting had occurred in response to the build-up of inventories of summer stock, stemming from unseasonable weather. It also stemmed from intense competition between major supermarket chains, which are currently engaged in a 'price war' on a large range of dry grocery items. However, rising global commodity prices and supply disruptions from local floods had resulted in sizable increases in wholesale fresh food prices, with many suppliers reporting that they were no longer able to absorb cost increases. Consequently, retailers were faced with higher wholesale prices and substantial increases in retail food prices were expected in coming months.