BANK OF ENGLAND

Agents' summary of business conditions

February 2008

- Consumption growth eased, driven by slower growth in spending on consumer services. Growth in spending on goods stabilised in the month.
- The easing in demand for housing continued, and house price inflation fell.
- Investment intentions fell further in both the service and manufacturing sectors. Tighter credit conditions weighed on investment intentions, mainly through their effect on uncertainty about demand.
- Demand for exports remained firm, as did forward orders.
- Growth in manufacturing remained healthy, while that in the construction and service sectors slowed.
- Employment intentions fell across all main sectors, and recruitment difficulties eased.
- Capacity pressures lessened, especially in service industries.
- Growth in total labour costs remained well contained. The Agents' pay survey identified that companies expected little change in pay settlements for 2008, and only modest upward pressure on total labour costs. (For details see the box.)
- For manufacturers, annual input price inflation picked up sharply, while annual output price inflation was little changed. Consequently, margins were compressed, though a growing share of companies were intending to pass on recent cost increases.
- Annual consumer price inflation increased, driven by increases in the prices of energy and food.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with over 650 businesses in the period between **late December and late January**. 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.

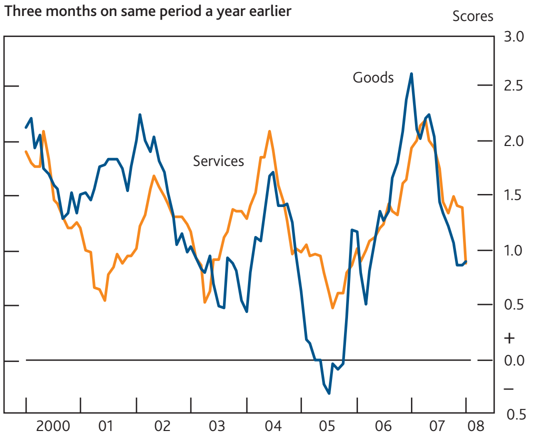
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

Agents reported that overall consumption growth slowed in January, and their scores for the value of spending on goods and services converged (**Chart 1**).

Chart 1 Consumption values



The Agents' score for retail sales of goods was little changed in January owing to a late surge in spending in the holiday period. Nonetheless, in the month as a whole, total sales growth was well below rates in the first half of 2007. Housing-related spending remained weak, as did spending by age groups most exposed to mortgage debt. In contrast, spending on electronics, food, fashion and leisure goods was firm. Since demand had been stimulated by heavy price discounting, the value of sales was likely to have grown more slowly than volumes.

Spending on consumer services slowed sharply in January, with the Agents' score falling to match that for goods (**Chart 1**). This slowdown was largely driven by softer domestic demand for services provided by hotels and restaurants as households reined in discretionary spending. Demand for new motor vehicles also eased noticeably in the month.

Housing market

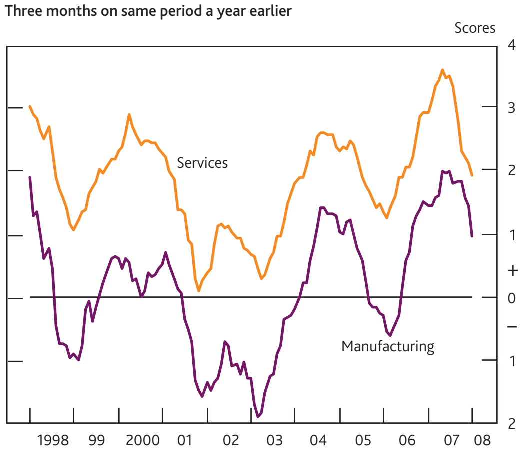
The weakness in housing demand continued in January. In the market for established housing, tighter credit conditions weighed on sentiment. Estate agencies reported fewer enquiries and instructions. Sale periods had lengthened, and there were reports of a sharp rise in the cancellation of sales. Vendors were commonly accepting discounts on asking prices of 10% or more. Consequently, price inflation for established homes slowed further.

Demand for new housing continued to weaken. Discounts and incentives remained prevalent, so that price inflation for new homes also slowed further. Despite a sharp fall in demand, the slowdown in house-building activity had been cushioned by pre-committed work. Contacts were responding to weaker demand by slowing the pace of development or seeking contracts for social housing.

Investment

Investment intentions fell again in January (**Chart 2**). Recent financial market turmoil had weighed on investment intentions, and compounded the effects of earlier increases in Bank Rate. This was especially so in the service sector. However, January also saw weaker intentions in a range of other industries. In particular, domestically oriented manufacturers were deferring investment decisions due to an expected slowing in UK growth. And some manufacturers of exports attributed reductions in investment intentions to increased uncertainty about world growth in 2008.

Chart 2 Investment intentions over the next twelve months



The direct effects of tighter credit conditions remained concentrated in the commercial property and finance sectors, and for highly geared companies seeking to refinance their debt. The majority of contacts were still not directly affected by changes to the cost or availability of finance. But concerns about the possible future effects of tighter credit conditions on growth were causing more companies to review their investment plans even if they were not directly affected by tighter credit conditions.

Overseas trade

External demand remained firm, despite ongoing difficulties for those exporting to the United States. The fall in US demand continued to be offset by strength in Europe, the Middle East, Asia and Africa. Some contacts reported an ability to divert sales from the United States to these more rapidly growing markets, a process aided by the depreciation of sterling. External demand was expected to remain buoyant in the near term, given the strength in export orders. However, expectations for the year ahead had been revised down slightly since the onset of financial turbulence.

Demand by UK companies for intermediate imports remained solid. But there were reports of a slowing in imports of motor vehicles and some consumer goods, consistent with the slowdown in household spending.

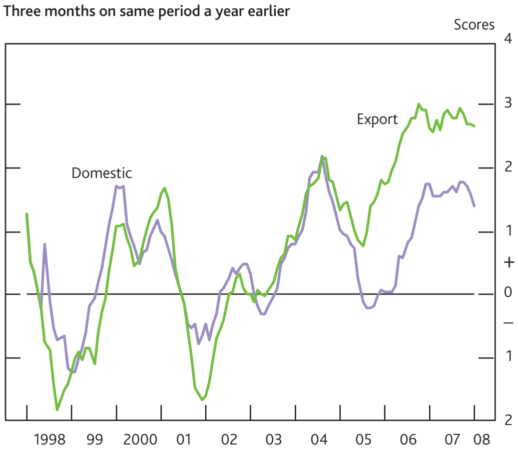
Output

Manufacturing

Manufacturing output growth ticked down again in January, but remained firm (**Chart 3**). External demand continued to provide significant impetus to growth, and production for domestic markets was maintained at a healthy pace. However, domestic orders pointed to a prospective slowdown in production for the UK market, especially for manufacturers of building materials or consumer goods. In contrast, export orders remained elevated.

Chart 3 Manufacturing output

Three months on same period a year earlier



Construction

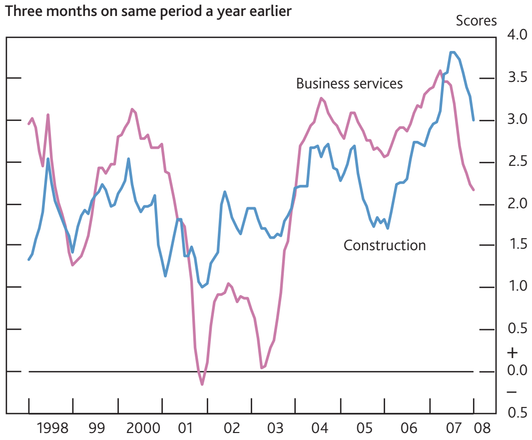
Growth in construction output eased again in January, driven by a softening in private sector housing activity outside London (**Chart 4**). While the pace of activity remained strong — given the volume of work already commenced — commitments to build had fallen. Some commercial developments were under review due to the effects of recent financial turmoil, and there were fewer speculative building projects. Consequently, contacts were revising down their expectations for output growth for the year ahead.

Services

The Agents' scores for both business and consumer services fell further in January, though remained at a high level. The fall in the business services score from its recent peak reflected weaker demand for professional and financial services. Financial market turmoil had amplified this decline, reducing demand for services relating to capital market transactions and property development. But in January, there was also a softening in demand for other business services (such as

Chart 4 Output growth

Three months on same period a year earlier



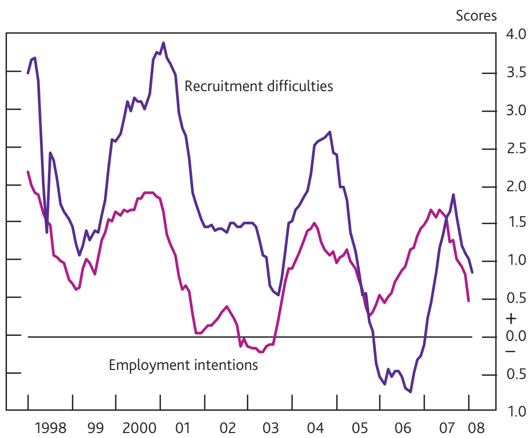
logistics and business catering). Furthermore, many business service contacts had become more pessimistic about the outlook.

Employment

Given the slowdown in activity, employment intentions continued to ease (**Chart 5**). Agents' scores for employment intentions fell in business services, consumer services and manufacturing. There were also reports of significantly reduced labour demand by house builders. More generally, companies reported an increased tendency to leave vacancies unfilled, particularly for less-skilled positions. In addition, there were some localised reports of reduced reliance on temporary migrant labour to meet production targets.

Consistent with the easing in labour demand, recruitment difficulties were less pronounced in January than in mid-2007. Nonetheless, structural skill shortages persisted for specific professions and trades.

Chart 5 Employment intentions(a)



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

Capacity utilisation

Contacts reported that capacity pressures were expected to ease considerably over the next six months, and the Agents lowered their scores accordingly. While the expected reduction in capacity pressures partly reflected recent additions to capacity, increasingly it was also being attributed to a projected slowing in activity. Capacity pressures were expected to ease most in the services sector, where a clear slowdown in activity was already evident. But pressures were also expected to ease in manufacturing and construction.

Costs and prices

Labour costs

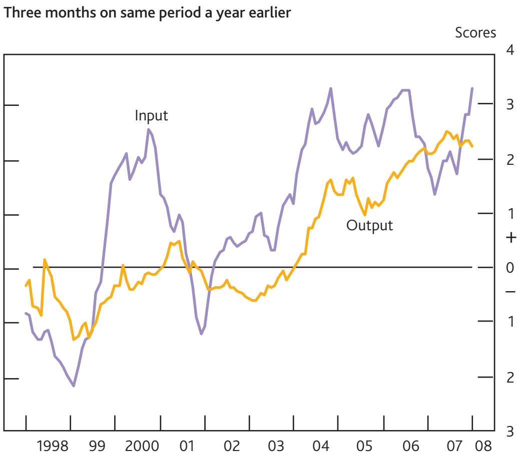
Agents reported that across-the-board pay settlements remained stable in January. Companies also reported a further easing in total labour cost growth in the month, due to slower growth in the variable component of pay. Looking ahead, responses to the Agents' latest pay survey suggested that settlements would remain broadly the same as in 2007, while growth in total labour costs would increase modestly. Skill shortages were the main source of upward pressure on pay settlements. This effect was being offset by expected reductions in company profitability. (See the box on the Agents' pay survey.)

Input and output prices

Input price inflation picked up sharply in January due to increases in the world prices of energy, oil derivatives, building materials and food inputs (**Chart 6**). There were further reports of increases in the cost of international freight, along with a greater tendency for local suppliers to impose explicit fuel surcharges. Many contacts reported increases in the cost of importing finished and intermediate goods from China and, to a lesser extent, India. These cost increases reflected increases in the domestic price of goods from these countries, along with the effects of the recent depreciation of sterling.

The score for manufacturing output prices was little changed in January. Given the renewed strength in input price inflation, manufacturers reported a compression in margins. Consistent

Chart 6 Manufacturers' input and output prices[(a)]



(a) Manufacturers' non-labour input and output prices.

with this, the Agents' score for manufacturers' pre-tax profitability fell again in January. But a growing share of contacts reported an intention to pass on recent cost increases, so that output price inflation was expected to rise.

Business-to-business service price inflation fell in January and was well down on levels in the first half of 2007, given increased commoditisation of services and an easing in demand. Recently there were also reports of lower insurance premia coming into effect.

Consumer prices

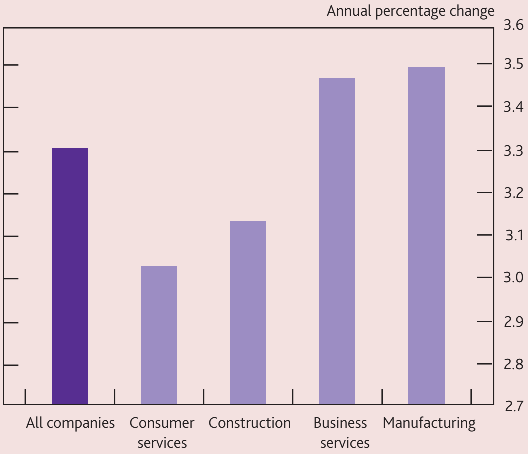
The Agents' score for annual goods price inflation ticked up again in January, reflecting further increases in the prices of energy and food. With annual service price inflation little changed, overall consumer price inflation also edged up.

Significant increases in the cost of food inputs continued to place upward pressure on retail food prices. While supermarkets had absorbed part of this increase in margins, they had become more active in passing on commodity-related cost increases to consumers. In contrast to higher food price inflation, discounting remained a feature of non-food prices, with discounting in January being deeper and of longer duration than usual.

Agents' pay survey

With around half of private sector pay settlements taking place in the first four months of the year, the Agents conduct an annual survey of their contacts to give an early read on pay prospects in the year ahead. This year, around 350 companies were interviewed across industries that are broadly representative of the structure of the economy. Across all companies, settlements were expected to average 3.3% in 2008, with only modest variation across sectors (**Chart B1**).

Chart B1 Expected pay settlements in 2008

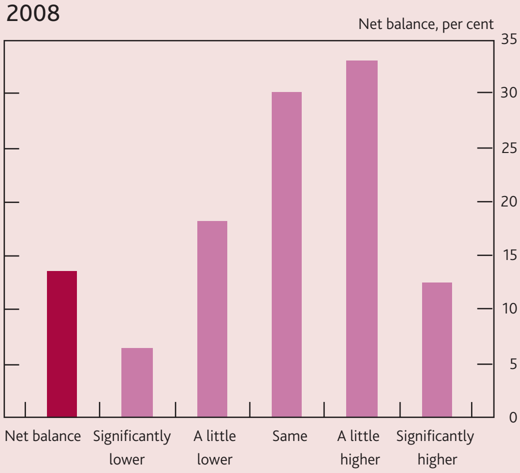


Overall, the expected level of settlements was marginally lower than in the same period a year earlier (**Chart B2**). Expected settlements in the consumer services and construction sectors were markedly lower than those of a year earlier. The reduction in expected settlements for construction, of around 1¼ percentage points, appeared to be in response to recent reductions in housing demand.

Chart B2 Change in expectations

While settlements were expected to be little changed in the year ahead, a positive net balance of respondents anticipated modest upward pressure on broader measures of labour costs (**Chart B3**). This included pressure on total pay (which includes overtime and bonuses) and total labour costs (which also includes pensions and leave).

Chart B3 Expectations for growth in total labour costs in 2008



Companies attributed the upward pressure on total labour cost growth to the persistence of skill shortages, expected increases in inflation and non-wage labour costs (such as leave entitlements) (**Chart B4**).

Chart B4 Factors influencing growth in total labour costs