BANK OF ENGLAND

Agents' summary of business conditions

January 2008

- Consumption growth remained well below its rate earlier in 2007. Growth in the value of Christmas sales was also less than at the same time a year earlier, and retailers resorted to extensive discounting. See the box on the Agents' retail survey.
- The easing in demand for housing continued, and house price inflation fell.
- Investment intentions fell further, with weaker intentions evident in both the services and manufacturing sectors, in part reflecting tighter credit conditions.
- In contrast to the slowdown in domestic spending, demand for exports remained buoyant.
- Growth in manufacturing was solid. Growth in construction and service sector output slowed further, albeit from high levels, so that growth in aggregate output also slowed.
- Employment intentions fell, and recruitment difficulties eased somewhat.
- Capacity pressures lessened, especially in service industries.
- Growth in total labour costs remained well contained, with little change expected in 2008.
- Annual input price inflation was unchanged in December following a rebound in preceding months. Annual output price inflation was unchanged.
- Annual consumer price inflation increased, with the effects of non-food discounting more than offset by increases in the prices of fuel and food.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with around 760 businesses in the period between **late November and late December**. 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.**

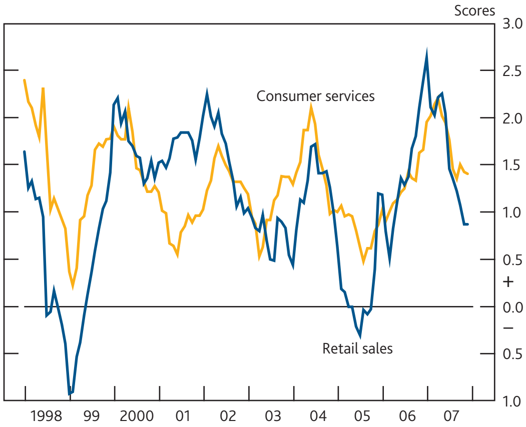
Demand

Consumption

The Agents' score for the value of retail sales was unchanged in December, but was well down on its level in the first half of the year (**Chart 1**).

Chart 1 Consumption values

Three months on same period a year earlier



A slowdown in consumer spending had been under way ahead of the recent financial market turmoil, though tighter credit conditions had become a factor in some spending decisions. Weakness remained evident in housing-related expenditure, consistent with weaker housing demand. There were also ongoing reports of weaker spending by age groups most exposed to mortgage debt. In contrast, spending on food, electronics and leisure goods displayed its usual seasonal strength.

Sales growth over Christmas was 'better than feared'. Nonetheless, it was lower than in the previous Christmas period. This was despite a late surge in spending in response to extensive discounting by retailers. Retailers were nervous about the outlook for early 2008. For further details see the box on the 'Agents' retail survey'.

Spending on consumer services was more resilient than for retail goods, though it too grew at a slower pace than in the first half of the year (**Chart 1**). International and domestic tourism remained supportive of demand for services.

Housing market

The slowdown in housing demand continued in December. In the market for established housing, tighter credit conditions and the extension of Home Information Packs weighed on sentiment. Estate agencies reported fewer enquiries from potential buyers. With sellers uncertain about the outlook for house prices, there were also fewer instructions and more properties were taken off the market than in earlier months. Sale periods had lengthened, and some vendors were accepting sizable discounts on sale prices. Accordingly, price inflation for established homes fell further.

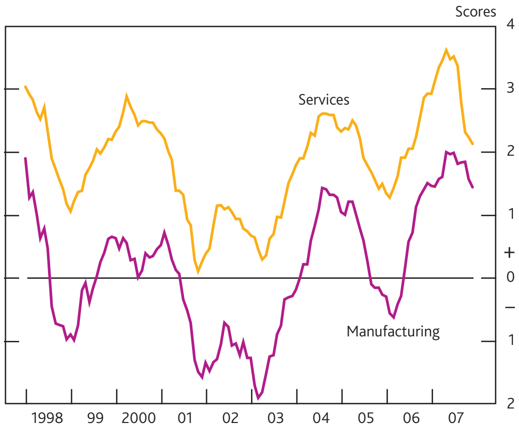
In the market for new housing, demand also continued to weaken. This was increasingly attributed to the effects of financial turmoil, as well as the cumulative effect of past interest rate rises. Discounts and incentives were commonplace, so that price inflation for new homes slowed further. So far, however, the reduction in building activity had been modest, owing to the volume of pre-committed work.

Investment

Investment intentions fell again in December, though the fall was less pronounced than in earlier months (**Chart 2**). Financial market turmoil had weighed on investment intentions, compounding the effects of past increases in Bank Rate. This was most evident in the service sector, where investment intentions had fallen sharply since July. However, part of the recent easing in manufacturers' intentions was because capacity expansion was now well advanced, with financial events having only a small role to play. While the majority of contacts interviewed in the month were still not directly exposed to tighter credit conditions, a significant share of companies was reviewing their investment plans. This was largely in response to concern about the effect of tighter credit conditions on the outlook for demand.

Chart 2 Investment intentions over the next twelve months

Three months on same period a year earlier



Overseas trade

As for much of 2007, external demand remained buoyant overall, despite difficulties for those exporting to the United States. The fall in US demand was offset by strength in Europe, the Middle East, Asia and Africa. Demand remained strongest for business services and capital goods. Some contacts commented on their ability to divert sales from the United States to more rapidly growing markets.

Demand by UK companies for intermediate imports was still high. But consistent with the reductions in desired inventories of retailers, there were reports of a slowing in imports of consumption goods.

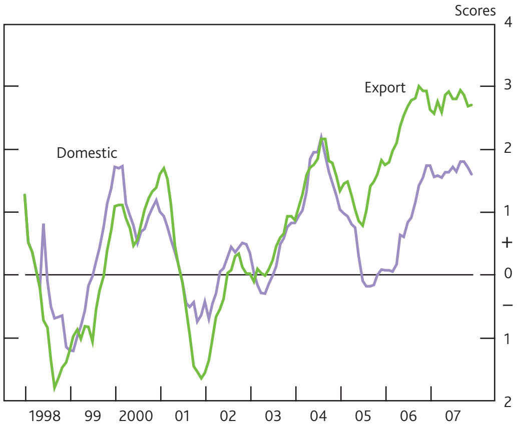
Output

Manufacturing

Manufacturing output growth ticked down slightly in December though remained firm (**Chart 3**). External demand continued to provide the main impetus to growth, though production for domestic markets was maintained at a healthy pace. Looking ahead, domestic orders pointed to a slowdown in production for the UK market. This was especially so for manufacturers of building materials who are exposed to residential construction. In contrast, export orders remained elevated, particularly for manufacturers of high-value capital goods.

Chart 3 Manufacturing output

Three months on same period a year earlier



Construction

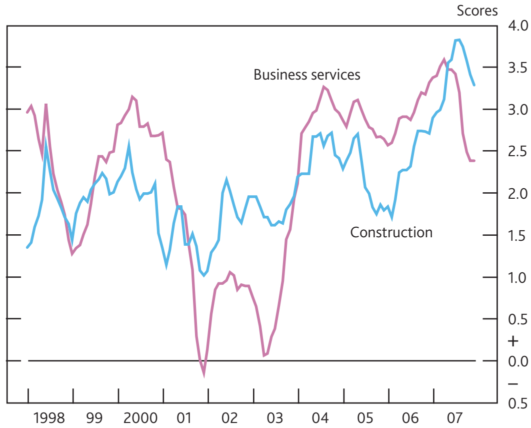
Growth in construction output had now clearly eased from its recent exceptional pace (**Chart 4**), though the level of activity remained high and capacity pressures persisted. There was a large amount of pre-committed work across a broad range of construction activities. Output was yet to be significantly affected by the downturn in demand for commercial property development. However, forecast output growth for 2008 had been revised down.

Services

The Agents' scores for both business and consumer services were unchanged in December, but were well below their recent peak in April. The fall in business services was most pronounced (**Chart 4**), reflecting a sharp slowing in demand for 'professional and financial' services. The slowdown in business service activity had been amplified by recent financial market turmoil, with demand for services relating to large capital market transactions and commercial property development most seriously hit. Other business service providers continued to report satisfactory trading conditions. However, many business service contacts had become more pessimistic about the outlook.

Chart 4 Sources of slower output growth

Three months on same period a year earlier



Employment

Consistent with the slowdown in activity, employment intentions continued to ease from their levels earlier in 2007. This had largely been driven by weaker employment intentions in the business service sector, where the recent slowing in activity had been most pronounced. However, in December, weaker intentions were also evident in consumer services and manufacturing. Most contacts attributed the reduction in intended hiring to uncertainty about demand; others cited the costs associated with increased statutory leave and the desire to achieve productivity improvements.

Structural skill shortages persisted for a range of professionals and skilled tradespersons. Nonetheless, there was further evidence of an easing in recruitment difficulties in December, mainly for staff in the service sector. Some contacts suggested that this easing in recruitment difficulties occurred despite there being fewer migrants looking for work.

Capacity utilisation

Contacts expected capacity pressures to ease over the next six months (**Chart 5**). While this anticipated easing partly reflected recent additions to capacity, it was increasingly attributed to expectations of a slowing in activity. Capacity pressures were expected to ease most in the services sector, where there had been a sharp slowdown in demand for various business services. They were also expected to ease in manufacturing and construction.

Chart 5 Capacity constraints over the next six months

Relative to normal

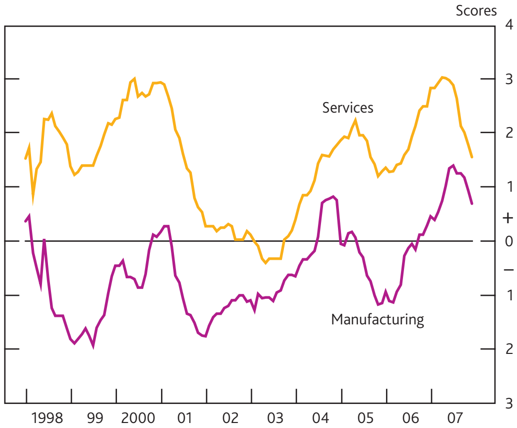
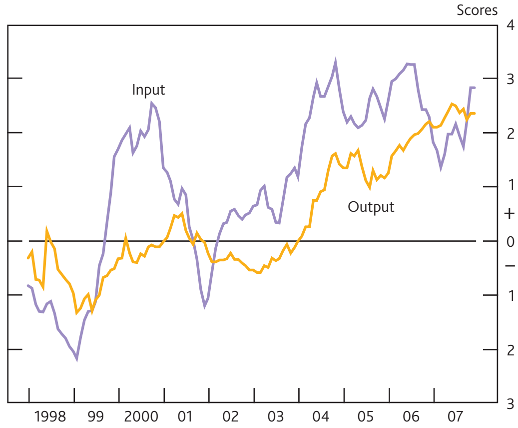


Chart 6 Manufacturers' input and output prices[(a)]

Three months on same period a year earlier



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

Costs and prices

Labour costs

Agents reported that across-the-board pay settlements remained stable in December. Their score for total labour cost growth was little changed in the month, and well below its level at the beginning of the year. Most contacts were expecting little change in settlements in 2008, despite increases in the cost of living. In part this reflected increased uncertainty about the outlook for demand. Weaker demand was also expected to reduce the variable component of pay, with anticipated reductions in commission-based earnings and bonuses for those in the service sector.

Input and output prices

Input price inflation was unchanged in December following a rebound in the preceding months (**Chart 6**). This increase on levels of mid year owed to sharp increases in the world prices of energy, oil derivatives, building materials and food inputs. Increases in the cost of international freight were also reported in the month, along with an increased tendency for local suppliers to impose explicit fuel surcharges. Many contacts reported increases in the cost of importing goods from China. There were also some reports of increased costs of importing from India.

The score for manufacturing output prices was unchanged in December. Given renewed strength in input price inflation in preceding months, manufacturers' margins were compressed, reversing the recovery evident earlier in the year. But part of this margin compression reflected a lag in adjustment of output prices. A growing share of manufacturers reported an intention to pass on recent cost increases.

Business-to-business service price inflation was unchanged again in December, but was clearly lower than in the first half of the year. Some Agents reported greater difficulty in securing price rises, given increased commoditisation of services and the recent easing in demand.

Consumer prices

The Agents' score for annual goods price inflation picked up again in December, largely reflecting higher prices for fuel and food. With annual service price inflation little changed, overall consumer price inflation also increased.

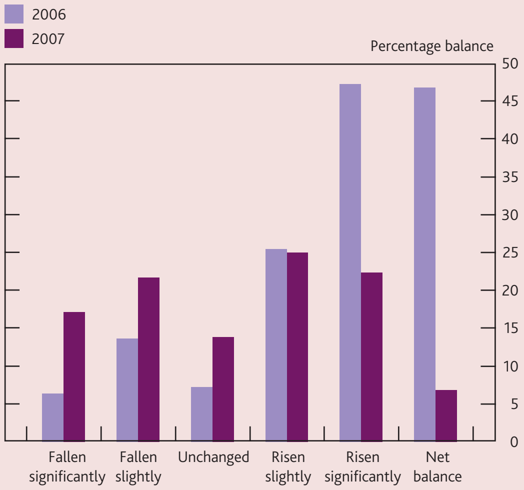
The increase in some retail food prices was in direct response to the rising costs charged by suppliers. Some suppliers reported significant increases in their contract prices with supermarkets on certain product lines. And while supermarkets had absorbed part of this increase in margins, they had become more active in passing on commodity-related cost increases to consumers. In contrast, increased discounting was a feature of prices for non-food items.

Agents' retail survey

In late December and early January of each year, the Agents contact a broad range of retailers in an effort to gauge the strength of retail sales over the Christmas period. This year, over 150 retailers were approached. The findings from these interviews are summarised in this box.

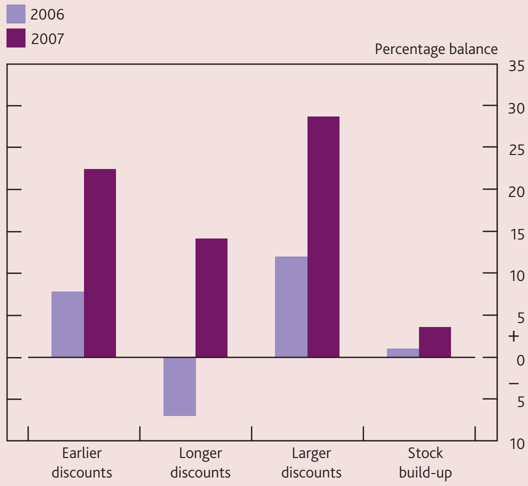
Compared with a year earlier, a larger share of respondents reported that sales growth had fallen, while a smaller share indicated that it had risen. Consequently, the net balance of respondents reporting an increase in sales growth was much smaller than in the previous year, when demand conditions had been buoyant (**Chart B1**).

Chart B1 Growth in Christmas sales



Nonetheless, retailers reported a late surge in sales that had been facilitated by discounting. A larger share of retailers reported that discounting commenced earlier than was the case last year. These discounts were sustained, so that the duration of discounting was longer than a year ago. Furthermore, the depth of discounting was reported to be greater (**Chart B2**). While this did not avoid some build-up of stock, the increase in retailers' inventories was modest.

Chart B2 Retail discounting



Partly as a consequence of discounting, sales outcomes were approximately as expected for a net balance of respondents. However, the majority of respondents expected that sales growth would slow in the first quarter of 2008 (**Chart B3**). This outlook was more pessimistic than at the same time a year earlier.

Chart B3 Outcomes and expectations