BANK OF ENGLAND

Agents' summary of business conditions

December 2009

- Consumer spending had grown relative to the same period a year earlier.
- In most parts of the United Kingdom, the gradual pickup in housing market activity had continued, but the volume of transactions remained well down on pre-crisis norms.
- Investment intentions remained weak (see box), with many firms planning to hold or reduce spending a little further during 2010. But throughout the fourth quarter, there had been more exceptions to that weak picture than had been the case earlier in the year.
- There had been a further improvement in the tone of recent reports from exporters as global demand — particularly from Asia — had picked up and sterling's depreciation was more widely seen to be boosting export orders than was the case earlier in the year.
- Most contacts had completed any material downward adjustment of their stocks, but remained cautious about rebuilding inventory.
- Business services turnover and manufacturing output remained down on the same period a year earlier, but with few reports of further contraction in recent months. Construction activity remained severely depressed.
- The pace of decline in employment had eased through the second half of 2009, and few firms were actively planning for significant future cuts. Those firms that were planning for their 2010 pay settlements expected pay growth to remain subdued.
- With few contacts anticipating any marked increase in demand over the next few months, capacity constraints were rarely regarded as a concern.
- Inflation in materials costs appeared low. But the majority view among contacts was that inflation was likely to rise as global demand recovered.
- Consumer goods price inflation remained low but positive.

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with contacts in the period between late October 2009 and late November 2009. 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.**

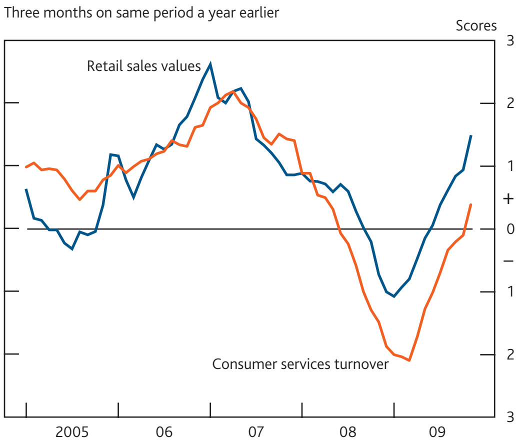
Demand

Consumption

Retailers had continued to report sales ahead of their levels a year earlier (**Chart 1**). While twelve-month comparisons were increasingly seen to be dominated by weak year-earlier comparators, the Agents' sense was that sales — particularly of food — had grown during the second half of 2009. Looking forward, many retailers described themselves as more optimistic about prospects for the Christmas period than they had been earlier in the year. But beyond that, many voiced concerns over prospects for 2010, and had tailored their orders for consumer goods accordingly.

Demand for consumer services also appeared less weak than earlier in the year (**Chart 1**). But the profile of demand for consumer services remained weak relative to retail sales. And any recovery in activity had occurred against a backdrop of consumers' reluctance to spend heavily — as an illustrative example, restaurants reported lower spend per visit.

Chart 1 Consumer spending



Housing market

In some parts of the United Kingdom, the pace of growth in demand had tailed-off or even halted as current levels of transactions were all that could be supported by the available pool of buyers able to secure finance. Elsewhere, the gradual increase in activity had continued. But while activity had grown through much of 2009, the flow of transactions remained well down relative to levels prevailing in early 2008. There were widespread reports of shortages of stock for sale that had contributed to further increases in price.

Business investment

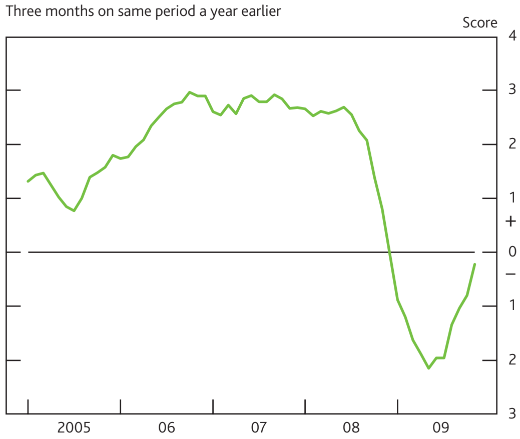
Levels of capital expenditure continued to be widely described as well down on the previous year. That impression had been reinforced by the results of an Agents' special survey on investment (see box). Investment in property remained particularly weak, with the notable exception of the major retailers who had continued to grow their investment in new stores and space for sale of non-food products.

Looking forward, most contacts still described their investment plans as weak, with many intending to hold or reduce spending further next year. But, as had been the case throughout the autumn, there were more exceptions to the picture of weak planned investment than had been the case in the spring. And, more generally, there were relatively few plans for a second round of sharp cuts to capital expenditure following this year's sizable reductions.

Exports

There had been a further improvement in the tone of reports from exporters (**Chart 2**) — albeit from a low base. The news through the second half of the year had been that global demand had picked up, most notably from Asia. Sterling's depreciation was described more frequently as having led to growth in orders — perhaps in part because exporters saw more potential to compete for market share in an environment of growing, as opposed to 'collapsing' world demand. That said, growth in world demand had come from a low base and some exporters felt that sterling's depreciation had had less of an upward impact than expected.

Chart 2 Manufacturing exports



Inventories

As had been the case throughout the autumn, most contacts felt they had completed any major de-stocking necessary to bring inventories down to levels commensurate with current activity. Many contacts had drawn attention to the challenge of managing their business with significantly reduced stocks. Some had been surprised by the productivity gains in inventory management that they had achieved during the recession, and planned to lock those gains in. Others described uncertainty over demand and availability of working capital as factors bearing down temporarily on planned inventory levels.

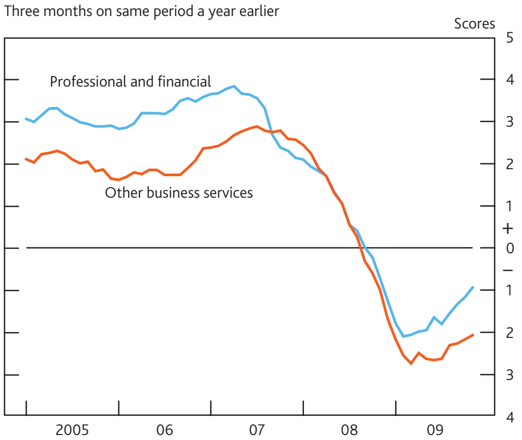
Output

Business services

There had been little change to the broad picture that while business services turnover was well down on the same period a year earlier, few contacts were reporting further contraction during the second half of 2009.

As last month, some professional services providers felt that demand had grown — for example, sales of advertising had risen from a very low base; and employment agencies had seen some increase in demand for temporary staff. But others reported that cuts in fees had continued to dominate, pressing down on their turnover. The profile of demand for professional services remained stronger than that for other business services (**Chart 3**) — for whom the dominant theme was one of customers managing their overheads extremely tightly in an environment of low activity.

Chart 3 Business services turnover



Manufacturing

While there was further evidence that manufacturing output had bottomed out during the summer, there was no sense that growth had picked up at all strongly through the autumn. Looking forward, contacts were not confident that the modest increases in orders seen recently would be sustained. Consumer-facing manufacturers and those in the automotive supply chain were most likely to have experienced growth in activity in recent months, while some capital goods and many construction materials producers continued to report shrinkage in demand.

Construction

Construction activity remained well down relative to the same period a year earlier. Although there had been widespread reports of growth in house building, such growth was typically described as small in scale with some house builders reporting difficulties in securing finance for larger scale expansion of their activities, while others had held back pending more solid evidence that the recovery in housing demand would prove lasting. Commercial property work had continued to shrink as projects were completed with only a weak pipeline of replacement work.

Throughout 2009, public sector demand had proved a key source of income for many construction companies. Many contacts had raised concerns over prospects for future public sector demand. But there was, as yet, limited evidence that activity had already slowed, with reports of ongoing tendering for public sector work weighing against those of postponements. Nor were there many reports from construction contacts that were further reducing their capacity in anticipation of future public spending cuts.

Credit conditions

Larger firms had continued to make use of non-bank finance. And there had been a further flow of reports from firms that had been able to access bank finance. But more generally, the Agents continued to hear from many small and medium-sized firms that had been rejected for finance or had seen the terms of their existing borrowing tighten. The Agents' sense therefore remained that while credit conditions had probably eased since the spring, they remained (considerably) tighter than in mid-2008.

Employment

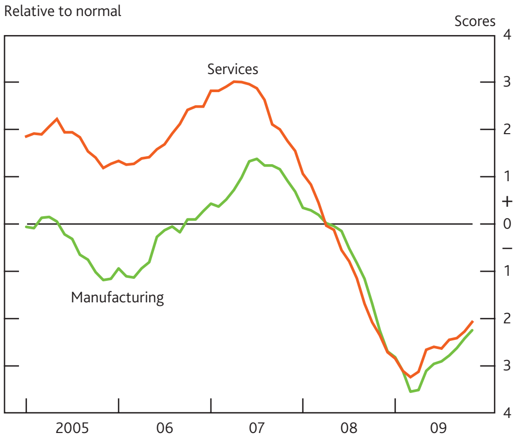
There were further signs that the pace of decline in employment had eased through the second half of 2009. While there had been a few further significant redundancies, such reports were rarer than earlier in the year. And on the upside, a few contacts had ended earlier freezes on recruitment as demand had picked up. More typically, firms were responding to any growth in demand by increasing average hours or hiring temporary staff — that is, through measures that would be easy to reverse were demand to fall back.

Looking forward, there were relatively few plans to increase permanent staffing levels significantly. It was more common to hear of plans to let headcount drift down through non-replacement of leavers. But few firms were planning actively for significant cuts — the pervading sense among contacts was that so long as demand did not fall further, any material rationalisation of their labour forces was substantially complete. One risk to that picture was that employment may fall further if the rate of insolvencies picked up sharply — something that a number of contacts anticipated because they expected creditors' forbearance to wane and because firms' balance sheets had been weakened through the recession.

Capacity utilisation

The broad picture remained one of widespread spare capacity. And, with few contacts anticipating any marked increase in demand over the next few months, capacity constraints were rarely regarded as a concern. While the recent small pickup in some firms' sales had led them to increase output, most had managed this through reversal of earlier cuts in hours and through use of temporary staff. That had motivated small increases in the Agents' scores for capacity utilisation — though the scores remained firmly negative (**Chart 4**).

Chart 4 Capacity utilisation



Were demand to rise further than most firms anticipated, however, one risk was that they would find it hard to respond to the increase in demand. Many contacts felt that availability of working capital would limit their ability to finance rapid increases in production — a position exacerbated by the much reduced stocks that some had chosen to hold.

Costs and prices

Labour costs

As had been the case for some time, private sector contacts described their per capita labour costs as down on the same period a year earlier — following changes to average hours, reduced bonus and commission payments, and widespread pay freezes imposed earlier in the year. Looking forward, those that were planning for their 2010 settlements expected pay growth to remain subdued. While a few of those who had frozen pay this year expected to offer small increases, there were also reports from firms that would freeze pay in 2010 after giving increases in 2009. Some of those who had frozen pay in 2009 planned to offer small bonuses to reflect growth in demand without committing to permanent increases in pay.

Non-labour costs

On average, inflation in materials costs was muted. Around this average, there continued to be significant variation across individual contacts' experience. In part, that variation was attributed to the recent volatility of commodity prices, which led to differences in prices paid depending on the point at which contract prices were fixed.

Looking forward, the majority view among contacts was that inflation in materials costs was likely to rise as recovery in global demand impacted on spot commodity prices and reduced the incentive for suppliers to negotiate on price. Indeed, there were some reports from firms whose costs had increased over the past few months as — for them — higher oil and metals prices had been passed through quickly.

Output prices

There remained little sign of inflation in output prices as substantial spare capacity weighed against price increases. Downward pressure on prices remained most clearly evident in the business services sector where year-on-year cuts in fees remained commonplace, as were reports from firms offering additional services for the same fee.

Consumer prices

The Agents' intelligence suggested that inflation in consumer goods and leisure prices had remained low but positive. On the upside, there had been further reports of pass-through of higher import prices. But on the downside, twelve-month inflation in food prices had eased. The Agents had been told that more consumers were spreading their grocery shopping across several stores — focusing their purchases on specific lines that were on promotion. Discounting in leisure services remained pervasive.

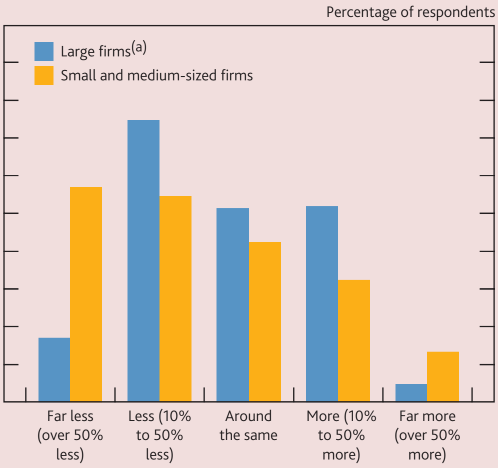
Looking forwards, the majority view among retailers was that there was likely to be less discounting over Christmas and the New Year than was the case last year — reflecting the low level of orders they had placed earlier in the year. But any changes in pricing were likely to be relatively marginal at a time when most retailers still regarded consumers as abnormally price-sensitive and evidence of trading up remained tentative. Few retailers had reported firm plans for dealing with the forthcoming increase in VAT — preferring to review in light of sales performance in the run-up to the New Year.

Agents' survey on business investment

Business investment had fallen sharply during the recession — substantially further than during previous recessions. Looking forward, credit conditions remained tight and the outlook for demand remained uncertain, which might weigh down on investment. But on the upside, business surveys suggested some recovery of confidence during the second half of 2009 while low levels of Bank Rate may have contained the cost of servicing outstanding debts. To explore the implications of these factors for business investment, the Agents conducted a survey of more than 400 of their private sector contacts, operating in a range of industries. All figures reported are weighted by UK turnover.

Respondents were asked how their capital expenditure had changed over the past twelve months. Almost half reported cuts in excess of 10% to their capital spending, 11% had cut investment by more than a half. While cuts to spending had been pervasive, small and medium-sized firms had cut capital spending by more — on average — than had the largest respondents (**Chart A**)

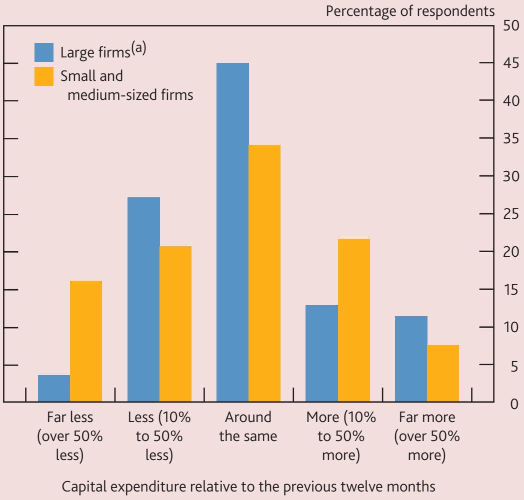
Chart A Change in capital expenditure over the past twelve months



(a) Large firms defined as those with UK turnover of £400 million or more.

Looking forward, respondents were asked how they expected to change their capital expenditure over the next twelve months. The forward view suggested a broad balance between those expecting to cut spending and those planning to grow it (**Chart B**). The absence of any widespread sharp bounce back in firms' plans corroborated the picture of muted investment intentions that the Agents had picked up from their routine visits with contacts in recent months. As with the backward-looking question, a greater proportion of small and medium-sized firms had described plans for substantial cuts to investment than was the case for the larger firms.

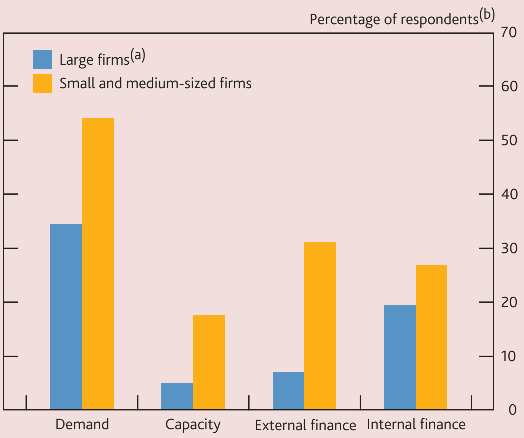
Chart B Change in capital expenditure expected over the next twelve months



(a) Large firms defined as those with UK turnover of £400 million or more.

Respondents were also asked about the key factors driving their capital spending plans. Demand conditions were cited frequently by those planning to cut investment, with a significant minority viewing internal financing as a factor — perhaps reflecting a reluctance to commit to drawing down cash balances at a time when future demand was particularly uncertain and working capital tight. While availability of external finance appeared less important across the full sample, there was a clear difference between larger respondents and small and medium-sized firms — for whom external financing conditions were often a factor driving down capital spending plans. That chimes with the Agents' broader intelligence on credit conditions, which suggested a clear difference between the ease with which larger firms and smaller firms could access finance, as discussed above.

Chart C Key drivers of investment decisions cited by those expecting to cut capital spending



(a) Large firms defined as those with UK turnover of £400 million or more.
(b) Respondents could select more than one option.