BANK OF ENGLAND

Agents' summary of business conditions

August 2010

- The Agents reported that business confidence across a wide range of industries had ebbed in recent months. Many contacts attributed the fall in confidence to the announcements made in the June *Budget*, although few contacts had changed their plans for output, investment or employment as a result.
- Consumer spending growth had softened over the past few months, reflecting weaker retail sales growth.
- The number of housing market transactions had also eased back.
- Investment intentions remained consistent with a gradual, rather than robust, rise in spending.
- Exports had picked up further, driven by a pickup in world demand.
- Services turnover had edged higher, although volume growth in the professional and financial sector was likely stronger than growth in turnover, reflecting lower prices and fees than a year earlier.
- Manufacturing output growth had been robust through Q2, reflecting stronger export growth and, to a lesser extent, increases in output for the domestic market.
- Construction activity remained subdued. Despite a rise in repair and maintenance, commercial construction activity remained weak, and some public sector projects had been postponed or cancelled.
- Private sector employment intentions had risen modestly in recent months. But contacts expected offsetting cuts in public sector headcount over the next year or so.
- Pay growth remained muted, albeit a little stronger than at the start of 2010. Many non-labour input costs had risen further.
- Contacts reported that imported goods price inflation had edged up, due to higher inflation and some emerging capacity constraints in the Far East.
- Annual consumer price inflation remained elevated in July, as weaker goods price inflation was offset by a modest rise in services price inflation.
- It remained too early to assess definitively the impact of the announced rise in VAT. But initial findings suggested that, on balance, contacts expected to pass through much of the rise early in January 2011.

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 June 2010 and late July 2010. 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

Business confidence

The Agents reported that business confidence, which had been building slowly through Q1, appeared to have ebbed in recent months. The fall in confidence was widely spread across contacts and industries. Many businesses linked the decline in confidence to the planned cuts in public spending, which were expected to lead to weaker demand, both directly in those sectors with significant public sector exposure, and indirectly by reducing public sector employment and hence household income.

Nonetheless, few contacts had, as yet, changed their plans for output, investment or employment in response to the announcements in the *Budget*. That reflected widespread uncertainty about the impact of the fiscal consolidation, with many contacts now waiting for the October Spending Review, which was expected to provide greater detail about the public spending cuts.

Consumption

The Agents reported that the underlying pace of retail sales values growth had softened over the past couple of months (**Chart 1**). Growth in volumes is likely to have been slower than growth in turnover, given elevated rates of retail goods price inflation.

Chart 1 Retail sales and consumer services

By contrast consumer services turnover had, on balance, edged higher through Q2 and into July (**Chart 1**). Domestic tourism contacts in particular reported strong demand, with more residents choosing to holiday in the United Kingdom in recent months. Nonetheless, trading conditions remained tough for many contacts in a wider range of consumer services industries, as consumers remained focused on value and unusually sensitive to pricing points.

Looking ahead, a number of contacts expected the rise in VAT in January 2011 to bring forward some expenditure into Q4, particularly on large ticket items. Nonetheless, the majority of contacts continued to express concerns about spending growth over the rest of the year, reflecting expected cuts in public sector employment and the associated squeeze on households' disposable income.

Housing market

The supply of properties coming to market had risen since the suspension of Home Information Packs in England and Wales. But demand continued to be restrained by the availability of mortgage finance and, according to some contacts, by consumers' concerns about future job security. On balance, the Agents judged that the number of housing market transactions had fallen back over the past three months.

Business investment

Investment intentions had continued to edge up gradually, although the Agents reported that businesses' plans remained consistent with a gentle, rather than robust, rise in investment spending. The majority of investment plans remained focused on asset replacement and maintenance (in particular car fleets and IT projects). A small number of exporters had planned to increase investment spending.

Exports

Export growth had continued to pick up in July. Many contacts ascribed the improvement in sales to stronger global growth, particularly in the Far East, the Middle East and Russia. By contrast, sales to the euro area had remained subdued.

The exchange rate appeared to have played only a limited role in the rise in exports to date, with most exporters using the lower level of sterling to boost their margins. But in July there had been a number of reports of businesses cutting their foreign currency prices and targeting market share. The small, more recent appreciation of sterling had not, as yet, had much impact on exporters' expectations.

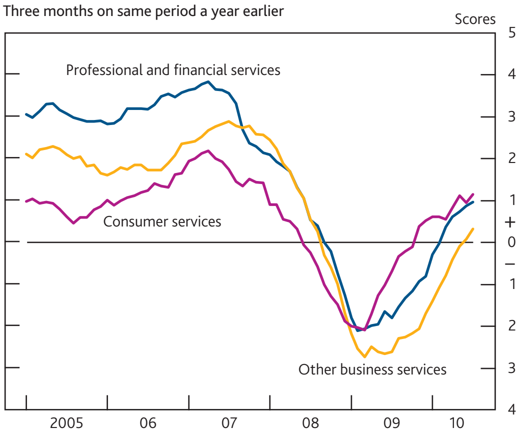
Output

Business services

The level of services turnover had edged higher in July, although four-quarter growth remained below trend (**Chart 2**). Demand growth remained strongest for legal and accountancy services, where growth in volumes was likely to have been stronger than growth in turnover, due to falls in many charges and fees over the past year. But contacts had become a little more pessimistic about the outlook for Q3 and beyond — those businesses with exposure to the public sector, including consultancies and advertising firms, had expressed particular concerns about falls in future revenues.

Turnover growth in the other business services sector had remained patchy. For example, transport, haulage and distribution activity had picked up, but demand for events and conferences remained little changed at subdued levels. Overall, the Agents judged that turnover was only marginally higher than a year earlier (**Chart 2**).

Chart 2 Services turnover



Manufacturing
Growth in manufacturing output continued to pick up, primarily reflecting stronger export growth. But output destined for the domestic market had also increased, in part reflecting increased demand from businesses who had previously sourced their goods from abroad. Output in the food and drink sector and in the automotive supply chain had both picked up. But activity remained extremely weak among those businesses supplying the construction sector.

Construction
Output in the construction sector remained significantly weaker than in the other sectors of the economy. Although repair and maintenance work had picked up in July, the pace of new residential home building had softened a little, and commercial construction activity remained weak.

Moreover, the impetus from public sector work, which had been considerable during the past two years, had begun to fade, with some projects being postponed or cancelled. Most contacts expected a further fall in public sector demand over the next year or so.

Credit conditions

Credit conditions had improved a little since the start of the year, although smaller businesses and those in certain sectors (such as the property sector) had benefited much less than their larger counterparts or those in other sectors. Demand for bank finance had remained weak and companies continued to pay down debt. The availability of trade credit insurance had improved in recent months, but demand remained subdued, as many businesses had adapted to the lower availability of cover following the marked tightening in conditions at the start of the financial crisis. Bad debts remained well contained.

Employment

In recent months, private sector contacts had reported only a modest rise in recruitment intentions, with uncertainty about the economic recovery prompting many contacts to meet increases in demand using their existing resources, or by hiring temporary staff. Moreover, the modest rise in private sector intentions had been outweighed by expected cuts in the public sector. A few contacts also noted that cuts in public spending might lead to further falls in private sector employment, by reducing demand for private sector services.

Capacity utilisation

On the whole, contacts reported that they had sufficient capacity to meet future increases in demand using their existing resources. The margin of spare capacity, however, had been shrinking following incremental increases in demand over the past year. For example, in some pockets of the manufacturing sector, contacts reported that the margin of spare capacity (particularly in labour) had been largely eliminated. Some contacts had also encountered strains in a few global supply chains (including automotive and electronics components). That, together with reports of limited availability of shipping containers, had led to lengthening lead times for certain components.

Costs and prices

Labour costs
Overall, growth in basic pay remained muted. But, since the start of 2010, pay freezes had become less common and average settlements had drifted a little higher. These small increases in basic pay were usually aimed at aiding staff retention, rewarding better trading performances and boosting morale among those who had accepted pay freezes over the past year or two. To date, the impact of elevated rates of consumer price inflation on pay negotiations had been limited. But a growing number of contacts expressed concerns about future pay rounds, especially were inflation not to fall back.

Pay drift (which captures changes in earnings related to working patterns) and bonuses had also picked up during the year. Those increases had reflected the restoration of hours and (in some cases) overtime, as well as increased commissions and bonus payments, which some contacts had used as an alternative to awarding increases in basic pay.

Non-labour costs
The Agents reported that materials cost inflation had continued to rise further, although the pace of increase appeared to have slowed since 2010 Q1. Metals (primarily steel) and cotton prices had continued to rise, as had the cost of paper, cardboard, packaging and transport containers.

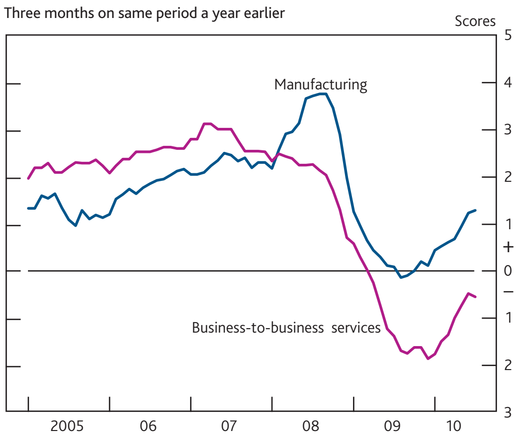
Contacts also reported that imported goods price inflation had edged higher in July, reflecting the lagged effects of the lower level of sterling (the recent appreciation notwithstanding) as well as higher cost pressures and emerging capacity constraints in some economies, particularly in the Far East.

That said, not all input costs had increased in recent months. For example, the prices of some oil derivatives such as plastics appeared to have reached their peaks, and utility costs had continued to decline for many businesses that had renegotiated their expiring contracts. A number of businesses had also benefited from lower commercial rents, or longer rent-free periods.

Output prices

Overall, contacts continued to report little pricing power. Businesses operating in the manufacturing sector had succeeded in raising output prices a little in recent months (**Chart 3**), passing on some (but not all) of the increases in fuel and raw materials costs to their customers. In the services sector, downwards pressure on prices and fees had persisted, reflecting strong competition and proactive negotiation by clients. On balance, the Agents judged that business services prices remained below their levels a year earlier (**Chart 3**). In the construction sector, the Agents continued to hear reports of businesses tendering for work at, or even below, cost.

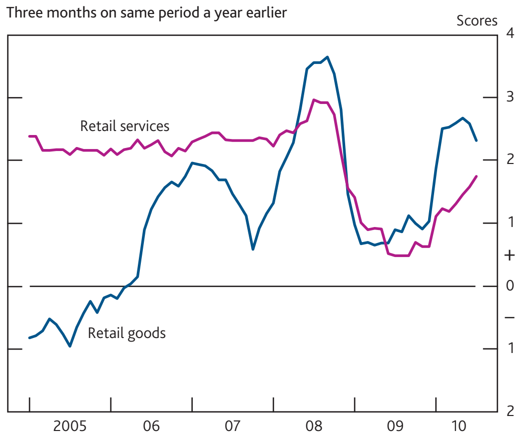
Chart 3 Output prices



Consumer prices

Overall, annual CPI inflation remained elevated, driven by the reintroduction of the standard rate of VAT in January 2010 and increases in import price inflation over the past year. In July, contacts reported a further, gradual increase in retail services price inflation (**Chart 4**). Residential rents had been picking up, and leisure services providers had also been increasing prices in recent months.

Chart 4 Consumer prices



By contrast, annual retail goods price inflation appeared to have eased back in July (**Chart 4**). Food price inflation had declined over the past few months, and some contacts reported falls in fuel prices, following strong increases earlier in the year.

Looking ahead, it remained too early to draw definitive conclusions about the extent to which contacts planned to pass on the rise in VAT. Based on the Agents' discussions so far, contacts expected to pass through much of the rise early in January 2011. But for many, the decision would ultimately depend on how the economy evolved over the rest of the year, and on the importance of pricing points, which would limit some contacts' ability to raise prices.