BANK OF ENGLAND

Agents' summary of business conditions

December 2010

- The Agents reported that the annual pace of growth in both retail sales values and consumer services turnover was broadly unchanged.
- The housing market softened further, with sales of both new and existing homes falling back.
- Investment intentions continued to improve, particularly in manufacturing, on the back of rising exports and planned efficiency gains.
- Growth in exports remained rapid, particularly of goods, driven by demand from emerging markets. Demand had also picked up in the euro area and the United States.
- Services turnover growth had softened slightly, reflecting continued downward pressure on fees.
- Manufacturing output was still growing robustly, helped by strong overseas demand.
- The Agents' score for construction output turned positive, indicating that the level of activity had risen compared to last year. But there were concerns about the outlook.
- Large firms had seen a further improvement in credit conditions but small firms continued to report that conditions remained tight.
- Private sector employment intentions rose a little, driven by the consumer services and manufacturing sectors.
- The degree of spare capacity remained wider than usual, particularly in services.
- Labour costs continued to edge up, reflecting rising productivity. And there was also a degree of compensation for past wage restraint.
- Materials cost inflation remained robust, due to global demand and supply pressures.
- Rising costs had been passed on to some extent in manufacturing output price inflation.
- Contacts continued to expect to pass on the bulk of the rise in VAT, with some already having raised prices.

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 2010 and late November 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

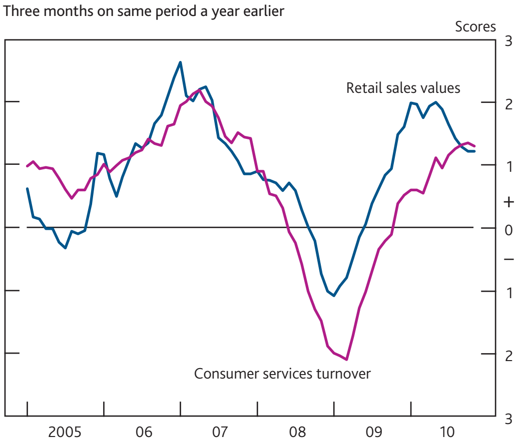
Consumption

The Agents reported that the annual growth rate of the value of retail sales remained broadly unchanged in November, having fallen back over the past few months (**Chart 1**). Promotions were still considered necessary to maintain demand, with consumers still focused on value for money. Some contacts expected a boost to sales as some spending was brought forward ahead of the rise in VAT. But there had been relatively little sign of that happening so far. And new car registrations were generally reported to have weakened.

The annual growth rate of turnover in consumer services was thought to be little changed compared to last month (**Chart 1**). According to a number of contacts, the entertainment sector was seeing some improvement in demand. And spending by tourists continued to support consumer services. Hoteliers in the south had seen reasonable growth in turnover, but the picture was rather weaker elsewhere.

Chart 1 Retail sales values and consumer services turnover

Three months on same period a year earlier



Housing market

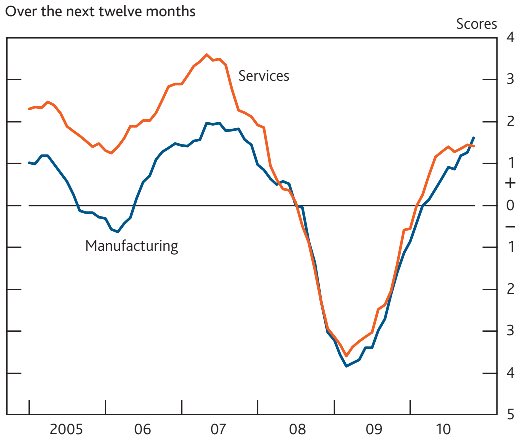
Contacts reported that there had been a further slowing in the housing market, with sales of both new and existing homes falling back. Confidence in the outlook for the economy, and so incomes, was increasingly felt to be weighing on demand. And there continued to be difficulties in obtaining mortgages, particularly for first-time buyers. As a result of the decline in owner-occupier demand, the rental market remained buoyant. That had helped to support rents, which were in turn generating an increase in interest from investors in buy-to-let property.

Business investment

Investment intentions in both manufacturing and services continued to point to a moderate increase in investment over the next twelve months (**Chart 2**). And investment intentions among manufacturers had risen a little. Some of the improvement in investment intentions in manufacturing reflected the continued strength of exports in a number of sectors. And there were numerous reports of investment in new outlets and refurbishment of existing stores, due to the ongoing expansion of some large retail chains. Contacts' efforts to raise efficiency were also a significant driver of spending, with much of the planned investment being in IT. And for a number of businesses, there was a need for replacement investment and to develop new products.

Chart 2 Investment intentions

Over the next twelve months



Exports

The annual rate of growth of the value of exports remained elevated, in large part due to the strength of trade in goods. Automotive, aerospace and chemical sectors were key drivers of growth. The performance of exports was thought to be primarily a function of global demand, particularly in emerging markets, rather than the past depreciation of sterling. Demand in some parts of Europe had begun to strengthen, but remained weak in others. And demand from the United States had also been picking up. Exports of services continued to be supported by the intake of overseas students and inward tourism. Contacts in both manufacturing and services with exposure to utilities and infrastructure projects abroad had also seen a rise in activity.

Import growth remained fairly strong, and there was still relatively little evidence that UK firms were switching towards domestic suppliers. The need to avoid disruption in supply chains was a concern, however, with several contacts reporting that orders of inputs had been diverted to other markets. But it was difficult to source those inputs domestically.

Output

Business services

The experience of contacts in professional and business services was very mixed. The Agents' score for annual growth in turnover continued to point to modest growth, although it had fallen slightly on the month. There was still significant downward pressure on fees — in part reflecting the efforts of public sector bodies to reduce costs, which were widely reported — and as a result, volumes may have risen rather more quickly than values. The provision of IT services continued to be a bright spot, and was possibly linked to investment expenditures to raise efficiency.

The Agents' score for other business services was broadly unchanged, and indicated only a moderate rate of growth. There had been a rise in the growth rate of turnover for firms supplying services to manufacturers, such as warehousing, logistics, and haulage. And contacts in hospitality and conferencing had benefitted from rising activity in the wider economy, although the impact of government savings measures had been felt there too.

Manufacturing

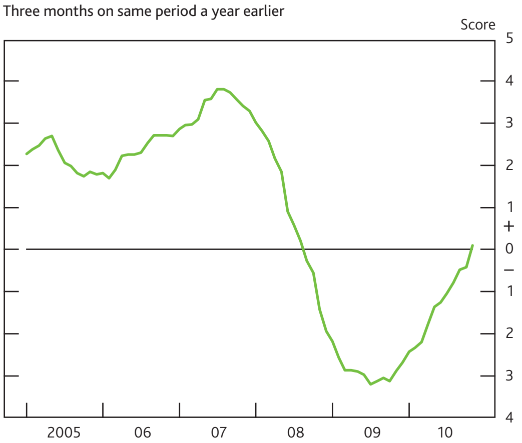
Manufacturing continued to grow robustly. The Agents' scores for both export and domestic manufactures ticked down a little, as very strong growth in the early stages of the recovery had dropped out of the annual comparison. Exports continued to be the primary driver of growth, but there were more reports of domestic demand beginning to contribute to the recovery. Growth in manufacturing output had been underpinned by the aerospace and automotive industries, and activity related to utilities and infrastructure projects. Contacts in the defence industry with exposures to the government had cut back on production and were concerned about the outlook.

Construction

The Agents' score for construction signalled that activity had risen compared with the same period last year (**Chart 3**). That was the first positive reading for annual growth since around the start of the recession. Construction projects in London, related to the Olympics, transportation and some sizable commercial developments, appeared to be responsible for part of the improvement in the sector. A number of contacts had seen a lift from utilities and infrastructure work. And fit-outs of new retail premises and home improvement had also contributed. Government spending was supportive of current activity, but was not expected to remain so next year.

Chart 3 Construction output

Three months on same period a year earlier



Credit conditions

Credit conditions continued to improve for large firms, although contacts in sectors related to property still had difficulties securing external finance. Small firms of all types reported that credit conditions remained very tight, both in terms of cost and availability. And there were further reports of overdrafts being withdrawn and of long delays waiting before decisions were made on loans.

According to contacts, lenders had in some instances moved away from offering overdrafts, in favour of types of financing that posed less risk to their balance sheets, such as invoice discounting. Small firms appeared to be less able than large ones to accommodate that switch. Small firms often found the application process prohibitively costly in terms of time and resource, or were discouraged by what were felt to be overly stringent collateral requirements. Contacts also felt that the use of credit scoring had limited the scope for local bank managers to use discretion when agreeing loans. That had contributed further to small firms' difficulties in securing finance.

Employment

Employment intentions in the consumer sector had picked up, driven by the need to staff new openings of retail outlets. Employment intentions in manufacturing had also risen a little, and remained above average. Business services employment intentions had edged down, and were significantly below pre-recession levels. There had been some recruitment by the financial sector, but law firms were reducing back-office numbers. Contacts remained cautious about hiring, and had made increased use of part time and temporary staff.

There was a small rise in the Agents' score for recruitment difficulties, although it remained well below normal. A few contacts mentioned shortages of certain skills, particularly in IT and engineering. And several contacts reported that they were making increased use of apprenticeships to meet skills gaps.

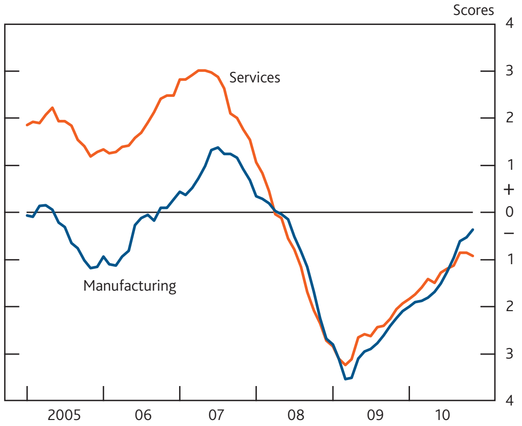
Capacity utilisation

The Agents' score for capacity utilisation in manufacturing continued to rise toward zero, which indicates a 'comfortable' level of spare capacity — that is, a level of spare capacity at which firms are confident that they could meet expected changes in demand over the next six months (**Chart 4**).

Meanwhile, the score for services fell back a touch, and suggested slightly more spare capacity in the sector. Broadly speaking, contacts felt that they could meet a rise in activity relatively easily with existing staff. But a few contacts in manufacturing and related services were at full capacity. And there was widespread mention of component shortages due to global supply constraints.

Chart 4 Capacity utilisation

Over the next six months relative to normal



Costs and prices

Labour costs

Labour cost growth had risen further in manufacturing and was approaching the average rate. Labour costs continued to grow at a slightly slower pace in services. The increase in labour costs was partly due to the reinstatement of shifts and overtime, as well as to pay increases on the back of rising productivity. In addition, some employers had rewarded staff for their loyalty following a period of wage restraint. And unions had been able to exert a little more pressure in some wage negotiations. There were fewer incidences of pay freezes, and a number of contacts had adjusted pay scales following the increase in the national minimum wage. But settlements were rarely linked to inflation, with employees mindful of competition in the job market.

Non-labour costs

Materials cost inflation remained robust, with rapid increases in the prices of agricultural commodities, plastics, wood, paper, cotton and wool, and metals. A pickup in the price of feed had pushed up on the cost of meat and poultry. The annual rate of inflation for imported finished goods ticked up, but was still slightly lower than for materials. Freight shipping and transportation costs were driving price increases. And some contacts thought that quotas on exports of certain rare metals from China had begun to feed through to the price of some of the electrical components that required them. And the price of imports of clothing had begun to reflect the rise in the cost of cotton.

Output prices

Manufacturing output price inflation rose a little, but remained fairly subdued. Contacts had been able to pass on some of the increases in costs, particularly when materials comprised a major part of the cost base, or when increases were widely known to have been large. But retailers had vigorously resisted attempts by food producers to pass on much of the rise in their costs.

In services, competitive pressures were still exerting a downward influence on prices, particularly for professional services of a broadly homogenous or 'commoditised' nature, such as audit. And there were further reports of public sector bodies renegotiating contracts to secure work at a lower cost. But there were certain niche services where firms had been able to exert a little more pricing power. And hauliers had been passing on higher fuel costs.

Consumer prices

The Agents score for consumer goods inflation had risen a little, but it still pointed to a rate of increase that was around the historical average. The Agents' score for consumer services was unchanged, and suggested a slightly slower pace of price rises. There had been some pass through of recent increases in the cost of imported finished goods. Where supermarkets had been unsuccessful in keeping down costs, they had been tending to pass them on to consumers. Rather than raise prices, restaurants had reworked menus to cut spending on ingredients. Air fares had gone up, along with motor and buildings insurance premiums.

Contacts still intended to pass on the bulk of the rise in VAT. Most of the increase would occur during the first few months of next year, but some had happened already. A few contacts, typically those that expected a large response in demand to any price change, intended to delay passing on the tax rise, or planned to absorb part of it.