BANK OF ENGLAND

Agents' summary of business conditions

February 2010

- Over the Christmas and New Year period, retail sales were reported to be well up on the same period a year earlier. They had subsequently fallen back, with the adverse weather affecting sales across much of the United Kingdom.
- Housing market activity had continued to recover, but there were more signs that the rate of growth had slowed.
- While investment intentions remained muted, few firms planned a further round of sharp cuts following last year's sizable reductions in spending.
- Exports had continued to recover modestly.
- Many contacts planned to maintain their inventories at low levels relative to sales.
- Reports of growth or stabilisation in demand for professional and financial services had become more common. But demand for other business services remained subdued.
- Reports of quarter-on-quarter growth in manufacturing output continued to outweigh those of shrinkage. Construction remained severely depressed.
- The Agents' sense of marginal improvement in credit conditions had strengthened in recent months.
- The outlook for employment continued to improve slightly, with few contacts planning significant further reductions in headcount.
- Few contacts anticipated encountering capacity constraints over the near term.
- Inflation in per capita labour costs was expected to be positive but muted during 2010 (see box). Inflation in materials costs had ticked up and was expected to rise further.
- Consumer goods price inflation had increased following the reversal of the temporary cut in VAT and the reduced scale of promotional activity relative to the same period a year earlier.

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 December 2009 and late January 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.**

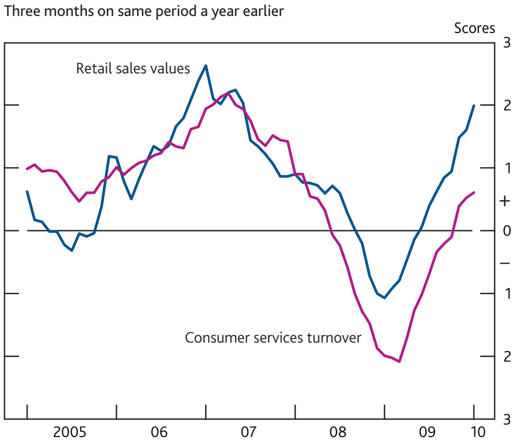
Demand

Consumption

The Agents' sense was that retail sales had recovered somewhat during 2009 Q4, and retailers reported that sales over Christmas and the New Year period had been well up on a year earlier, reflected in further increases in the Agents' score (**Chart 1**). Initial indications were, however, that demand had fallen back in early January, when the heavy snowfall was widely reported to have impacted adversely on sales.

Demand for consumer services also appeared to have picked up since mid-2009, although any recovery had been less marked than for retail sales (**Chart 1**). Hotels and restaurants reported that sales volumes had been higher than a year earlier in the run-up to Christmas. Holiday bookings had also grown, although there were widespread reports that the inclement weather had affected demand.

Chart 1 Consumer spending



One result of the adverse weather was that retailers found it hard to distinguish between a temporary fall in demand and any change in 'trend'. Nonetheless, many expected demand to slow through the early part of 2010. In part, that reflected their view that customers had brought spending forward in anticipation of the rise in VAT — demand for big-ticket items, such as furniture, had grown sharply in the immediate run-up to the New Year. But more generally, many had been surprised by the strength of demand during late 2009.

Housing market

The number of property transactions remained higher than a year earlier but was still well below pre-recession levels. But there was mounting evidence that growth had slowed in recent months. While there were further signs of a marginal easing in mortgage availability, these continued to be dominated by reports that a lack of finance was constraining activity. Such constraints appeared most marked in the market for new homes, where a number of estate agents continued to report that surveyors were providing conservative valuations.

Business investment

Investment plans continued to be widely described as muted, with very few contacts anticipating significant growth in capital expenditure. But while the level of investment remained lower than before the recession, there were few reports of plans for a further round of sharp cuts following the previous year's reductions.

Concerns over prospects for demand continued to be cited widely as a factor deterring investment spending, with many contacts considering their capital utilisation to be well below normal (see below) and few expecting demand to grow significantly during 2010. A number of contacts had deferred investment until after the general election, when any changes in taxes, capital allowances and government spending would come to light. On the upside, a number of contacts needed to increase investment in vehicles, machinery and IT, following deferral of routine replacement programmes during 2009.

Exports

There had been little change to the broad picture of modest recovery in exports painted in recent months, with global demand widely seen to have strengthened through the latter part of 2009. Although some exporters had experienced increases in competitiveness and market share in the wake of sterling's depreciation, many others had continued to take any benefit through increases in their margins. But there was some evidence that more businesses were looking to enter export markets. For example, Chambers of Commerce reported growth in demand for the export documentation services they provide.

Inventories

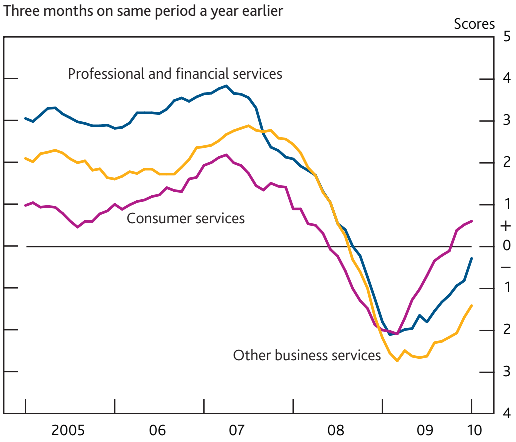
As had been the case throughout 2009 Q4, inventories were widely described as being around desired levels. Looking forward, the Agents' sense was that few firms were increasing their stocks, with many firms planning to hold lower stock levels (relative to sales) than had been the case prior to the recession. In large part, that was driven by the lower availability and higher cost of working capital. Contacts also cited uncertainty over prospects for demand as a factor pressing down on planned inventories.

Output

Business services

Reports of stabilisation or modest growth in demand for professional and financial services had become more common in recent months. But any recovery in demand was less evident than in the consumer services sector (**Chart 2**), with many contacts stressing that growth had come from a low base. For example, although demand for property-related and

Chart 2 Services turnover



other transactional work had grown in recent months, activity remained well below pre-recession levels. The overarching impression remained one of customers managing their overheads extremely tightly.

Outside the professional services sector, any evidence of recovery in business services was even more patchy. Spending on corporate hospitality remained very weak relative to pre-recession levels — for example, a greater number of Christmas parties had been paid for by employees rather than their employers. And the extreme weather had impacted on a number of business services providers, with reports of cancellation of conferences and some disruption to distribution.

Manufacturing

The broad picture remained one of activity growing since its trough in the summer of 2009. But although reports of expansion outweighed those of shrinkage, there was still little sense that growth had picked up strongly or consistently. Contacts continued to report volatility in orders and shorter than normal order books. And looking forward, few were banking on strong growth through 2010. Some firms had seen output disrupted by the weather, but such reports were very much in the minority.

Construction

Construction activity remained well down on the same period a year earlier. Commercial property activity was particularly weak, with no material pipeline of new projects to replace those being completed. Some Agents had been told that the pipeline of public sector projects was dwindling, although such reports were far from universal, with a few public sector bodies still bringing work forward. House-building activity had, however, continued to pick up a little, with some further reports of land purchases and site preparation work. Spending on repair and maintenance work was broadly stable.

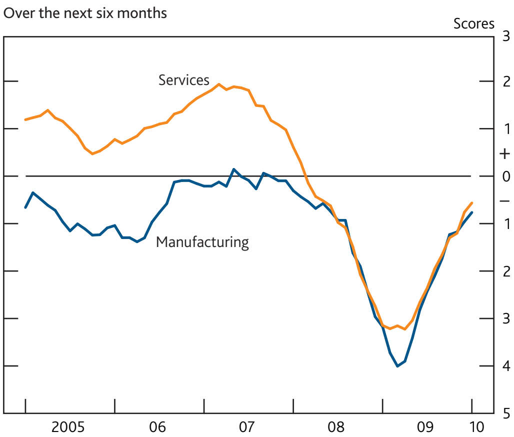
Credit conditions

The Agents' sense of marginal improvement in credit availability had strengthened in recent months. But, as had been the case for some time, that loosening had not been felt uniformly across contacts. Access to finance continued to be delineated by firm size and sector. For example, reports of improved credit availability were more common among larger companies and those operating outside the property sector. On average, lending spreads had probably narrowed a little through the second half of 2009, though they remained wide relative to pre-crisis levels. Reports of high fees and tough non-price terms (such as management information requirements) remained pervasive. Demand for finance remained weak.

Employment

In most parts of the United Kingdom, the pace of decline in employment had slowed through 2009 Q4, with few reports of significant redundancies and some of selective rehiring. Looking forward, the outlook for employment continued to improve slightly (**Chart 3**), with few contacts planning significant cuts to staff numbers during 2010. But there were also few plans to increase permanent headcount, with many contacts expecting to respond to any increase in demand by reversing earlier cuts to average hours or taking on temporary staff.

Chart 3 Employment intentions



Capacity utilisation

The recent pickup in demand experienced by some firms had led to increases in their capacity utilisation. A few contacts had started to face capacity constraints — for example, some reported lengthening lead times where demand had surged and others encountered sporadic recruitment difficulties for specific skill sets. But such reports remained rare and were set against a backdrop of widespread spare capacity.

Costs and prices

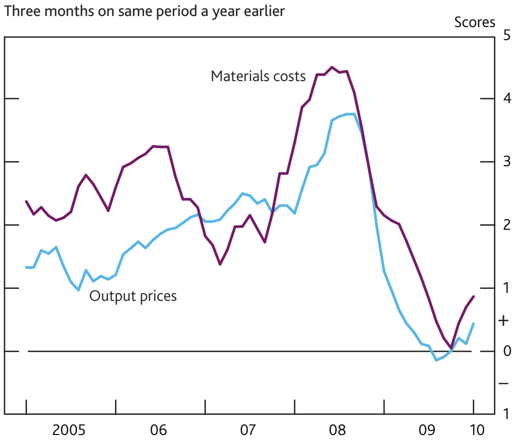
Labour costs

Private sector contacts had continued to describe their per capita labour costs as down relative to the same period a year earlier. Looking forward, the Agents had conducted a Special Survey of prospects for per capita pay and labour costs (see box). The overarching sense from that survey was that inflation in labour costs was expected to be positive but subdued during 2010. A significant number of contacts planned to freeze pay, and very few expected to make settlements in excess of 2%. But total per capita labour costs were expected to rise a little faster than during the previous year — in part, because some firms anticipated making higher pension contributions.

Non-labour costs

The Agents' sense was that inflation in materials costs had picked up a little since the summer (**Chart 4**). In part, that was because last year's falls in fuel prices had previously driven annual inflation rates lower. Diesel prices had increased through the second half of 2009, as had the price of some oil derivatives such as plastics. And global supply pressures had led to increases in the price of some other commodities. Looking forward, contacts expected a further, slight pickup in non-labour costs — albeit to nothing like the same extent as experienced during 2008.

Chart 4 Manufacturers' input and output prices



Output prices

Substantial spare capacity had continued to push down output prices for many firms. That pressure remained most clearly evident in the construction and business services sectors, where prices achieved were widely regarded as well down on the previous year. Against that backdrop, there had been further signs that downward pressures on pricing had eased (**Chart 4**). More manufacturers anticipated making modest increases in prices, or holding prices stable, where they had previously expected small decreases. Some business services providers had also reported stable charge rates through the latter part of 2009, after sharp falls earlier in the year.

Consumer prices

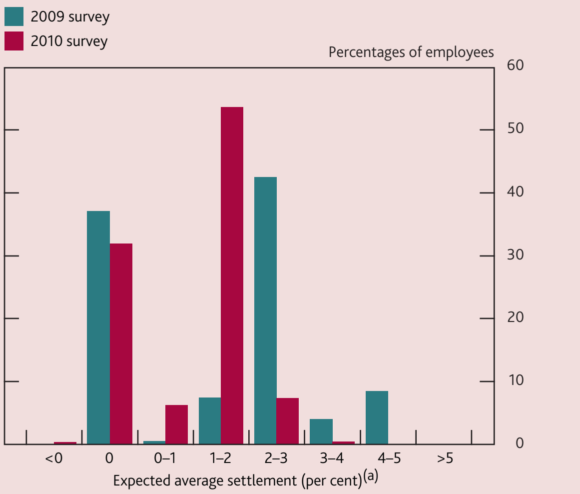
The Agents' contacts reported that consumer goods price inflation had increased sharply, reflecting both the reversal of the temporary cut in VAT and the limited scale of promotional activity. Retail contacts reported that they had entered the Christmas period with lower stocks than the previous year. That, coupled with stronger sales, had left them with less stock to shift compared with a year earlier. As a result, promotions were less widespread, and were typically tailored to just a few product lines. Many retailers had passed through, or expected to pass through, much of the VAT increase onto their customers. The VAT rise had also affected prices in the consumer services sector. But here, promotional activity remained pervasive.

Agents' survey on prospects for pay and per capita labour costs

A significant number of private sector pay settlements take place during the first four months of the year. To provide an early indication of prospects for pay in the year ahead, the Agents conduct a survey of their contacts each January. This year, around 325 private sector firms responded. All figures shown are weighted by UK employment.

Contacts were asked what they expected their pay settlement to be during 2010. The average across all respondents was 1.3%, down from 1.9% in the 2009 survey. As in 2009, a significant proportion expected to freeze pay this year (**Chart A**). But, in contrast to 2009, very few respondents anticipated making settlements in excess of 2%. This picture of low settlements was common across all sectors of the economy, but was most marked among firms in the construction sector. That chimed with the Agents' reports that construction has been one of the weakest sectors of the economy for some time.

Chart A Expected average pay settlement

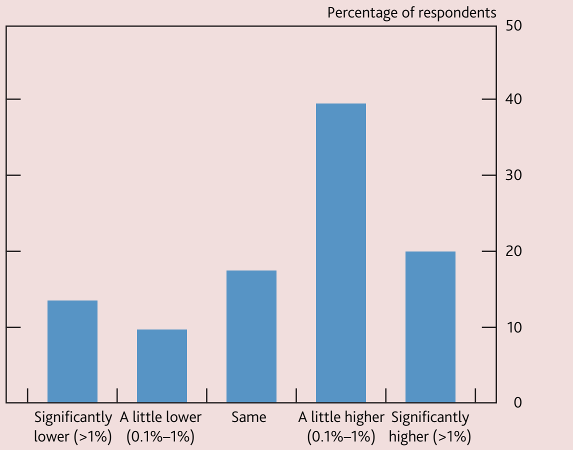


(a) A settlement that is a round number is classified within the bucket where that round number is the upper bound. For example, a 2% settlement is included within the 1%–2% bucket.

Basic pay is only a part of firms' total labour costs — changes in overtime, bonuses and pension contributions also play a role. Survey respondents were asked how they expected their total per capita labour costs to evolve during 2010. Despite low expected pay settlements, the majority of respondents expected per capita labour costs to grow more quickly (or shrink more slowly) than in the previous year (**Chart B**).

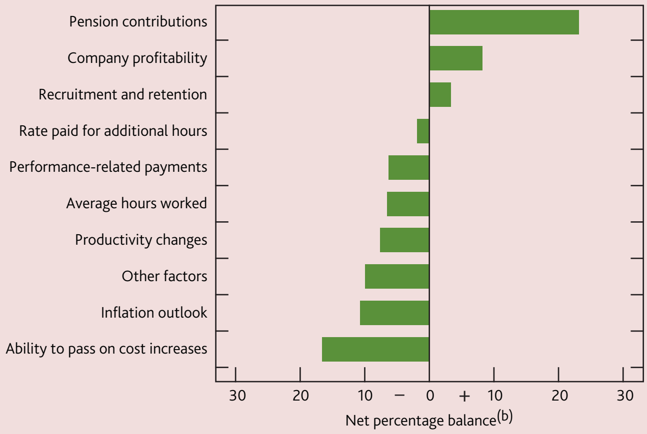
Respondents were also asked which factors most explained any expected changes in per capita labour costs. On the upside, pension contributions were widely expected to increase (**Chart C**) — most markedly among larger firms. The Agents' discussions with contacts suggested that a number had seen downward revaluations of their pension funds, partly reflecting lower gilt yields, and were planning to respond by increasing employer contributions. On the downside, the outlook for inflation and some firms' difficulties in passing any cost increases on to their customers were cited as pressing down on the remuneration respondents expected to offer.

Chart B Expected changes in total per capita labour costs relative to a year earlier(a)



(a) Respondents were asked: 'How fast do you expect total labour costs per employee to grow in 2010 compared with growth in 2009?'.

Chart C Factors influencing expected changes in per capita labour costs(a)



(a) Respondents could select more than one box.
(b) Proportion describing each factor as leading to stronger per capita labour cost growth less the proportion describing it as leading to weaker growth.