BANK OF ENGLAND

Agents' summary of business conditions

July 2010

- There had been some signs that consumer spending growth had slowed through Q2.
- Activity in the housing market, which had been rising gently for much of 2010, had also eased back.
- Investment intentions remained consistent with a gentle rise in spending, rather than a more robust recovery.
- Export volumes rose at a steady pace, with a growing number of contacts selling to new, fast-growing markets.
- Services turnover had continued to grow modestly, reflecting higher demand for professional services, as well as a small increase in distribution activity.
- Manufacturing output had risen further, on the back of stronger external demand and, to a lesser extent, domestic demand.
- Construction output had been little changed in recent months. But the level of activity remained lower than a year earlier, and contacts feared a further contraction over the next year or so.
- Credit conditions remained tight for many firms, although the Agents sensed that the availability of funding had improved a little during 2010.
- Contacts expected a small increase in private sector employment over the next six months, but public sector employment was expected to fall.
- Pay growth remained muted overall, although the upward creep in wage settlements noted in the past couple of months had continued.
- Businesses' input costs had risen further, reflecting increases in global demand as well as some supply shortages for certain components.
- Corporate margins had, on balance, been little changed over the past year (see box).
- Consumer price inflation remained elevated. Most contacts had expected a rise in VAT to be announced in the June 2010 *Budget*, but it remained too early to assess the degree to which the rise would be passed on to consumers.

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 May 2010 and late June 2010. It provides information on the state of business conditions from companies across all sectors of the economy. The vast majority of discussions had been held prior to the June 2010 *Budget*. 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.

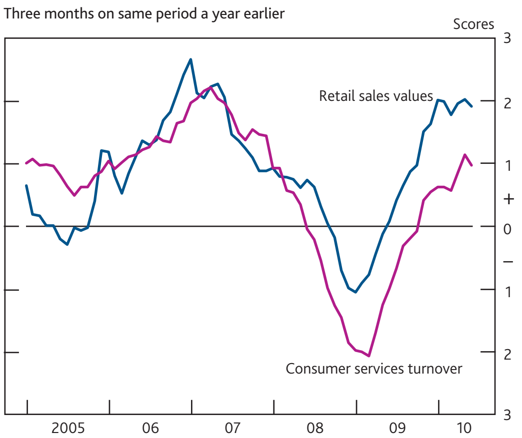
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

The Agents' contacts reported that retail sales values growth, which had remained broadly steady during the early months of 2010 (**Chart 1**), had slowed a little through Q2. Many contacts thought that consumer sentiment had softened, and that shoppers had begun to reduce expenditure in response to expected changes in taxes and concerns about job security. Sales volumes growth is likely to have been weaker than values growth — while turnover had been higher than a year ago, retail prices had also risen over that period.

Chart 1 Retail sales and consumer services



New car sales had eased back in recent months, although they remained above their levels a year earlier. In part, dealers attributed the relative resilience of car sales to the promotional schemes they had introduced over the past three months, aimed at supporting demand following the expiry of the car scrappage scheme.

Turnover in the consumer services sector, which had been little changed in recent months, also showed some signs of easing. Spending in restaurants and pubs had been subdued, and demand for housing-related services had fallen back in line with housing market activity (see below). That said, visitor attractions reported increases in demand, and many contacts hoped that the low level of sterling and concerns about travel disruption (from airline strikes and the volcanic ash cloud) would encourage domestic residents to holiday within the United Kingdom.

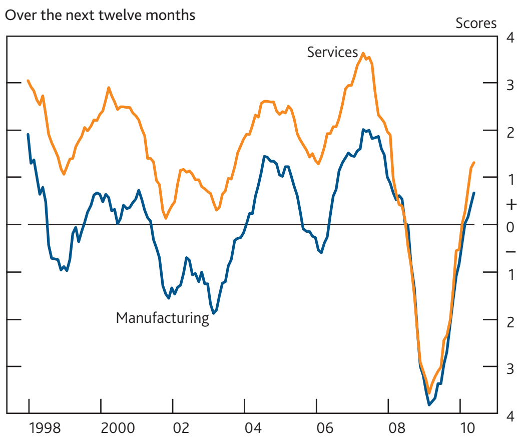
Housing market

Activity in the housing market, which had been rising gently during 2009 Q4 and early 2010, had softened a little in recent months. Despite a slight increase in the availability of credit, demand continued to be constrained by the restrictions on mortgage finance, particularly for first-time buyers. At the same time, the decision to suspend Home Information Packs in England and Wales had encouraged sellers into the market, boosting the supply of properties. As new sales instructions had risen, the stock of available rental accommodation had declined. That, coupled with strong demand from those unable to buy homes, had led to a further increase in rents.

Business investment

Investment intentions had continued to pick up (**Chart 2**), although they remained consistent with a gradual rise in spending, rather than a more robust recovery. New spending plans remained in large part focused on improving efficiency (eg via saving energy and improving IT) or replacing assets whose lives had been extended during the recession (eg vehicle fleets). On balance, there remained few reports of investment in new capacity. The exceptions included some supermarkets and major retailers, which had continued to fund expansion of new stores, and some businesses that had increased spending to expand export capacity. Capital spending was usually being funded by internal resources, although many businesses remained reluctant to part with the holdings of cash that they had sought to accumulate during the recession.

Chart 2 Business investment intentions



Exports and imports

Exports had risen further in June, mainly reflecting demand growth in the Far East, Africa and (to a lesser extent) the United States. A growing number of contacts had begun to seek out new export opportunities, although this process was expected to take some time. Signs of expenditure switching away from imports towards domestically sourced goods and services had increased a little further, but the lack of appropriate supply capacity in the United Kingdom continued to prevent many contacts from sourcing more components domestically.

Output

Business services

Demand for professional and financial services (such as legal, accountancy, recruitment, advertising and IT services) had been rising gradually over the past six months. As a result, the

Agents judged that turnover in Q2 was higher than its level a year earlier. Moreover, volumes growth is likely to have been stronger than growth in turnover, given continued year-on-year declines in many professional and financial services prices. Growth in businesses services turnover remained quite patchy. Demand for distribution and logistics services had increased a little, reflecting the gentle rise in activity and some selective restocking in pockets of the economy.

The nascent recovery in demand for services had, however, been gradual, and companies had continued to manage overheads extremely tightly over the past six months. More recently, the Agents had heard widespread reports that the public sector had begun (and was expected to continue) to economise on costs and cut back on discretionary spending.

Manufacturing

Manufacturing output had been picking up for much of 2010, largely reflecting an increase in exports. But output destined for the domestic market had also increased, in part reflecting some re-sourcing of previously imported components back to the domestic economy (eg in the automotive sector) and tentative signs of restocking in some parts of the economy.

Construction

Following steep falls during much of the past two years, construction output had begun to stabilise in recent months. The recent stability had, however, masked divergent and offsetting trends in different subsectors. New residential construction had been recovering slowly for some months now, although the level of activity remained low, and developers continued to report concerns about future economic activity and difficulties in accessing bank finance. Offsetting the gentle recovery in residential construction, private commercial construction remained weak and the pipeline of projects had continued to dwindle, as existing work was completed but not replaced with new activity. And some public sector construction projects (eg road maintenance and social housing projects) had already been put on hold or cancelled. The majority of contacts expected the further planned reductions in public spending to prompt a renewed fall in construction output over the coming year or so.

Credit conditions

On balance, the Agents judged that the availability of bank credit had improved a little since the start of 2010. That said, conditions remained significantly tighter than those prevailing prior to the financial crisis, and individual businesses' experiences had remained extremely diverse. For example, small and medium-sized businesses, along with property developers and those with significant exposures to the construction sector continued to face particular difficulty accessing affordable finance. Demand for bank loans remained muted, with many businesses continuing to reduce their leverage by paying down bank debt.

Bad debts had so far remained well contained, and insolvencies remained well below many contacts' expectations. But looking ahead, a number of contacts, particularly those in the property sector, expressed concerns about their ability to refinance loans. Some worried that these issues would lead to a rise in corporate failures over the coming year.

Employment

The Agents reported a modest improvement in private sector employment intentions. But the pickup in recruitment was expected to be limited: some companies would still be able to meet higher demand through increases in hours, including the reintroduction of overtime. And where companies were planning to recruit, they often planned to hire temporary staff, rather than increase permanent headcount, due to uncertainty about the economic outlook. Moreover, contacts felt that the news about public sector employment prospects had been less encouraging. Some public bodies had already begun reducing staff numbers, and the planned fiscal consolidation was expected to lead to further reductions in headcount.

Capacity utilisation

Overall, contacts reported that there remained an ample degree of spare capacity in the economy, although increases in demand had led to an incremental rise in capacity utilisation. Indeed there were sporadic concerns that stronger increases in demand would put pressure on some supply chains, especially those where capacity had been cut or where operations had been consolidated. And a few other companies, usually operating in the manufacturing sector, reported that they were working at or even above current capacity, following earlier reductions in their headcount. Most contacts reported little difficulty filling vacancies, although recruitment of highly skilled individuals was proving more difficult in some sectors.

Costs and prices

Labour costs

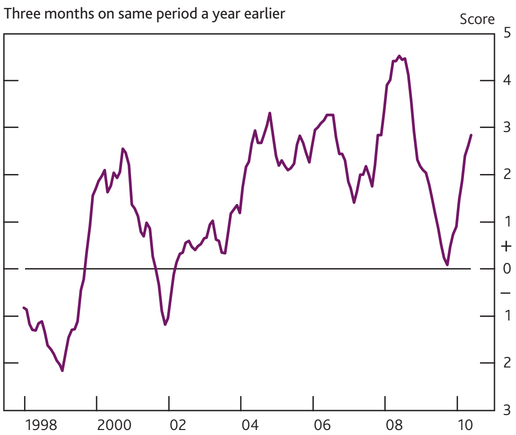
Overall, pay growth remained muted, although pay freezes had become less common and the upward creep in wage settlements, noted over the past couple of months, had become more widespread. Most contacts had agreed to small increases in pay to reward staff for a much improved trading performance, or in some cases to retain staff in the face of an expected upturn in demand. Generally, contacts reported that pay negotiations had not been materially influenced by recent inflation outturns, although some businesses had become more concerned about the impact that higher inflation might have on employees' future wage demands.

Total labour costs had been rising for a number of months, as the restoration of hours and overtime, as well as small increases in bonuses and commissions, had led to increases in employees' take-home pay.

Non-labour costs

Most contacts reported further increases in materials costs in June (**Chart 3**). In some markets, such as those for fuel and timber, contacts thought that increased demand (particularly from emerging economies such as China) had been the dominant factor pushing up prices. But in other markets — including freight, paper, construction materials and electronics — supply shortages following reductions in global capacity during the recession had also played a significant role. Imported goods prices had also continued to rise. Contacts attributed the latest increase to a combination of rising Chinese inflation, and the recent fall of sterling against the dollar (which had increased the prices of dollar-based imports from the Far East).

Chart 3 Materials costs

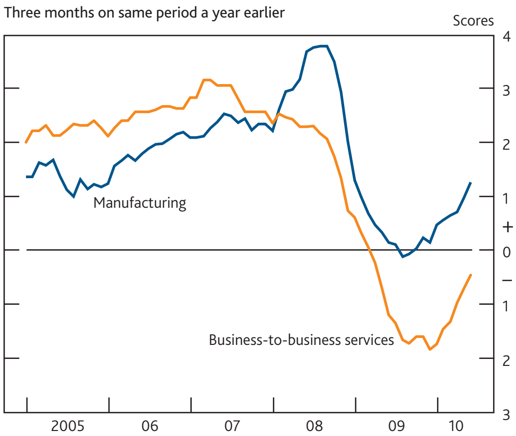


The rise in businesses' non-labour costs had not been universal, however. For example, energy costs had fallen for many contacts, who had renewed expiring contacts at lower rates. And many businesses had also benefited from lower rents or longer rent-free periods, reflecting the significant overhang of empty properties, and landlords' desire to retain tenants and prevent voids.

Output prices

Manufacturers' output prices had edged higher over the month, as the impact of spare capacity continued to be offset by pass-through of materials and fuel costs through escalator clauses and surcharges respectively. Some services prices had also begun to increase quarter on quarter, although the Agents judged that, on balance, prices remained below their levels a year earlier (**Chart 4**). By contrast, output prices in the construction sector continued to decline, with many businesses bidding for work at, or even below cost, in an attempt to secure cash flow.

Chart 4 Output prices



Despite only limited increases in output prices, the Agents reported that pre-tax profitability had been recovering during 2010, as increases in commodity and component prices had been offset by reductions in labour and operational costs made during 2009. As a result, businesses' margins had, on balance, been broadly unchanged over the past year (see box).

Consumer prices

Annual consumer price inflation remained elevated, reflecting the earlier restoration of the standard rate of VAT to 17.5%, and increases in imported goods prices. Looking ahead, trends in both goods and services prices were expected to be mixed. For example, clothing and footwear prices were expected to rise in the near term, reflecting further pass-through from the lower level of sterling. But food price inflation was expected to ease back over the remainder of 2010.

A rise in VAT (confirmed in the June 2010 *Budget)* had been widely expected by contacts. But, given that the vast majority of the Agents' meetings had occurred prior to the *Budget*, it remained too early to assess the degree to which the rise in tax would be passed on to consumers.

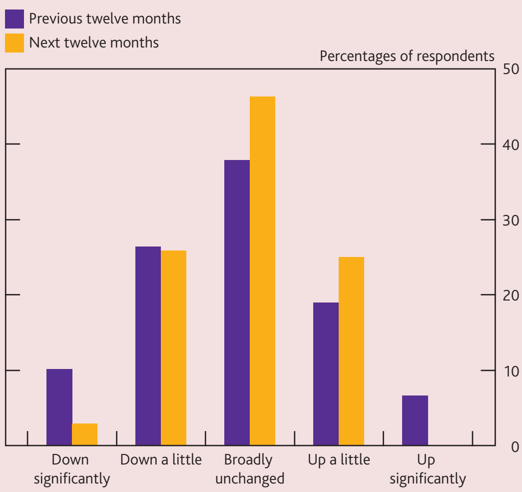
Agents' survey on corporate margins

UK inflation has been surprisingly resilient since the onset of the recession in mid-2008. One possible explanation relates to the behaviour of corporate margins. In the past, profit margins have tended to fall back during periods of weak demand, perhaps because companies chose to keep prices down temporarily and forego current profits in order to support demand for their products. But during the latest recession, estimated profit margins have been unusually resilient, falling no more than during the early 1990s recession, despite a larger fall in output.(1)

To investigate this further, the Agents asked contacts how their gross profit margins had evolved over the past year, the main factors that had driven any change, how their margins compared to more 'normal' levels, and how they expected margins to change going forward. Around 350 businesses responded to the survey. All figures shown are weighted by turnover.

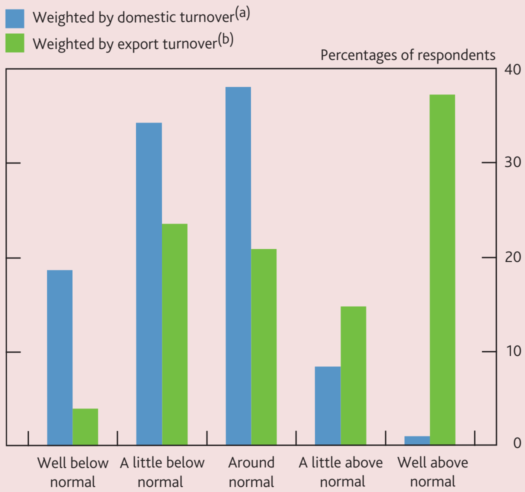
Consistent with the official ONS data, the Agents' survey results suggested that, on balance, corporate margins had been little changed over the past year (**Chart A**), although the distribution of responses was quite wide. Firms operating in the construction sector were more likely to report significant declines in profit margins, while those in the consumer services sector tended to report small increases. Exporters' responses suggested that their profit margins had risen significantly over the past year.

Chart A Changes in businesses' gross profit margins



The results also suggested that, overall, businesses thought their margins were currently a little below normal levels (**Chart B**). Again that is consistent with the ONS data, which show that the profit share is currently a little below its pre-recession level. Exporters typically reported that margins were currently well above normal levels, consistent with the sharp rise in sterling export prices since the depreciation of sterling in mid-2007.

Chart B How would you describe your current gross profit margin?



(a) Total domestic turnover accounted for 86% of turnover in the sample.
(b) Total export turnover accounted for 14% of turnover in the sample.

Contacts reported that weak demand and strong competition had contributed to downward pressure on their margins. Similarly, many reported that margins had been squeezed by increases in raw material costs, which few had been able to pass on in full. In aggregate, however, these influences had been broadly offset by reductions in labour costs and improvements to operational efficiency, most of which had happened during 2009.

Looking ahead, few contacts expected to be able to replicate the reductions in costs they had achieved over the past year. And, on balance, there was little evidence to suggest that firms believed they would be able to raise prices over the next twelve months. As a result, most contacts expected margins to remain steady over the next year (**Chart A**).

(1) For more information, see page 34 and **Chart 4.6** of the May 2010 *Inflation Report*.