BANK OF ENGLAND

Agents' summary of business conditions

June 2010

- The Agents' sense was that, abstracting from the erratic factors that had distorted the pattern of sales earlier this year, retail sales values growth had been steady during the first half of 2010.
- Consumer services turnover had remained broadly flat in recent months.
- Investment intentions had picked up, but remained consistent with a gradual recovery from a low level, rather than a robust pickup in spending.
- Exports had continued to recover. There had been more widespread reports of businesses preparing to export to new markets, where growth had been more robust than in the United Kingdom's traditional trading partners.
- Business services turnover had risen further, primarily reflecting recovering demand for professional services. Growth in volumes was likely to have been stronger than growth in turnover, given ongoing falls in services output prices.
- Manufacturing output volumes had also continued to rise, reflecting both stronger foreign and domestic demand.
- Construction output had begun to stabilise, but contacts expected cuts in public sector spending to prompt a renewed contraction over the next year.
- The availability of bank credit continued to improve slightly, although conditions remained tight for most businesses.
- Private sector contacts expected employment to remain stable over the next six months.
- Pay growth remained muted, although the slight upward creep noted over the past couple of months had continued.
- Materials costs remained elevated, reflecting both demand and supply-side factors.
- Consumer price inflation remained little changed, with contacts continuing to report little pricing power.

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 April 2010 and late May 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.

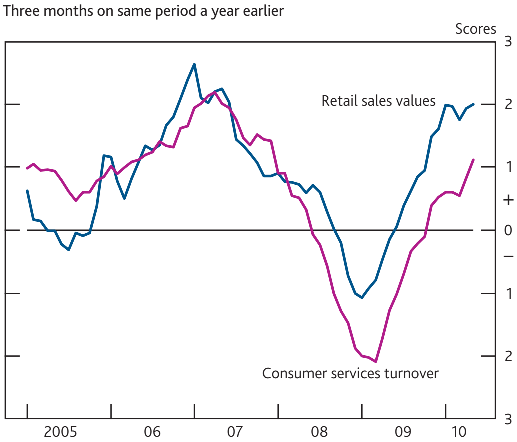
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

The Agents' sense was that, abstracting from the numerous erratic factors that had distorted the pattern of spending earlier this year, retail sales values growth had been steady through the first half of 2010 (**Chart 1**). New car sales had declined a little following the expiry of the scrappage scheme, but by less than many dealers had feared. Several contacts believed that their own promotional deals had played an important role in mitigating the fall in sales following the end of the government subsidy.

Chart 1 Retail sales and consumer services



Consumer services turnover had remained broadly flat in recent months, but annual growth had continued to pick up due to weak year-earlier comparators. Restaurant visits and hotel occupancy rates had both improved a little, although the boost to turnover had been in large part offset by discounts offered to attract custom. Although airline revenue had been hit significantly by the volcanic ash cloud, train, bus and ferry operators had benefited, such that the net effect on consumer spending was thought to be small.

Looking ahead, the World Cup was expected to boost sales of some products (eg food and alcoholic drinks). But contacts remained cautious about prospects for consumer spending during the remainder of 2010 — many continued to express concerns that future cuts in public spending would lead to weaker growth and lower employment.

Housing market

Activity in the housing market appeared to have remained broadly stable. House prices had also remained little changed in recent months. Demand for housing, especially among first-time buyers, continued to be suppressed by tight credit conditions, although the availability and cost of mortgage finance had improved slightly in recent months. The number of properties coming to market had increased again, in part as some investors moved to sell their properties in advance of a possible increase in Capital Gains Tax. Moreover, many contacts expected supply to increase further following the suspension of Home Information Packs in England and Wales, which would reduce the upfront costs homeowners incur when marketing their properties.

Business investment

Investment intentions had continued to recover, although they remained consistent with a gradual recovery in capital expenditure, rather than a more robust rise. Intentions continued to be depressed by uncertainty about future demand and by the existing margin of spare capacity. Moreover, businesses remained keen to retain the precautionary holdings of cash that they had built up during the recession. The restrictions on bank finance, however, had played a secondary role in suppressing investment thus far — most investment is accounted for by large businesses, who had been able to tap non-bank sources of finance over the past year.

Where investment intentions had strengthened, spending plans remained focused on reducing costs and improving efficiency, or replacing assets whose lives had been extended through the downturn (eg vehicle fleets). The only notable exceptions were some major retailers, who planned to increase capacity or refurbish existing premises.

Exports

Exports had continued to pick up, with many ascribing the improvement to a recovery in world demand. Although recent concerns about the impact of fiscal consolidation plans in the euro area had contributed to pessimism and uncertainty about future growth prospects, demand in the United States appeared to have stabilised and many Asian economies continued to record strong growth rates. Moreover, the Agents had received an increasing number of reports from businesses looking to export to new, fast growing markets, although contacts stressed that this was a long and drawn out process. The lower level of sterling had provided a lesser boost to trade volumes, as relatively few businesses had reduced their foreign currency export prices significantly over the past year. That reflected, in part, a significant concurrent increase in businesses' material and imported costs. But it also reflected the desire among some exporters to boost or rebuild their profit margins.

Output

Business services

Signs of recovery in services activity had persisted in May. Turnover in the professional and financial services sector had risen further, despite further falls in business-to-business services prices. That implied that volume growth had been stronger than the Agents' turnover scores suggest. Demand for accountancy, advertising, recruitment and legal services had picked up in recent months, and there were tentative signs of a rise in M&A activity. Commercial property transactions had risen as investors looked to capitalise on relatively low prices and, in the case of overseas investors, the weakness of sterling.

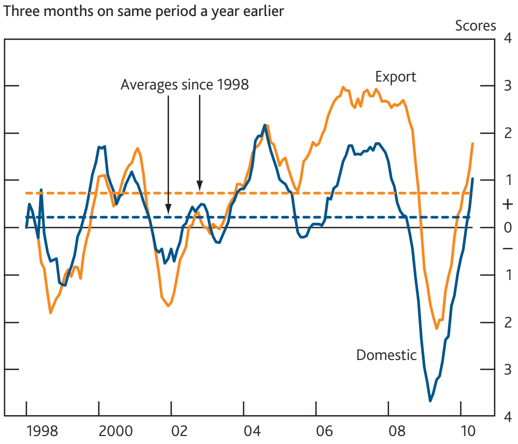
Other business services turnover also continued to recover, albeit at a less rapid pace than demand in the professional and financial sector. Turnover in the haulage and distribution sector had picked up, and there were some signs that corporate hotel bookings had also risen. But demand for business conferences remained subdued.

Manufacturing

There had been a further pickup in the volume of manufacturing output, reflecting both stronger export performance and, to a lesser extent, a recovery in domestic demand. Both scores, which summarise the Agents' sense of growth over the past three months relative to a year earlier, were now well above their post-1998 averages (**Chart 2**). Although some of the rise in the scores had reflected weak year-earlier comparators, the Agents reported that final demand had also increased in recent months. For example, contacts noted that production in the automotive sector had been particularly strong over the past month or so, primarily reflecting a combination of stronger export demand and a growing propensity to source components domestically, rather than from abroad.

Chart 2 Manufacturing output

Three months on same period a year earlier



Looking ahead, the majority of manufacturing contacts had become more optimistic about growth prospects. But there remained pockets of the sector that were less upbeat, particularly those manufacturers serving the defence and construction sectors, who were particularly concerned about prospective cuts in government spending.

Construction

The volume of construction activity remained well below its level a year earlier. But the pace of contraction had moderated somewhat in recent months, with a number of contacts reporting that output had begun to stabilise, or even pick up. The recent improvement largely reflected a gradual resumption of private home building, although the level of activity remained low, and development work continued to be suppressed by economic uncertainty and by restrictions on the availability of finance.

The rise in residential construction had, however, been largely offset by waning demand from the public sector, as some planned projects were shelved and as the pipeline of new work continued to shrink. Looking ahead, many contacts feared that private sector demand would prove insufficient to offset the withdrawal of public sector support, resulting in a widely held belief that construction output would fall again over the next year.

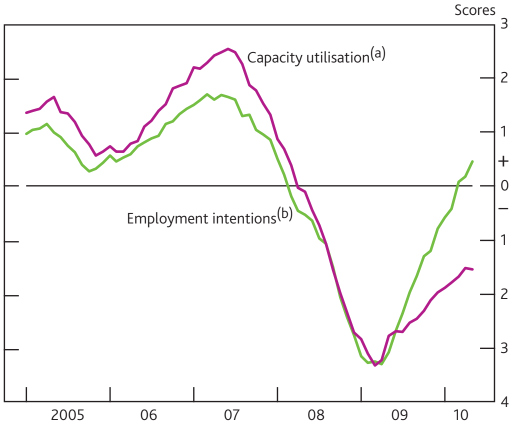
Credit conditions

On balance, the Agents continued to report a gradual easing of credit conditions. The availability of bank lending had picked up a little, and spreads on new facilities had narrowed a touch, reflecting increased competition from both domestic and foreign lenders. But, as had been the case for many months, this gradual improvement was far from uniform across contacts. For example, conditions facing smaller businesses had, in general, remained significantly tighter than those facing their larger counterparts. Demand for bank credit remained subdued, as businesses continued to repay debt and, where possible, replace bank finance with non-bank debt and equity funding.

Employment

The aggregate employment picture remained little changed in May — the Agents' contacts suggested that the majority of large private sector redundancy programmes had been completed, but increases in demand had usually been met by the restoration of hours and, where necessary, use of temporary staff. Looking ahead, private sector employment was expected to remain broadly stable over the next six months (**Chart 3**). The exceptions were concentrated in the services sector, where some major retailers expected to increase recruitment to staff new stores, and in the financial services industry, where there had been some selective hiring. In contrast to the expected stability in private sector employment, public sector headcount was expected to fall back.

Chart 3 Capacity utilisation and employment intentions



(a) Relative to normal. Manufacturing and services scores weighted together using shares of gross value added in 2005.
(b) Over the next six months. Manufacturing and services scores weighted together using employment weights derived from Workforce Jobs data.

Capacity utilisation

There remained a wide margin of spare capacity in the economy, although incremental increases in demand had led to a gradual increase in capacity utilisation in recent months (**Chart 3**). Where businesses were recruiting, they had generally experienced little difficulty in finding suitable candidates. That said, conditions in the labour market were reported to have tightened over the past six months, and some highly skilled staff, such as engineers, remained in short supply.

Costs and prices

Labour costs

Overall, pay growth remained muted, with a significant minority of contacts continuing to freeze pay. But the slight upward creep in pay growth noted over the past couple of months had continued. In general, those small increases in pay growth reflected businesses' desires to reward improved trading performance, to boost morale among those whose pay had previously been frozen, and to aid staff retention in advance of a further increase in demand. Total labour costs had risen more rapidly than pay settlements due to the restoration of hours and, in a few isolated cases, overtime.

Non-labour costs

The price of materials such as metals, oil, plastics, paper and packaging had risen significantly over the past six months, largely reflecting renewed increases in demand from emerging economies such as China. But in some cases, supply constraints had also played a role. For example, shipping costs had increased markedly since the start of 2010, as supply which had been mothballed during the recession had yet to be brought back on stream. Imported price inflation had been waning, but remained positive in recent months. In part, that reflected the immediate impact of sterling's most recent fall against the dollar on globally traded commodity prices. But it also reflected ongoing pass through of sterling's earlier depreciation into a wider range of goods.

Output prices

Overall, businesses continued to report little pricing power, with many of the Agents' contacts reporting that the significant margin of spare capacity had continued to exert downward pressure on prices (**Chart 4**). Where price increases had been achieved, they mainly reflected fuel surcharges and materials escalator clauses, which allowed businesses to pass on cost increases directly to their customers. Manufacturers were generally more likely to have raised prices than their counterparts in the services sector.

Chart 4 Output prices

Three months on same period a year earlier

Despite having limited pricing power, contacts reported that pre-tax profitability had continued to recover through 2010, largely reflecting the impact of one-off cost reductions made during 2009. But contacts noted that the recent increases in materials costs would eat into future profitability, barring some combination of further cost reductions or increases in output prices.

Consumer prices

Annual retail price inflation remained elevated, driven primarily by the restoration of the standard rate of VAT to 17.5% and higher prices of imported consumer goods. Retail petrol prices had made an increasing contribution to inflation in recent months, following earlier increases in sterling oil prices. And there had been some signs that retailers were discounting more selectively, given the lower level of stock (relative to sales) that they were carrying.