BANK OF ENGLAND

Agents' summary of business conditions

May 2010

- The pace of consumer spending growth, which had been slowing since the end of 2009, appeared to have stabilised.
- The number of homes for sale had risen, prompting a further correction in the imbalance between demand and supply in the housing market.
- Investment intentions had stabilised in recent months, and there were occasional reports of businesses planning to invest more in the year ahead.
- Exports continued to increase gently, although the pace of recovery had been constrained by weak growth in the United Kingdom's main trading partners.
- Both business services turnover and manufacturing output had continued to recover gradually.
- Output in the construction sector had begun to stabilise.
- Credit conditions remained tight, although there were further reports of a marginal improvement in the availability of bank credit.
- Employment intentions remained stable, but there were a few signs of selective plans for increased hiring during 2010.
- Pay growth remained muted, although there had been a slight increase in pay awards relative to late 2009. In most cases, those awards were aimed at rewarding performance, recognising employees' loyalty and boosting morale.
- Overall, materials costs continued to rise, in some cases sharply. Higher steel, plastic, timber and fuel prices were regularly cited as putting upward pressure on businesses' costs.
- Imported goods prices had also risen, reflecting further pass-through from sterling's depreciation.
- Retail price inflation remained elevated.

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 March 2010 and late April 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 both retail sales and consumer services turnover remained higher than a year earlier (**Chart 1**). Extracting the underlying trend in sales in recent months remained extremely difficult, however, due to: weak year-ago comparators; the restoration of the standard rate of VAT in January 2010; changes in the pattern of discounting; the inclement weather early this year; and the timing of Easter (which fell earlier in 2010 than in 2009). Looking through these factors, the Agents' sense was that retail sales growth, which had been slowing from the rates experienced towards the end of 2009, had stabilised, and that consumer services turnover had been broadly flat in recent months.

Looking ahead, retailers remained concerned about the outlook for households' disposable incomes, given the renewed rise in the prices of some essentials such as petrol, and the possibility of further tax increases and reductions in employment (particularly in the public sector).

Chart 1 Retail sales and consumer services

Three months on same period a year earlier

Housing market

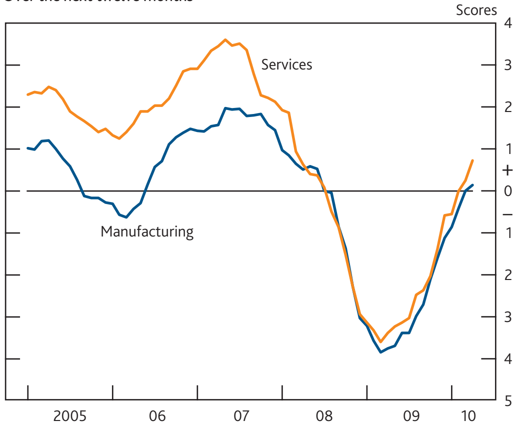
Contacts reported that the supply of secondary market properties for sale continued to increase. But restrictions on the availability of mortgage finance had continued to suppress the effective demand for houses, particularly among first-time buyers. Together, these developments had led to a further reduction in the imbalance between excess demand and insufficient supply that had opened up during 2009 in the housing market. As a result, contacts thought that house prices, which had picked up in late 2009 and early 2010, had remained little changed in recent months.

Business investment

Contacts remained cautious about increasing investment spending (**Chart 2**), primarily due to uncertainty about future demand and, for some, the tightness of credit conditions. Nonetheless, there were occasional reports of businesses

Chart 2 Business investment intentions

Over the next twelve months



planning to invest more in the year ahead. Those spending plans mainly reflected the resumption of deferred maintenance work, projects aimed at delivering lower costs, or those which would yield a rapid return. Few companies planned to invest in additional capacity, given the significant margin of slack within businesses.

Overseas trade

Contacts reported that both export and import volumes had picked up in recent months. But the pace of the recovery in exports had been constrained by weak demand in the United Kingdom's largest trading partners, and the fact that many exporters continued to use sterling's depreciation to boost their margins, rather than to increase their market share. On imports, there remained only limited signs of significant expenditure switching, which contacts largely attributed to a lack of suitable domestic alternatives.

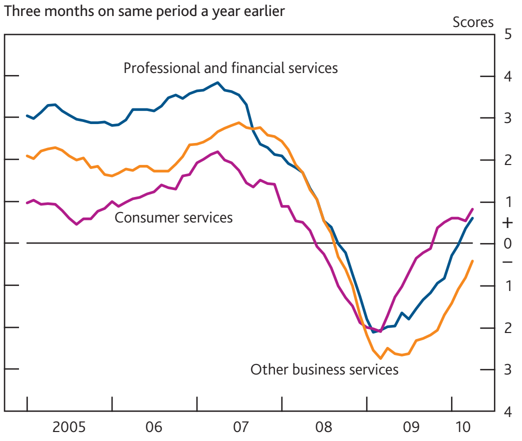
Output

Business services

The level of business services turnover remained subdued, although the gradual recovery that had emerged over the past few months had continued (**Chart 3**), and become more widespread. There had been modest increases in M&A and corporate finance activity, demand for accountancy, litigation and advertising, as well as a rise in prime commercial property investment transactions. Insolvency work had also risen, albeit by less than many had expected.

The recovery in other business services turnover, while also apparent (**Chart 3**), had been much patchier, as businesses continued to manage overheads tightly. That said, turnover in the transport and haulage sector had risen (in part reflecting increases in fuel and freight costs), notwithstanding any short-run disruption caused by the volcanic ash cloud. Spending on corporate travel and entertainment had passed its trough, and there were some tentative signs that corporate hotel bookings had also begun to rise.

Chart 3 Services output



Manufacturing

Manufacturing output had continued to rise gradually. The recovery had been driven primarily by increased export demand, although output for the domestic market also appeared to have risen. The rise in output had been quite well spread across industries, with the exception of those manufacturers supplying the construction sector, where activity remained very weak. But even in that sector, there were sporadic signs that output had reached its trough over the past month or so.

Construction

Output in the construction sector had begun to stabilise, following significant falls over much of the past two years. New homebuilding had picked up, and repair and maintenance activity had continued, in part reflecting the impact of the inclement weather earlier in the year. These developments had, however, been offset by weakness in commercial construction, where the significant oversupply of properties and limited credit availability had continued to discourage new projects. Looking ahead, contacts remained concerned about the impact of the forthcoming fiscal consolidation, given the extensive support that public projects had provided to the industry over the past year.

Credit conditions

Credit conditions remained tight, although the gentle improvement in the availability of credit, evident for much of the past six months, had continued, and spreads on new facilities had narrowed slightly. Nonetheless, experiences remained diverse — smaller businesses and those perceived to be more risky had benefited much less from the gradual increase in credit availability than their larger or less risky counterparts. And some companies operating in the property and construction sectors continued to report particular difficulty accessing bank finance.

The availability of trade credit insurance had continued to improve, although the low level of cover available, coupled with the gentle recovery in demand, had forced some businesses to take risk onto their own books. But for many companies, bad debts remained under control, and any rise had been smaller than expected at the start of the year. There had even been a few reports of reductions in the incidence of bad debts in recent months.

Demand for bank credit remained weak. Many businesses had continued to pay back bank debt, and others had been building up buffers of cash, in advance of maturing bank liabilities or in case of future adverse economic developments.

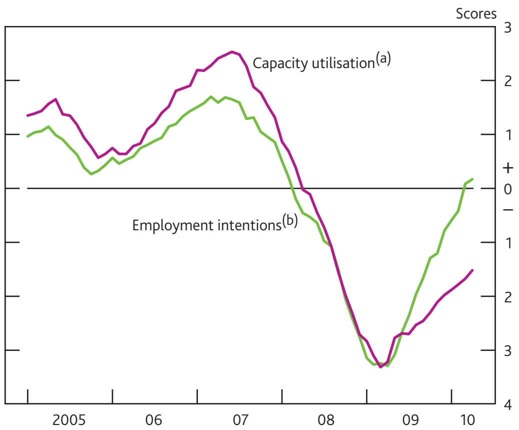
Employment

The outlook for private sector manufacturing and services employment had remained broadly stable (**Chart 4**), but there were a few signs of selective intentions to recruit in some sectors. For example, some companies in the business services sector had reinstated trainee and graduate recruitment schemes to cope with an expected increase in demand. The expected stability in much of the private sector, however, contrasted with the expected reductions in headcount in the public sector.

Capacity utilisation

There remained a significant margin of spare capacity within businesses. Although incremental increases in demand had led to a gradual increase in capacity (mainly labour) utilisation (**Chart 4**), most businesses believed that, were demand to recover rapidly, they could increase output easily without additional capital or labour. Moreover, the majority thought that, should the need arise, they would experience little difficulty increasing recruitment, given the deep pool of available labour.

Chart 4 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.

Costs and prices

Labour costs

Labour costs remained muted, with the majority of contacts either freezing pay or making small positive pay awards. There had, however, been some tentative signs that pay growth had edged higher — the proportion of contacts freezing pay was lower than reported in 2009, and more contacts had made small positive awards in order to reward improved profitability, to recognise employees' loyalty or to boost morale. Looking ahead, the significant degree of labour market slack was expected to keep pay growth contained, although a few contacts acknowledged possible upside risks should inflation remain elevated or from the prospective increase in the national minimum wage later this year.

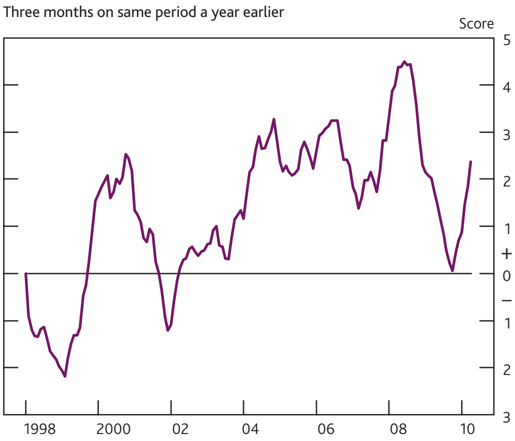
Total labour costs had picked up by slightly more than pay settlements. In part, that reflected the restoration of full-time working, higher commission payments in the business services sector and, in a few instances, the reintroduction of overtime. But it also reflected higher pension fund contributions among those companies with significant deficits.

Non-labour costs

Raw materials prices continued to rise, leading to a further increase in the Agents' scores, although these remained well below their peaks during 2008 (**Chart 5**). The pickup in prices over the past six months had primarily reflected a rise in demand from emerging economies, but some prices had also been pushed up following a reduction in global capacity during the recession. Contacts reported higher prices for steel, plastics and oil derivatives, paper and timber. In addition, the higher cost of fuel had, through an increase in the prevalence of fuel surcharges, contributed to a rise in freight and transport costs. Moreover, a number of contacts had either already faced or were expecting to face significant increases in business rates, which would further increase their overall costs. And import prices had also risen, reflecting continued pass-through of sterling's depreciation.

Not all costs had risen, however. Wholesale food prices had stabilised, or even begun to fall a little. Many businesses had renegotiated expiring energy contracts in recent months, resulting in a reduction in their utility bills. And the excess supply of commercial premises had encouraged landlords either to reduce headline rents or offer larger incentives (eg rent-free periods) to businesses, in order to prevent vacant lots.

Chart 5 Materials costs



Output prices

Although some businesses had been able to pass on cost increases via escalator clauses in customer contracts, the Agents' overall sense was that output prices remained under downward pressure. For example, services prices had continued to fall (although the pace of deflation had eased in recent months), as had prices in the construction sector, where firms continued to compete fiercely for a limited quantity of work. Overall, contacts continued to report little pricing power and, given the difficulty associated with raising prices, the majority expected higher costs to eat into profit margins.

Consumer prices

The Agents reported that retail prices continued to be boosted by the reintroduction of the standard rate of VAT, import prices and, to a lesser extent, fuel prices (via both petrol prices and higher transport and haulage costs). But the rate of inflation, which had stabilised last month, was thought to have been little changed again in April.