BANK OF ENGLAND

Agents' summary of business conditions

November 2010

- Retail sales values growth continued to ease. Consumer services turnover growth had strengthened a little, largely reflecting higher price inflation.
- Housing market activity continued to weaken.
- Investment intentions were reported to have picked up further, but prospective growth in capital expenditure was comparatively modest.
- Export growth remained robust.
- Services turnover growth had eased a little.
- Manufacturing output growth for the domestic market was little changed, and remained below that of exports.
- Construction output was broadly flat compared with last year's weak levels. There were tentative signs that homebuilding activity had softened.
- Credit conditions had continued to improve for large firms. But banks remained risk-averse with regard to their exposure to other firms.
- Private sector employment intentions were a little stronger, consistent with modest growth in the year ahead.
- The amount of spare capacity reported by contacts was little changed. While utilisation was reported to be only slightly lower than normal, many firms had scope to raise capacity quite readily should demand recover.
- Pay settlements continued to rise modestly.
- Non-labour input costs inflation had increased.
- Output price inflation was stable, with suppliers generally reporting limited pricing power.
- Retail goods price inflation was little changed. Inflation had risen further for consumer services.

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 September 2010 and late October 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.

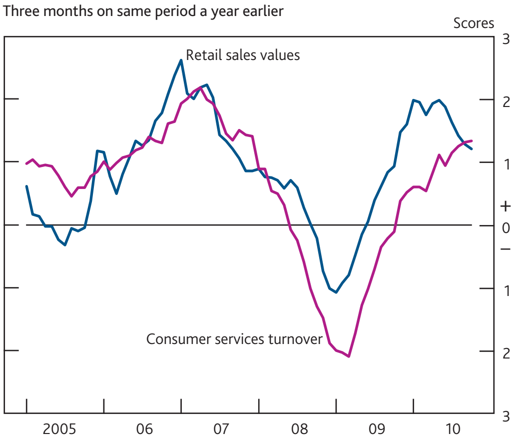
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

The Agents' score for annual retail sales growth eased lower (**Chart 1**). The uncertain economic outlook was reported to be weighing on consumer confidence, and discretionary spending on big-ticket consumer durables such as consumer electronics and homeware had waned as a result. Recent levels of private car registrations were better than dealers had expected, but nonetheless were lower than a year earlier due to the end of the government's scrappage scheme.

Chart 1 Retail sales values and consumer services turnover



Demand for consumer services continued to accelerate modestly (**Chart 1**). Hotel occupancy and air travel had increased, assisted by higher numbers of overseas tourists. But discretionary spending at pubs, restaurants and nightclubs continued to weaken in the face of declining consumer confidence.

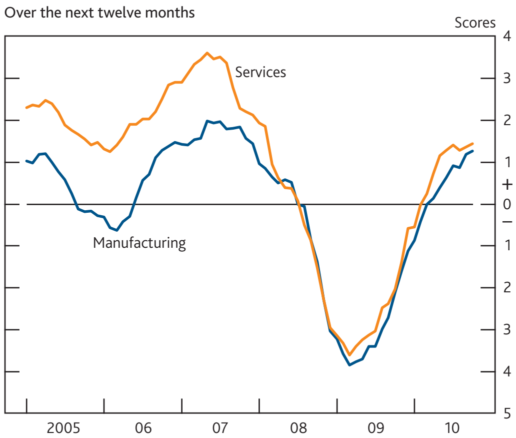
Housing market

Some contacts reported further declines in housing transactions volumes. The main cause of that slowdown was thought to be a perceived deterioration in the economic outlook. Expectations of further declines in house prices had also reduced demand for owner-occupied housing. By contrast, in the rental market demand had risen to match hitherto excess levels of housing supply and rental yields had firmed a little — especially in parts of southern England. Access to mortgage finance had improved slightly in the buy-to-let market, and investor demand for residential property had continued to rise moderately — stimulated by the low rates of return available on liquid assets.

Business investment

Both current and planned levels of investment in the service and manufacturing sectors had continued to accelerate moderately (**Chart 2**). Following measures to curtail running costs during the recession, many contacts were now benefiting from increased profitability owing to the recovery in demand in the past year. Some contacts were using surplus funds to deleverage and/or accumulate cash balances. But many others were gradually increasing capital spending. Typically, large firms were more willing to raise planned investment than small and medium-sized enterprises, and had relatively greater cash reserves to do so. National retailers (and, to a lesser extent, some financial institutions) had raised the level of capital spending on their estate of properties recently — including the construction of new stores and the refurbishment of existing premises. In most cases, however, contacts' investment decisions focused more on efficiency improvements than on expanding capacity. Ageing vehicles were being replaced due to rising maintenance costs of existing fleets; IT investment was being stepped up in part to reduce labour requirements; and commercial property was being refurbished in preference to the occupier moving to more costly premises. Looking forward, many multinational companies planned to invest surplus profits in new capacity in emerging economies.

Chart 2 Investment intentions



Exports

Growth in exports of manufactures remained robust. Following a period of sustained acceleration, the Agents reported a rather more mixed picture for exports in the past month. Many contacts reported continued buoyancy in overseas demand, particularly in emerging economies and especially for commercial aeroplanes, cars and related components. But some observed that growth had lost momentum recently. Some contacts cited the restraining influence on demand for UK manufactured goods of increasing fiscal consolidation across Europe. Others reported that the re-stocking cycle in overseas markets that had been evident earlier in the year had now run its course. Turning to the service sector, there was stronger growth in overseas demand for the professional services of UK lawyers, engineering consultants and advertising agencies. And net tourism revenues had increased on account of higher numbers of overseas tourists.

Import growth remained firm. The extent of import substitution — whereby contacts had switched from overseas to domestic suppliers — remained muted and was exceeded by the number of reports citing the unavailability of UK manufactured products.

Output

Business services

Turnover for professional and financial services continued to increase, but at a slightly slower rate than in recent months. That modest deceleration mostly reflected weaker public sector demand for various professional services, including IT and training consultants, and recruitment and advertising agencies. Overall, the Agents reported the recovery in demand remained intact, but that prospects of a more robust pickup were very uncertain in the short term. This partly reflected concerns that prospective public sector spending cuts would further restrain activity. And while some modest growth was evident recently, volumes of mergers and acquisitions and commercial property transactions (seen as important drivers of value-added in the sector) remained subdued.

Growth in demand for other business-to-business services was broadly stable. Corporate spending on entertainment, conferencing and travel — especially air travel to emerging market destinations — continued to accelerate gently, but that had been largely offset by reduced demand from public sector bodies. Spending on road haulage services had grown at a slightly quicker pace, though that mostly reflected higher output price inflation due to increasing fuel surcharges.

Manufacturing

Manufacturing output growth for the domestic market was steady, following a sustained period of recovery. There were tentative signs that a deceleration in public sector spending had started to weaken domestic demand — for example, manufacturers of defence-related capital goods reported weaker orders and the occasional cancellation of projects. By contrast, output of some intermediate goods such as chemicals (used in paint manufacturing, for example) had strengthened a little. Some contacts speculated that the much-reduced level of housing and commercial property transactions had stimulated demand for products associated with repair and maintenance.

Construction

Contacts reported broadly unchanged construction activity compared with last year's weak levels. A few private commercial projects had restarted recently, and activity in Greater London had been supported by some large projects such as the London Olympics. But there were tentative reports that homebuilders had suffered a downturn in demand recently, resulting in lower numbers of housing starts. Levels of publicly financed construction had been maintained. Going forward, the planned cuts in Government capital spending continued to weigh on confidence in the sector.

Credit conditions

There remained a substantial divergence in the credit conditions faced by contacts with robust balance sheets (often larger firms) and those experiencing either poor trading conditions or impaired balance sheets.

For some firms in the former group, access to external finance was more or less back to normal, although the cost of funds in terms of margin over Bank Rate remained somewhat elevated. Some contacts reported that bank credit was readily available. Others were increasingly able to tap equity and bond markets. Access to trade credit insurance continued to improve.

However, banks remained risk-averse when lending to firms with less robust balance sheets. Numerous reports were received of small firms having overdraft facilities either reduced or withdrawn, and instead having to access more expensive asset-backed finance (typically invoice discounting). Since those firms often already suffered from low margins, these additional costs were often onerous.

Employment

Private sector employment intentions improved a little more in the service sector, but were slightly weaker in manufacturing. The Agents' scores were consistent with positive, if only modest, employment growth in both sectors over the next year.

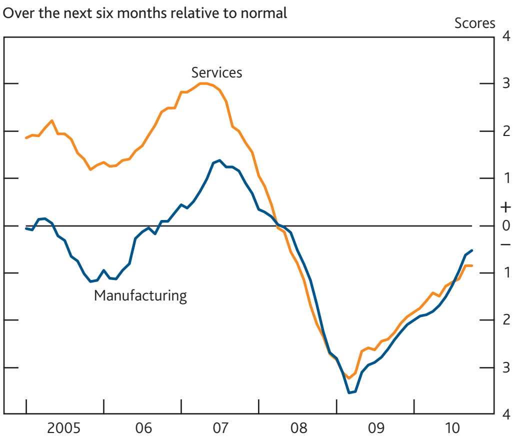
Employment prospects in the business and consumer services sectors had improved slightly. Firms in professional and financial services were recruiting, in part, to accommodate future regulatory and compliance requirements. And retailers' demand for lesser-skilled and part-time workers had risen commensurate with the net expansion of floor-space. While some major retailers were planning further labour shedding due to the weak outlook for consumer spending, overall the continued expansion of the national supermarkets held sway. Some contacts in the leisure industry had raised staffing levels due to the upturn in tourism. Manufacturers' employment intentions had weakened slightly in the face of a somewhat more subdued outlook for demand growth. Contacts had found recruiting skilled workers slightly more difficult recently.

Capacity utilisation

The amounts of spare capacity in the service and manufacturing sectors were reported to be little changed in October, having gradually reduced over the past year or so

(**Chart 3**). The Agents' scores for capacity utilisation in both sectors were now only slightly below normal. Demand had begun to recover, and many firms had reduced the quantum of resources employed during the recession, in order to better match running costs with lower revenues. Jobs had been shed, hours of work reduced (for example by employing more part-time workers), capital had been mothballed or scrapped and investment delayed, and many manufacturers had reduced the number of shifts being worked. Even so, many contacts were in a position where, should demand recover further, they could fairly quickly redeploy those underemployed resources. However, some bottlenecks had emerged during the recession that might delay this redeployment. For example, some UK supply chains had disappeared, and contacts had become more dependent on global suppliers whose prime focus was on servicing overseas markets.

Chart 3 Capacity utilisation



Costs and prices

Labour costs

Labour cost growth was steady in the service sector but had increased in manufacturing — in part reflecting that sector's comparatively stronger recovery in output this year. Those firms that had seen a marked recovery in demand and profitability during 2010 were more willing and able to award slightly higher pay settlements and bonus payments than last year, especially to their core skilled workers. Overall, the historical link between pay and RPI inflation had continued to dissipate, and companies were increasingly trying to focus pay pots on rewarding their most productive workers.

Non-labour costs

Material cost inflation had increased, but imported goods inflation had eased further. Evidence of increasing materials prices was fairly widespread. Some of the recent increases in the spot prices of metals, textiles and arable commodities had started to feed through into higher prices being paid by manufacturers. Utility costs, which until recently had been falling, were now rising again. (However, the full impact of higher spot material prices was likely to be drawn out, reflecting the frequent use of forward contracts by many firms.) But the picture was not entirely one-sided, with, for example, reports of lower price inflation for some other foodstuffs such as fruit and vegetables, reflecting bumper harvests.

The rate of inflation for imported finished goods continued to ease back from recent elevated levels. With excess global capacity still evident in many industries, contacts were able to negate some of the inflationary pressures emanating from China by re-sourcing supplies from other Far Eastern emerging economies.

Output prices

Manufacturing output price inflation was reported to be unchanged. Manufacturers had sought to recover recent increases in non-labour costs through higher output prices, but overall their customers had been largely successful in resisting most of manufacturers' proposed price rises. A case in point was the increased cost of arable foodstuffs faced by food manufacturers. Few had been successful in passing these increases on to the supermarkets. Business-to-business services prices remained slightly lower than a year earlier. Professional services fees for work related to corporate transactions and commercial property management remained under downward pressure. And charge-out rates of consultants and fees charged by some advertising agencies had softened as public sector clients increasingly negotiated discounts. By contrast, haulage prices had firmed owing to increases in fuel surcharges.

Consumer prices

Consumer goods price inflation was steady but services prices had accelerated a little further. Retail food price inflation was stable, in spite of increasing inflationary pressures in the supply chain. New car prices had fallen. Retail price inflation for clothing and footwear had increased and contacts expected further significant price increases in the coming months. Price inflation for a variety of consumer services had also increased in recent months. Household insurance premiums for motor cars had risen sharply; prices of hotel rooms and air travel had risen in response to stronger demand; and housing rents had firmed a little. But pricing had been somewhat softer for those consumer services suffering from weak demand, including restaurants and some leisure activities. The Agents continued to report that the 2011 VAT rise was likely to be passed on in full by a majority of contacts.

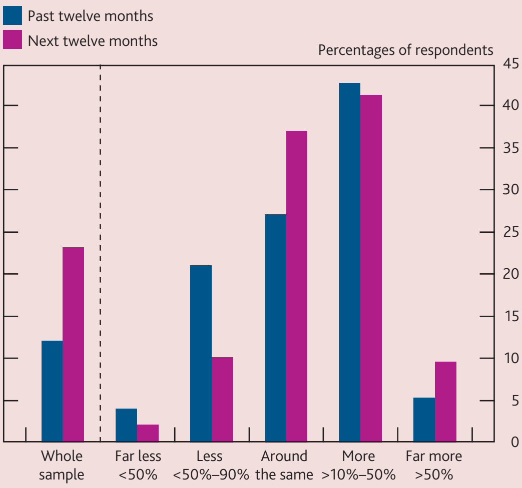
Agents' survey on capital expenditure

Following an unprecedented decline during the recession, recent ONS data have suggested that business investment began to grow again during the first half of this year.

To help to assess the likely pace of the recovery in investment, the Agents surveyed contacts' planned investment(1) levels in the coming year relative to their actual spending in the previous year; the key drivers of planned investment; and whether those plans would be reviewed in light of the HM Treasury *Spending Review*. 283 firms responded to the survey.(2)

Weighting contacts' responses by turnover, the survey results suggested that investment plans over the next twelve months were more positive than outturns had been over the past twelve months (**Chart A**). Fewer firms wished to cut capital expenditure than a year ago, and those that had increased spending over the past year planned to increase spending by more in the coming year.

Chart A Investment plans over next twelve months compared to actual spend over past twelve months

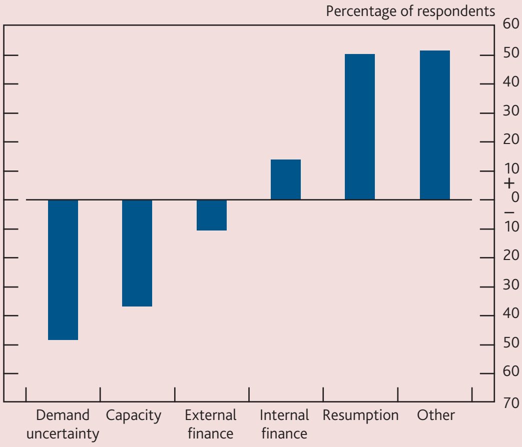


By sector, business services and construction respondents no longer intended to cut investment, and firms in manufacturing and consumer services planned to increase investment markedly. That was consistent with Agents' reports of a pickup in planned investment, particularly in manufacturing.

Small and medium-sized firms(3) were more likely to have cut investment over the past year, and larger firms to have increased investment a little. Overall, the net balance was for an increase in expenditure over the next year, although again sentiment was more positive for larger firms.

Contacts were also asked to indicate the most significant influences(4) upon their investment plans, and the direction of that influence (**Chart B**). Demand uncertainty and capacity were seen as the primary impediments to investment, particularly for firms in construction and, to a lesser degree, in business services. The overall impact of finance was broadly neutral, as the positive reported balance for internal finance roughly offset the negative balance for the cost and availability of external finance. The resumption of postponed asset replacement provided a strong positive driver of intentions. Other factors such as health and safety, regulation and addressing inefficiencies were also regarded as key influences on investment plans.

Chart B Key drivers of investment plans



Financing conditions appeared to be more of a constraint to smaller firms. The availability of internally generated funding was reported to be weighing on investment intentions for a modest net balance of firms with less than £75 million turnover. By contrast, it was cited as a positive factor for firms with turnover above that threshold. But external finance conditions remained a negative factor for all firms.

Survey responses indicated that one third of firms sampled (on an unweighted basis) intended to reappraise their investment plans in light of the *Spending Review*.

(1) Broadly comprising machinery, IT, vehicles and construction of buildings. R&D and property purchases were excluded.
(2) The survey was conducted between 8 and 20 October, in advance of the HM Treasury *Spending Review*.
(3) Firms with annual turnover of less than £100 million.
(4) Factors were: demand; capacity; external finance; internal finance; resumption of postponed asset replacement; and 'other'.