BANK OF ENGLAND

Agents' summary of business conditions

October 2010

- The Agents reported some further moderation in retail sales values growth against a background of fragile consumer confidence, but stable consumer services turnover growth.
- Housing market activity had stayed weak after the summer. House prices were expected to stabilise or fall slightly.
- Investment intentions had picked up in manufacturing, and continued to point to modest growth in services.
- Robust growth continued in exports, particularly of goods, driven by global demand.
- Services turnover continued to grow modestly.
- Manufacturing output growth for the domestic market had strengthened, but continued to grow at a slower pace than for export.
- Construction output was reported to be roughly on a par with last year's weak levels, but contacts feared a further decline in 2011.
- Credit conditions had continued to improve marginally for larger and less highly-leveraged contacts, but demand for credit remained weak.
- Private sector employment intentions had eased slightly after improving earlier in the year. Contacts remained very cautious about expanding the labour force.
- Spare capacity was reported to have fallen over recent months, particularly in manufacturing. Nonetheless, capacity utilisation remained slightly below normal.
- Pay settlements continued to rise modestly.
- Growth in non-labour input costs inflation had eased slightly.
- Output price inflation remained modestly positive year on year in manufacturing, but business services prices remained slightly below a year earlier.
- Retail goods price inflation had eased slightly, but inflation had picked up for consumer services.
- The 2011 VAT rise remained likely to be passed on in full in early January by a majority of contacts, although there were some reports of contacts planning either slightly pre-emptive or slightly delayed pass-through.

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 August 2010 and late September 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.

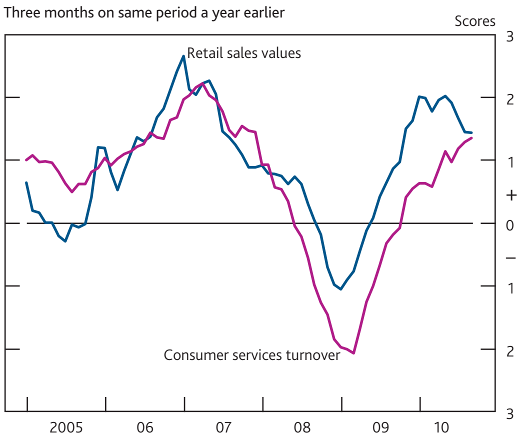
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

The Agents reported some further moderation in annual retail spending growth from its peak earlier this year (**Chart 1**). Retailers noted that consumer confidence remained fragile given uncertainty around the extent and timing of public sector spending cuts, and their impacts on disposable income. Value continued to be a key driver of demand, boosting, for example, growth in internet sales, as sales volumes and footfall in stores remained fairly flat. New car sales were reported to have continued to decline relative to a year earlier but the underlying trend was difficult to disentangle from post-scrappage effects.

Chart 1 Retail sales and consumer services



Consumer service providers (**Chart 1**) continued to see steady turnover growth. Domestic tourism had enjoyed slight further growth compared to a strong 2009. Promotional pricing remained an important driver of demand for leisure activity as spend per head continued to be restrained.

Housing market

Activity had remained weak. Weaker potential purchaser confidence, both in the macroeconomic outlook and the likely path of house prices, had started to weigh on demand, along with restricted availability of mortgages for first-time buyers. For example, some potential purchasers were deferring decisions to proceed on transactions. Most contacts expected house prices to stay flat or fall slightly in coming months, partly reflecting higher stocks of houses for sale. Rental demand remained strong as many potential first-time purchasers chose to rent instead, but robust supply growth of rental properties was limiting any increases in rents. Continuing low debt-servicing costs for some landlords had also helped to limit rent increases.

Business investment

A pickup in planned investment by manufacturers had continued on the back of growth in demand, while plans for services firms showed continuing stable but modest growth. Total investment remained below pre-recession levels but had continued to pick up through 2010, focusing on overdue replacement of ageing kit, efficiency enhancements and cost-saving through IT. A need to boost capacity was becoming a more significant driver of increased investment, mainly for manufacturing exporters.

Continuing external finance constraints meant capital spending was more likely to be funded from internal resources than it had been pre-crisis for most contacts. But these constraints were acting as less of a restraint than a year earlier as firms had built up cash balances (see box).

Exports

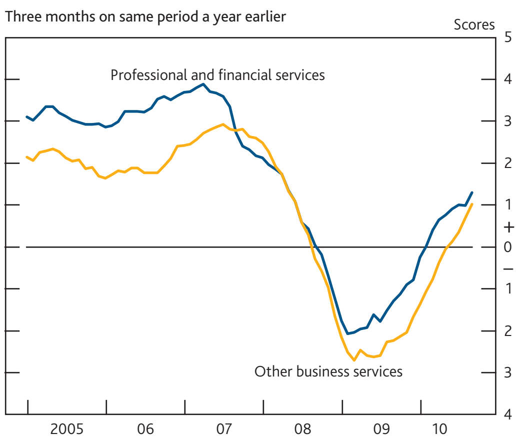
Exports continued to grow robustly, particularly of goods, with contacts citing increased global demand as the main driver. Euro-area activity remained patchy. Orders from Germany had strengthened over the past quarter, but demand from Ireland and Spain had remained weak. Reports on exports to the United States were mixed, but demand from emerging markets remained strong, for example growing in professional services such as those related to engineering. Inward tourism and higher education intakes to UK colleges and universities also looked reasonably strong this year.

Output

Business services

The Agents' scores for turnover of both professional and financial services and other business services firms increased modestly. Pricing remained under downward pressure for professional and financial services firms, implying a slightly stronger recovery in volumes than implied by turnover (**Chart 2**). But the impact of tightening public sector spending continued to be a concern for many contacts in the sector. Financial services providers reported a slight increase in commercial transaction income, but contacts in property saw a continuing weak market with oversupply and little new build.

Chart 2 Services turnover

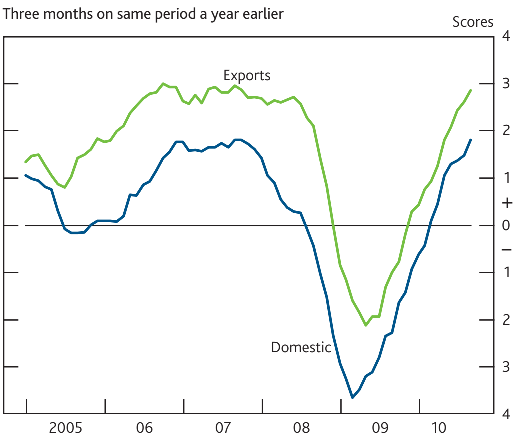


There were signs of demand picking up for other business services firms, in areas such as business travel and road haulage, the latter partly reflecting manufacturing output growth. But many companies continued to keep a tight rein on such costs, particularly on items such as hospitality and conferencing, where private sector demand was recovering only very slowly from prior year lows. And public sector demand had started to ease over the summer, with further declines expected.

Manufacturing

Agents' reports this month pointed to strengthening output growth for the domestic market, assisted by export-led supply chain demand (**Chart 3**). A small but increasing number of manufacturing exporters noted that output was back on a par with pre-recession levels, although for most manufacturers there remained a marked, albeit narrowing shortfall. And the pickup in output for domestic markets remained less consistent than that seen by exporters. There was concern about the impact of government spending cuts starting to impact future orders in subsectors with greater exposure such as defence and construction.

Chart 3 Manufacturing output



Construction

Activity in the construction sector was reported to be roughly on a par with last year's weak levels. But contacts in the sector generally had a more pessimistic outlook than for other sectors for 2011. Public sector work had started to edge down, and contacts felt the decline would accelerate in 2011, with new orders unlikely to replace current work running off. Tight finance conditions for companies linked to the sector remained a constraint for many contacts.

Credit conditions

Credit conditions continued to improve marginally but not uniformly, and terms and conditions enjoyed by borrowers remained tighter than pre-crisis levels. Availability and terms of credit were improving for (mainly larger) companies outside property and construction with lower levels of debt. But credit for SMEs generally remained difficult, although an improvement in trade credit insurance terms was assisting cash flow. Competition for new business among banks remained low. Demand for credit continued to be weak, focusing mainly on refinancing, so net lending growth was also weak (see box).

Employment

Private sector employment intentions had eased slightly after improving earlier in the year. Of those expanding, most preferred to use temporary rather than permanent recruitment, given caution about future demand prospects, and citing the need to maintain strict control over future labour costs. Contacts that had held on to labour during the downturn felt able to cope with rising demand with little additional headcount, mainly through increased productivity. Public sector headcount had only fallen slightly to date but the rate of reduction was expected to accelerate through 2011–12. Recruitment difficulties remained lower than normal.

Capacity utilisation

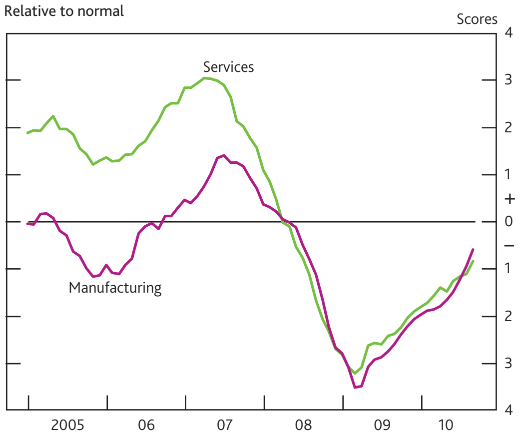
Spare capacity was reported to have tightened over recent months, particularly in manufacturing. Nonetheless, capacity utilisation remained slightly below normal (**Chart 4**). The tightening was greatest for exporters and their suppliers on the back of a strong pickup in external demand. Some manufacturing investment was therefore directed towards capacity expansion. But operations that formed part of multinational groups also noted that in many cases increases in demand could currently be met by European sister plants, which had greater spare capacity. There were reports of pockets of capacity shortfalls in supply chains in the Far East in electronic and power components, causing longer lead times on some parts. Contacts expected such issues to improve by early 2011 as capacity was brought back on stream. Service sector contacts saw slower reduction in slack, and consequently less need to invest in capacity than their counterparts in manufacturing.

Costs and prices

Labour costs

Pay settlements continued to rise modestly, as company profitability and productivity recovered. Some contacts had wished to acknowledge their workforces' understanding, following a period of pay freezes and shorter working hours, by awarding pay increases, albeit modest ones. Pay freezes continued but were diminishing in number in the private sector. A growing number of companies were opting for salary increases for some members of staff rather than across the

Chart 4 Capacity utilisation



board pay rises, to reduce growth in total labour costs in the face of uncertainty about growth prospects. Few contacts were budgeting for a marked increase in pay settlements due early 2011 to reflect RPI. Employees remained less likely to move to other employers than pre-recession, and pay freezes and/or headcount reductions in the public sector were dampening private sector pay expectations. The 2.2% increase in the National Minimum Wage in October was only expected to create limited upward pressure on other employees' pay.

Non-labour costs

There was further evidence this month that growth in material cost and imported finished goods inflation had eased slightly, although costs remained higher than a year earlier. Concern remained about the near-term outlook for imported component costs given pressures on capacity and production costs in Asia, and weather-related price shocks to commodities such as wheat and cotton. The recent appreciation of sterling had helped dampen cost increases a little for some, but hedging had delayed the benefit for others.

The cost of imported finished goods also remained higher than a year earlier but the pace of growth had slowed. This was mainly due to the effect of sterling appreciation offsetting some underlying cost pressures.

Output prices

Manufacturing output prices were broadly unchanged over the past three months, and slightly up on a year earlier. Contacts were achieving a little more pass-through of cost inflation than a year ago or were resisting decreases in their prices with greater success, but there was a range of views on the future direction of prices. Services prices remained slightly down on last year, and flat over the past quarter. Profitability in both manufacturing and services was ahead of last year due to volume growth and tight cost control but margin growth had faltered a little. Construction margins were under pressure in the face of rising material costs and intense competition to replenish thinning forward pipelines of work.

Consumer prices

Retail goods price inflation had eased slightly, but inflation had picked up for consumer services. Underlying cost increases in commodities such as wheat and cotton had yet to feed through into higher retail goods prices but were of concern to retailers. Reports of increases in new car prices had become less common than earlier in the year. Within consumer services, price inflation had picked up. Insurance premiums were up significantly, in both home and motor cover; hotels and restaurants were passing on some food cost increases; and airline travel and ancillary charges had risen.

The 2011 VAT rise was likely to be passed on in full in early January by a majority of contacts. However, a sizable minority was planning to pass through the rise only by mid-February, and a smaller number were considering an earlier pass-through during 2010 Q4.

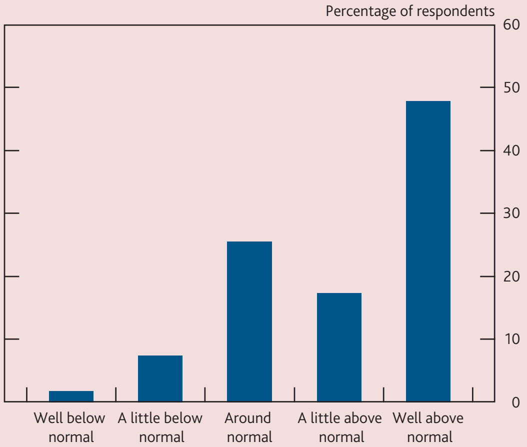
Agents' survey on cash holdings

According to official data, the aggregate financial surplus[1] of UK corporates was relatively high going into the recession and rose further during the recession. An assessment of the prospects for corporate spending, eg on capital investment, stocks and debt repayment, depends in part on whether the corporate surplus (and rise in saving) was planned or unplanned, and if planned what factors drove it.

To investigate this further, the Agents asked contacts about the current level of their cash holdings[2] relative to 'normal', the changes to those holdings over the past year and those planned for next year, and the reasons behind those changes. Around 440 businesses responded to the survey. All figures shown are weighted by turnover.

The survey results suggested that a significant majority of firms had cash holdings above 'normal' (**Chart A**). Larger firms[3] were much more likely to report cash balances well above 'normal', while other firms tended to report average balances only a little above normal.

Chart A How would you describe your current cash holdings?

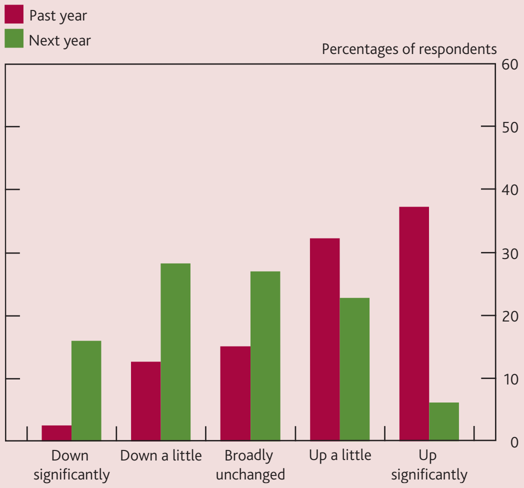


The results also suggested that the majority of firms had increased their cash holdings over the past year (**Chart B**), in many cases significantly, consistent with the picture shown by the official financial balance data.

Firms in all sectors reported that holdings had risen over the past year, with manufacturing contacts reporting the largest rise.

Higher profits were the most frequently cited reason by contacts to explain the rise in cash holdings over the past year. Firms had also chosen to build up larger 'buffers' of cash to protect themselves against uncertainty, for example in demand conditions and credit availability.

Chart B Changes in cash holdings



The results also suggested that a small net balance of firms were planning to reduce their cash holdings over the next year (**Chart B**), despite expecting on average a positive contribution from profits. A significant minority reported plans to increase holdings.

A small net balance of larger firms were expecting to reduce their cash balances a little over the next year, whereas on average smaller firms were expecting to maintain holdings around current levels.

Firms operating in the manufacturing sector were expecting to maintain their higher balances over the next year: firms in other sectors were expecting to reduce their balances.

Some contacts reported that the small reduction in cash holdings planned over the next year reflected their expectations for a modest increase in investment financed from cash. That was consistent with Agents' reports of a pickup in planned investment, in particular by manufacturers. Other contacts cited debt repayment as a factor likely to reduce cash holdings; and it was possible that M&A activity might increase.

(1) Alternatively defined as: savings minus investment; or the accumulation of assets less liabilities.
(2) Net cash balances, short-term deposits (up to a year) and committed (but undrawn) overdraft facilities.
(3) Firms with annual turnover of at least £100 million.