BANK OF ENGLAND

Agents' summary of business conditions

September 2010

- The Agents reported a further softening in the pace of retail sales values growth. By contrast, consumer services turnover growth remained steady.
- Investment intentions remained little changed on the month. Overall, intentions are consistent with a gradual, rather than robust, pickup in spending.
- Export growth had picked up further. The rise in exports since early 2010 had mainly reflected strengthening world demand, although the lagged effect of the lower level of sterling had played an increasingly important role in recent months.
- Services turnover continued to rise modestly.
- The widespread pickup in manufacturing output had continued, reflecting stronger exports but also a rise in domestic demand.
- Construction output remained well below its level a year earlier.
- Credit conditions had become increasingly polarised in recent months, easing for those firms perceived to be better-quality credits, but remaining tight for many smaller firms, and those operating in certain sectors.
- Private sector employment intentions had been rising modestly in recent months, but contacts expected that improvement to be offset by cuts in public sector headcount.
- Pay settlements had been edging higher throughout 2010, although they remained moderate overall.
- Non-labour input costs continued to rise, but there were tentative signs that the annual inflation rate might have passed its peak.
- Contacts continued to report little pricing power. Output price inflation remained muted.
- Consumer price inflation appeared to have stabilised in recent months.
- The majority of contacts expected to pass on the 2011 VAT rise in full in January.

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 July 2010 and late August 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.

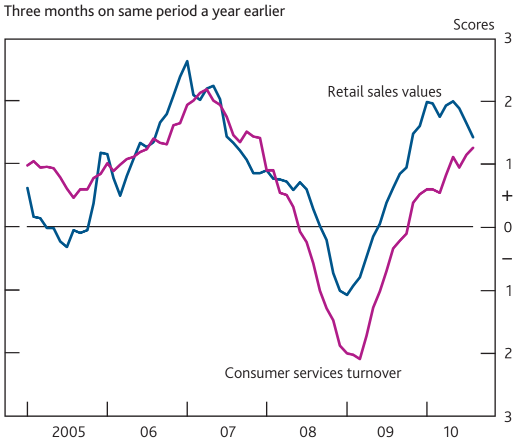
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

The Agents reported further signs of softening in retail spending, prompting a further reduction in the Agents' score for retail sales values growth (**Chart 1**). Retailers reported that consumer confidence had ebbed in recent months, which many ascribed to concerns about future employment prospects, in part given the public sector spending plans in the *Budget*. That had led to a decline in footfall and, together with a continued focus on value and promotional activity, a reduction in spending growth. Spending on big-ticket items such as furniture had been weak, and private new car registrations had fallen markedly in the past month or two.

Chart 1 Retail sales and consumer services



Consumer services providers, by contrast, appeared to have fared better than retailers in recent months, with many reports of steady, if not slightly higher, spending. The Agents' score, which reflects annual turnover growth, ticked up further (**Chart 1**). Hotel occupancy had risen, although lower prices meant that businesses' turnover had not improved as much. And although contacts in the domestic tourism sector reported that turnover had been a little lower than a year earlier, they acknowledged that 2009 had been an unusually good year for the industry, such that the year-on-year comparison belied the resilience of demand in recent quarters. Indeed, recent reports continued to suggest that UK residents had substituted away from foreign holidays, given the lower level of sterling and some lingering concerns about disruption to air travel.

Housing market

There were mixed reports on housing market activity, with reports of increased sales and viewings broadly offset by reports of declines. But looking ahead, most estate agents expected prices to fall over the remainder of the year. For many that reflected the combination of weak demand (reflecting restrictions on mortgage finance, consumer uncertainty and lower confidence) as well as an increase in supply of properties for sale (in part following the suspension of Home Information Packs in England and Wales).

Business investment

The Agents' scores on investment intentions remained broadly stable over the past three months. Many contacts planned to increase capital expenditure over the next year, but increases would be gradual, and from a very low base. Many spending plans remained focused on improving efficiency and replacing assets whose lives had been extended during the downturn. But some export contacts reported plans to invest in additional capacity and equipment, following strong increases in demand over the past nine months or so.

The main impediment to firmer investment plans remained uncertainty about the economic outlook, and about how cuts in public sector spending will affect demand. For some, the limited availability of affordable bank credit was also weighing on investment intentions, although some businesses expected to finance investment using cash reserves.

Exports

Export growth continued to pick up in August. Much of the recovery in exports during 2010 had reflected increases in world demand, driven primarily by rapid growth in emerging market economies. But prospects for the euro area appeared to have improved over the past month or so. And while reports in early 2010 had suggested that the lower level of sterling had done little to boost export volumes, more recent reports suggested that a growing number of businesses had actively sought new trade opportunities. Some contacts had also won business due to their ability to deliver goods and services quickly. Contacts reported that the recent appreciation of sterling had not, as yet, affected trade flows.

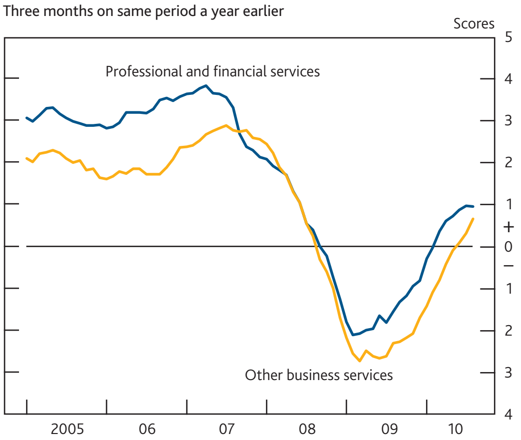
Output

Business services

The Agents reported that turnover in the professional and financial services sector had continued to rise, although the pace of growth remained modest (**Chart 2**). But with many professional and financial fees and charges remaining below their levels a year ago, four-quarter growth in volumes would have been stronger than the Agents' turnover scores suggest. Demand for IT services had been robust, reflecting in part the focus of many businesses' investment spending. Demand for litigation services had also picked up, as had demand for financial services, including corporate restructuring and mergers and acquisitions (albeit from a low base).

Turnover in the other business services sector continued to recover (**Chart 2**), although many contacts, including hoteliers and event organisers, reported that a pickup in private sector demand was being offset by a reduction in spending by public

Chart 2 Services turnover



sector bodies, who had been cancelling events or trading down to economise on costs.

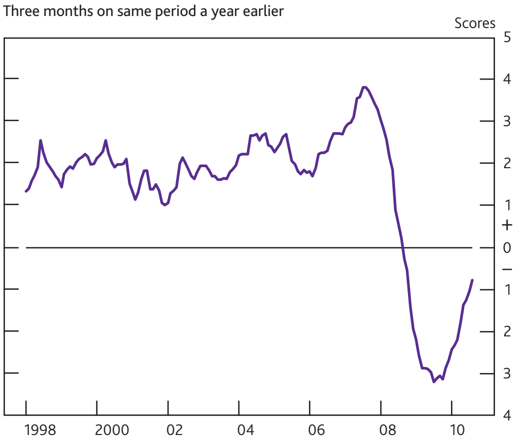
Manufacturing

The Agents reported that the manufacturing sector remained the most buoyant part of the economy. Output had continued to rise, mainly off the back of a strong recovery in export demand during 2010 H1. But output for the domestic market had also risen somewhat. The pickup in output had been quite widespread, with the automotive, food processing and packaging, and chemicals sectors performing well. Suppliers to the construction sector, however, continued to report weak demand for their products.

Construction

Contacts generally acknowledged that the extreme weather had disrupted construction activity early in 2010, leading to some volatility in the quarterly profile of construction growth. But the Agents' contacts reported that the level of output had risen only a little in recent months, and remained well below its level a year earlier (**Chart 3**). Contacts remained pessimistic about the outlook for the sector, with many citing concerns about the impact of cuts in public sector spending on demand over the coming year or so.

Chart 3 Construction output



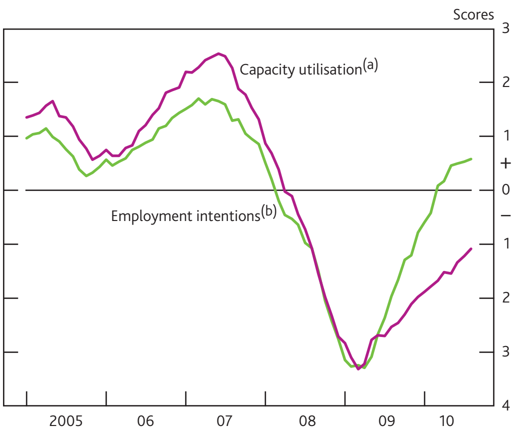
Credit conditions

Overall, credit conditions had remained tight, but the lending market had become increasingly polarised in recent months. Smaller businesses, and those operating in the construction and property sectors, continued to report difficulty in accessing affordable finance. For these businesses, fees and spreads remained significantly higher than pre-crisis levels, and there had been little improvement since the start of the year. By contrast, larger businesses and those perceived by banks as stronger propositions had seen a gradual improvement in both the cost and the availability of bank funds through 2010. But those businesses tended to have little appetite for increased bank borrowing, focusing instead on paying down debts and accumulating cash reserves.

Employment

There had been further reports of modest rises in private sector employment intentions in August (**Chart 4**). Although most companies planned to make further use of temporary staff, some had increased their plans for full-time recruitment, and others had resumed their graduate recruitment and apprenticeship programmes. The strongest recruitment intentions were concentrated among exporting manufacturers, but there had also been some reports of planned hiring in the retail and homebuilding sectors. Overall, however, the modest rise in private sector recruitment intentions continued to be offset by expected cuts in public sector headcount.

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.

Capacity utilisation

Most contacts continued to report significant spare capacity (**Chart 4**). But utilisation of capital and (particularly) labour had risen gradually through 2010, and reports of some pinch points in certain sectors, noted last month, had persisted. For example, the availability of both containers and container vessels remained limited, prompting lengthening lead times on some imported goods. And contacts in the automotive and electronics sectors continued to report that they were operating at close to, or in some cases at, full capacity. For some, that had reflected the pickup in output and exports, although others noted that reductions in overseas capacity, both in Europe and in Asia, had also led to a rise in orders from UK sites.

Costs and prices

Labour costs

The Agents reported that pay settlements, which had been edging higher throughout 2010, had continued to rise. Although some businesses had continued to freeze pay, the Agents had frequently received reports of private sector settlements of 1%–3% over the past month or so. Much of the rise in pay awards had been attributed to businesses rewarding employees' forbearance following a couple of years of pay freezes. But it also reflected improved trading performance, particularly in the manufacturing sector, where exporters had benefited from a more rapid rise in demand than their domestically orientated counterparts. Looking ahead, some contacts noted that prospects for pay and employment in the public sector were likely to help private sector contacts keep pay growth in check. Elevated rates of consumer price inflation had not, as yet, had a noticeable impact on pay growth.

Total labour costs had been rising faster than basic pay for a number of months now, reflecting increasing contributions to businesses' defined benefit pension schemes, as well as increases in bonuses and commissions following the improvement in activity during H1.

Non-labour costs

The prices of a number of raw materials, including steel, timber, cotton and paper, had risen very significantly over the past year. Those prices had all continued to rise this month, although there were some signs that annual materials cost inflation had peaked. Oil and fuel prices had retreated from their recent peaks, and reports of increases in shipping rates were balanced by reports of declines. Contacts also continued to report reductions in commercial rents, which continued to be suppressed by a significant overhang of empty commercial premises. The rise in wheat prices had not, as yet, led to significant increases in livestock feed or food prices. Indeed some contacts noted that any pass-through would be delayed due to existing hedging contracts, although others expressed concerns that increases in these food commodity prices might feed through to higher consumer prices later in the year.

Imported finished goods price inflation had eased back, although the Agents continued to hear reports of upward pressure on prices from capacity constraints in emerging economies. Some contacts continued to report upward pressure on costs from the lower level of sterling, but others reported that cost pressures had abated a little following the most recent exchange rate appreciation.

Output prices

Manufacturing output price inflation remained positive, although there had been tentative signs that it had begun to ease back. Professional services prices remained under pressure from spare capacity and intense competition — the Agents, on balance, judged that fees and charges remained slightly below their levels a year earlier. Construction output prices remained weak, with frequent reports of businesses bidding for work at, or below, cost in an attempt to win contracts. Across the economy, there had been reports that the public sector had been pushing to renegotiate contracts, in a bid to reduce government expenditure.

Consumer prices

The Agents' reports suggested that consumer price inflation had stabilised in recent months. Reports in August suggested that both new car prices and motor insurance premia had picked up. But set against that, used car prices had resumed their downwards trend, and hotel rates had continued to fall. Food price inflation had also eased back, despite increases in prices of commodities such as wheat and coffee.

Looking ahead, the Agents' reports suggested that the majority of retail and consumer services contacts intended to pass on the 2011 VAT rise in full in early January. But many businesses stressed the importance of key pricing points, with a number reporting that they were likely to re-engineer their products (ie reduce the quantity/quality provided) rather than change their prices.