BANK OF ENGLAND

Agents' summary of business conditions

August 2011

- The growth rate of nominal spending on consumer goods and services remained weak.
- Activity in the housing market continued to be subdued, and was thought to have fallen further in some areas.
- Firms planned further investment to find efficiencies and in some cases build capacity, but the growth rate of capital spending was expected to level off.
- The Agents' score for growth in goods exports had fallen back somewhat from recent highs.
- There had been a slowing in the pace of growth of manufacturing output, reflecting softening domestic demand as well as the slight moderation in export growth.
- Turnover in business services was growing at a modest pace, as rising private sector activity offset slowing public sector work.
- The gradual pace of growth in construction continued, but a marked fall in new public sector orders was beginning to be felt.
- Contacts in manufacturing and business services were planning further modest increases in employment over the next year, while consumer-facing businesses planned to keep headcount broadly flat.
- Capacity utilisation was around normal in manufacturing. Services firms typically reported some degree of slack.
- The annual rate of labour cost growth continued at around 2%–3% in both manufacturing and services. Upward pressure appeared relatively more muted in the latter.
- Inflation in raw materials costs remained high but was thought to have been slowing. But many contacts would not feel the full impact of higher energy prices until contracts were renewed later in the year.
- Elevated inflation in the price of imported finished goods continued to be boosted by increases in materials costs, wages in emerging markets, and transport costs.
- Output price inflation remained high as rising materials and import costs were passed on, albeit only partially.
- Consumer goods and services price inflation remained high.

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 June 2011 and late July 2011.
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 pattern of weak nominal retail sales growth continued. Discounting was often required to drive sales, with an increasing number of contacts reporting that promotions were now used almost year round. Unexpectedly weak demand had generated an overhang of stocks, and in order to clear inventory, summer sales had begun earlier, and were expected to be deeper than usual. Spending on food and other essentials remained the strongest part of consumption, while demand for discretionary items, especially durables, was weaker. The low level of activity in the housing market was weighing on demand for furniture and electrical goods, with households only purchasing replacements as needed. Changes in market share continued, with high streets losing ground to destination shopping centres, discount stores and the internet. And spending had become increasingly volatile and spikes around pay days more marked.

The growth rate of turnover in consumer services also remained weak. Growth in spending on non-discretionary services was relatively steady, in large part due to increases in prices. The cost of rental accommodation had gone up and there had been a rise in the prices of telecommunications, insurance and transport. The last of these had also benefited from a rise in passenger numbers, reflecting households' efforts to reduce their use of private vehicles. The increase in the price of non-discretionary services had squeezed the amount of disposable income left for households to spend on non-essentials, such as visits to pubs and restaurants. But domestic tourism had benefitted from a switch away from holidays abroad, along with an increase in foreign visitor numbers. And hotels and leisure attractions reported some resilience in demand.

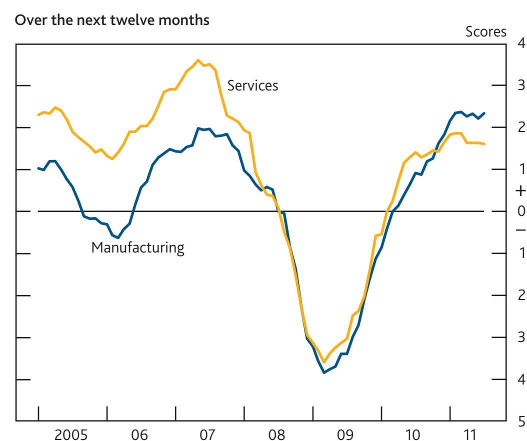
Housing market

The level of activity in the housing market remained subdued, and had softened further in some areas. London continued to be a notable exception, partly due to foreign demand. There were a number of reports of an increase in caution among prospective buyers, and of a rise in the number of mortgages being withdrawn at a late stage in the transactions process. According to contacts, this had led to more frequent instances of housing chains having broken down. First-time buyers continued to find it difficult to secure funding. But weak demand from would-be owner-occupiers had supported rents in the lettings market, which continued to attract buy-to-let investors.

Business investment

Investment intentions in the manufacturing sector continued to point to steady growth in spending on new capital, particularly among exporters and those supplying them (**Chart 1**). Firms' investment plans primarily reflected ongoing efforts to find efficiencies and lower costs, as well as some expansion of capacity in areas where demand was growing strongly. Rising energy costs had stimulated increased investment in renewables and energy efficiency. But uncertainty was weighing heavily on the plans of producers of some consumer goods, especially durables. The pace of investment growth in the service sector was expected to be slower than in manufacturing (**Chart 1**). And there were signs of a slight softening in intentions over the past few months, particularly among consumer-facing firms. But many other businesses were investing in IT to try to lower costs, or to comply with regulatory requirements, particularly in the financial sector. And there were continuing reports of the resumption of investment projects that had been deferred during the recession.

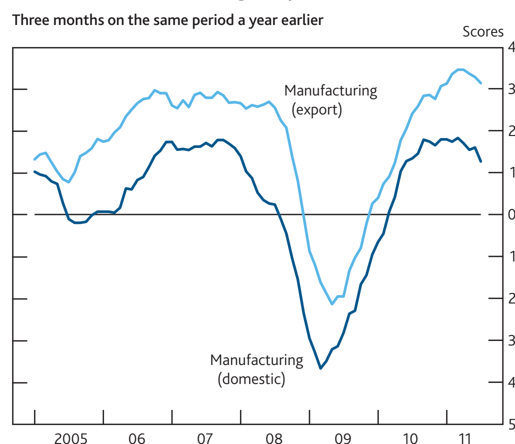
Chart 1 Investment intentions



Exports and imports

The Agents' score for manufacturing export growth had fallen back from recent highs, but still pointed to a rapid pace of expansion (**Chart 2**). Demand continued to grow strongly in emerging markets, and that was increasingly extending to luxury consumer goods, having previously been focused primarily on investment goods. And exports to Germany and the United States were also growing steadily. But exports of cars remained below normal as a result of a fall in the

Chart 2 Manufacturing output



availability of certain components sourced from Japan. And orders from countries most affected by tensions in sovereign debt markets were weakening. There had also been a small drag on activity arising from political tensions in the Middle East, particularly for exporters of goods and services in the construction and business consultancy sectors.

Output

Business services

The picture of overall modest growth in professional and financial services persisted. Public sector work had slowed, but private sector activity had more than offset this, driven in large part by mergers and acquisitions, with a growing number of deals in the pipeline. Firms seeking guidance on strategic positioning or hoping to expand market share had also been supporting advisory work. Energy consultancy had picked up as firms sought advice on how to reduce their costs. And IT companies continued to benefit from firms' efforts to find efficiencies and to be compliant with rising regulatory requirements

There had been a gradual increase in the level of turnover in other business services, in part due to the pass-through of higher fuel costs in transport and logistics. And there continued to be spillovers for firms supplying services to the manufacturing sector. But distribution companies reported some slowing in activity, mirrored by increased demand for warehousing as retailers adjusted to unexpectedly high stock levels. Corporate travel, hospitality and conferencing had seen some growth in work for the private sector, but contracts with the public sector were dwindling in number.

Manufacturing

Manufacturing activity continued to grow at a moderate pace, bolstered by production of intermediate and capital goods for the export sector, but the Agents' score indicated a slowing in recent months (**Chart 2**). That reflected both weakening output for the domestic market, as well as the slight slowing in the pace of export growth. But reports of disruptions to supply chains arising from the natural disaster in Japan were becoming less frequent, suggesting that the peak impact on output had passed. Some contacts exposed to the public sector had seen a fall in procurement, with defence orders particularly affected, and signs of cuts and delays in projects related to health and education.

Construction

Construction output appeared to be rising gradually, supported by some sizeable infrastructure and energy related projects, along with several large commercial developments in London, and activity related to the Olympics. There had also been some increase in residential construction, although there were signs of a loss of momentum, reflecting softening conditions in the housing market. Large firms with agreements with the public sector had seen activity hold up slightly better than expected. But there had been a marked fall in new orders from the public sector, and that was beginning to be felt. As big contracts became scarcer, smaller companies were experiencing increased competition from large firms for work on small-scale extension and maintenance projects.

Credit conditions

Large firms reported that they were able to access bank finance at reasonable terms. And contacts had perceived an intensification of competition among banks for the business of the most creditworthy borrowers. Credit conditions were also improving for some medium-sized companies with strong balance sheets, particularly if they were content to use asset-backed forms of finance. But small companies, with weak cash flow or relatively little collateral, still found borrowing terms prohibitive. There had recently been some signs of an easing in credit conditions due to the return of venture capital funds and non-bank providers of asset-backed finance. But some contacts reported that trade credit had become more difficult to obtain, particularly for suppliers to the retail and construction sectors.

Employment

Private sector employment intentions pointed to further modest job creation over the coming year, although there had been a dip in the Agents' scores across sectors. Intentions remained strong in manufacturing, particularly among exporters. But the anticipated rate of employment growth appeared to have levelled off in recent months, as expectations about the durability of the recovery, especially in the domestic market, had been revised down a little. In business services, intentions pointed to a continued gradual increase in headcount, although at a pace that was well below pre-recession levels, held back in part by expectations of ongoing weakness in public sector activity. The Agents' score for employment intentions in the consumer-facing sector had been falling for several months, and suggested that there would be little or no growth in jobs over the next year.

Capacity utilisation

The degree of spare capacity remained around normal in the manufacturing sector. Exporters, in particular, tended to report having the least scope to accommodate further increases in demand, although some investment in additional capacity was now coming on stream. Firms facing the domestic market were less likely to be working at full capacity. And some contacts reported that they would be able to meet extra demand by changing shift patterns, but were reluctant to do so while domestic demand conditions remained uncertain. And some suppliers to the consumer sector had seen capacity utilisation fall in recent months, as demand had weakened. In the service sector, there continued to be significant spare

capacity, although it was declining in some professional and financial services hotspots. Some contacts reported a fall in labour productivity due to the increased effort required to secure new business, as well as to comply with rising regulatory requirements. And while these developments had kept staff busy, in certain sectors there was often a sense of 'too many firms chasing the same work', pointing to generalised overcapacity in that particular line of business.

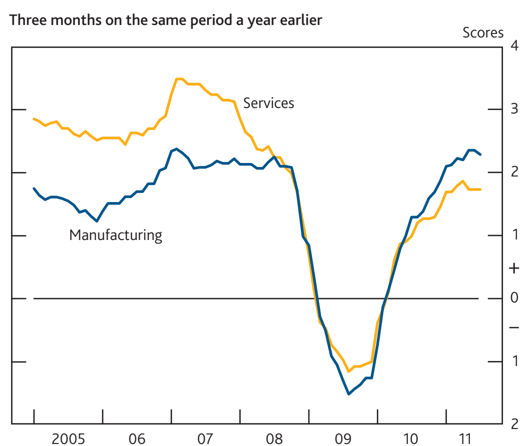
Costs and prices

Labour costs

The Agents' scores suggested that total labour costs would continue to grow at a fairly moderate pace in both manufacturing and services (**Chart 3**). Settlements were typically between 2% and 3%, with upward pressure from overtime and changing shift patterns in manufacturing beginning to abate as working arrangements normalised. Across sectors the link between settlements and retail prices continued to weaken. And many firms were abandoning across-the-board increases in favour of merit awards based on individual performance. Private sector unions were generally reported as having taken a pragmatic approach to such changes. Across sectors, contacts reported concerns about the Agency Working Regulations, due to become effective at the beginning of October, which some firms felt would raise labour costs and lower employment.

Chart 3 Total labour costs per employee

Three months on the same period a year earlier

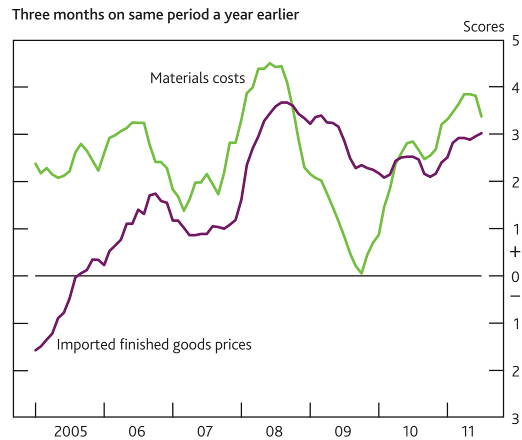


Non-labour costs

According to contacts, non-labour costs continued to rise at a rapid pace, but upward pressures had begun to moderate across a range of materials (**Chart 4**). And the rate of inflation was expected to continue to fall back from recent peaks over the second half of the year. That said, a number of contacts still anticipated sharp rises in energy bills as fixed-term contracts came up for renewal. The price of imports of finished goods continued to rise quickly, reflecting a number of factors: pass-through of higher commodity prices; wage inflation in many emerging markets, especially China; and higher transport costs (**Chart 4**). Some contacts believed that these forces would keep import price inflation elevated in the near term.

Chart 4 Material costs and imported finished goods prices

Three months on same period a year earlier



Output prices

Manufacturing output prices continued to grow as firms sought to pass on higher costs. But contacts were typically only able to pass on some of the increase. Greatest pass-through was generally achieved in export markets, with firms dependent on the domestic consumer least able to pass on higher costs. Manufacturers of materials used in the construction sector were also largely unable to pass on cost increases. Business services output prices had risen a little compared with a year earlier. The use of escalator clauses had enabled some transport and logistics firms to pass on higher fuel costs, although these were sometimes resisted. Some specialist professional and financial services companies had achieved a rise in rates, but prices of standardised services remained under considerable downward pressure due to fierce competition.

Consumer prices

Annual retail goods price inflation remained elevated, on the back of the rise in VAT at the start of the year, and increases in the cost of food and imported finished goods. Further price rises for clothing were expected during the autumn as new product lines came into the shops, but upward cost pressures were expected to begin to abate in time for next spring. Stock overhang of clothing and big-ticket items had led most stores to start summer sales earlier than usual, with discounts deeper and across a wider range of goods than usual. In food retail, there were also some signs of a move towards straight price discounting, rather than multi-buy promotions.

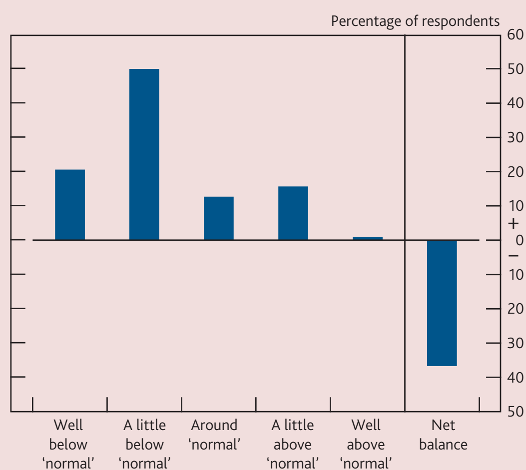
The pace of consumer services price inflation also remained fairly robust, especially for essentials, such as car insurance, and for services with a high energy or commodity content. Inflation in the price of discretionary services, such as meals out, leisure and tourism, had been much weaker, and promotional activity was widespread.

Agents' survey on corporate profit margins

The evolution of firms' profit margins is a significant influence on the path of inflation. To try to ascertain the likely path of profit margins over the coming year, the Agents asked contacts about: the level of current profit margins — given by revenues less costs as a percentage of revenues — compared with 'normal'; the change in margins over the past year; and the expected change in margins over the coming year. 246 firms responded, with a combined turnover of over £51 billion. The charts below are all weighted by turnover.

A significant majority of the sample reported that margins were currently below normal levels (**Chart A**). And margins were below normal in all sectors. But looking across industries, the margins of exporters were a touch above normal. The margins of small firms were further below normal levels than those of large firms.

Chart A Current profit margins relative to normal(a)

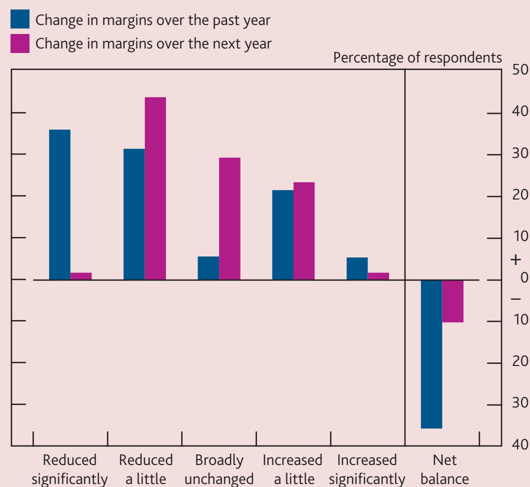


(a) The net balance is calculated by applying a weight of +/-1 to extreme responses, a weight of +/-0.5 to moderate responses, and a weight of zero to responses in the middle of the range.

Most firms also reported that margins had declined over the previous year (**Chart B**). Again, this picture was apparent in all sectors. But looking across the whole sample of companies, exporters' margins were reported to have been relatively stable.

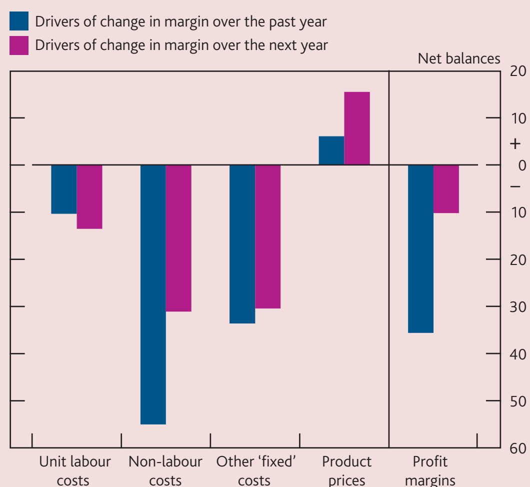
Contacts were also asked how margins had been affected by changes in product prices, variable labour costs, non-labour production costs, and other (or fixed) costs. The major part of the squeeze in margins had come from increases in non-labour production costs, reflecting rising prices for a range of commodities, raw materials, and imported goods, along with other fixed costs (**Chart C**). There had been some offset to rising costs from higher prices charged to customers, but that had been insufficient to prevent margins from falling overall.

Chart B Changes in margins(a)



(a) The net balance is calculated by applying a weight of +/-1 to extreme responses, a weight of +/-0.5 to moderate responses, and a weight of zero to responses in the middle of the range.

Chart C Influences on margins(a)



(a) The net balance is calculated by applying a weight of +/-1 to extreme responses, a weight of +/-0.5 to moderate responses, and a weight of zero to responses in the middle of the range.

Over the next year, the same number of contacts expected margins to increase as expected them to decrease. But the weighted net balance pointed to a further modest decline (**Chart B**). That was the case in most sectors, although manufacturers expected to be able to rebuild some of their lost margin. And the net balance was slightly positive for consumer services companies, although the sample of businesses in that particular sector was quite small. Across industries, exporters expected a slight rise in margins.

Over the next year, a larger net balance of firms' expected to be able raise prices, compared to the past year (**Chart C**). And respondents foresaw relatively little downward pressure on margins from rising labour costs. But increases in other variable costs and fixed costs were expected to continue to squeeze margins in the year ahead.