BANK OF ENGLAND

Agents' summary of business conditions

February 2011

- Retail sales continued to grow, albeit moderately, with some recovery of spending that had been lost as a result of the bad weather.
- The Agents' score for annual growth in turnover for consumer services had slipped further, despite the improvement in the weather in January.
- Activity in the housing market remained subdued, and prices continued to fall.
- Investment intentions had risen again on the month, with a few more reports of plans to increase capacity.
- The annual growth rate of goods export values rose further still, helped by world demand and past declines in sterling.
- There had been modest growth in services turnover, but there was still some downward pressure on fees for professional and financial services.
- Manufacturing output growth had also risen somewhat, probably reflecting robust overseas demand.
- Activity in the construction sector had been disrupted by the weather. Underlying activity was thought to be broadly similar to the level a year earlier.
- Large firms reported that credit was available, but small firms continued to face difficulties in securing loans.
- Employment intentions pointed to modest growth in jobs in the private sector over the next six months.
- According to contacts, capacity utilisation was around normal in manufacturing, while there was rather more spare capacity in services.
- Labour costs were growing at a moderate pace on a year earlier, reflecting both improvements in productivity, but also some degree of recognition of past inflation.
- Flooding in Australia had caused further increases in the prices of some raw materials.
- Some of the past increase in the cost of raw materials had been passed on in manufacturing output prices.
- The annual rate of consumer goods and services 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 December 2010 and late January 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 Agents' score for retail sales continued to point to a relatively gentle pace of annual growth, but had risen slightly compared with last month (**Chart 1**). That reflected, in part, some recovery of spending that had been postponed as a result of the bad weather during December. And the annual comparison was flattered somewhat by the disruption caused by the snow in January 2010. Given the fairly elevated pace of retail goods inflation, the modest rate of growth in turnover belied rather weaker growth in real spending. There was thought to have been relatively little improvement in sales of big-ticket items.

Chart 1 Retail sales values and consumer services turnover

The Agents' score for turnover in consumer services continued to weaken, despite better weather conditions in January, and pointed to fairly lacklustre growth compared to a year earlier. According to contacts, spending on consumer services, including meals out, hotel stays, and travel services, had been disappointing. Demand was expected to return, now that weather conditions had improved. But there was widespread concern about the impact on consumer spending, from headwinds for real disposable income growth.

Housing market

Concerns about future incomes and the possibility of further declines in house prices were thought to be continuing to weigh on activity in the housing market. The lower end of the market was particularly subdued. That was partly a function of the difficulty faced by some potential first-time buyers in saving a deposit large enough to secure a mortgage. Would-be first-time buyers were helping to support rents and yields in the rental market. That had attracted buy-to-let investors, and increased the demand for rental property.

Business investment

Investment intentions continued to rise, with contacts in the manufacturing sector expecting reasonably strong investment growth over the next twelve months. The rise in the Agents' score reflected, in part, reports that exporters were beginning to invest in additional capacity to keep up with rapid growth in foreign demand. A number of contacts were investing to try to reduce their exposure to further increases in commodities and energy prices. More generally, investment intentions were still underpinned by the need to maintain and repair existing capital, and the aim to boost efficiency.

Investment intentions were also rising in the services sector, and pointed to a moderate pace of growth in spending over the coming year. Efficiency and productivity gains were important drivers of investment growth for many firms, with spending still focused heavily on IT. In professional and financial services there was also a significant amount of new investment under way in order to comply with regulatory changes. Hoteliers continued to invest in additional capacity, but were prepared to reappraise plans for further investment if there was no improvement in conditions in the sector. And there was ongoing investment by retailers in new stores and warehousing capacity.

Exports

Contacts reported that goods exports were increasing rapidly, and the Agents' score edged a little higher on the month. The rise in foreign demand was driven by emerging economies, but trade with Germany was also thought to have been growing quickly, and activity in the United States had strengthened somewhat. Along with rising world activity, a number of contacts recognised that the past depreciation of sterling was helping to boost trade. Exports of electrical goods, and of components for use in the aerospace and automotive industries, had all been growing quite strongly.

There were some further reports of re-sourcing of inputs to domestic suppliers, as rising transport and labour costs had rendered some foreign producers less competitive. But such switching was still not commonplace.

Output

Business services

The Agents' score for the growth rate of turnover in professional and financial services continued to point to only a gentle pace of recovery. There had been a small increase in the score compared to last month, with a number of contacts at law firms having seen a further rise in M&A activity. And suppliers of IT services were still busy thanks to the focus of investment in the wider economy. Contacts in commercial property leasing reported that conditions had been difficult, with a large overhang of unlet space in many city locations.

The Agents' score for other types of business services pointed to a modest increase in activity compared to last year, although there had been a sizable drag from the wintry weather. Among hauliers, hoteliers, suppliers of conferencing facilities, and firms related to the construction sector, there were many reports of firms having fared badly.

Manufacturing

Output of the manufacturing sector continued to grow strongly on the back of overseas orders. Suppliers to the aerospace and automotive sectors had seen rapid increases in output. Production of medical and pharmaceutical products, food and packaging had also been growing strongly. But activity among firms supplying to the domestic construction sector was reported to have fallen. And in the defence sector, financial constraints on governments, both in the United Kingdom and abroad, were beginning to be felt.

Construction

Reports of a severe impact on the sector from the extreme weather were confirmed this month. Output was expected to recover as improvement in the weather permitted work to be resumed. And there were some reports of a rise in repair and maintenance work as a result of damage caused by the severe conditions. Activity continued to be underpinned in part by large projects in London. More widely, there were reports of construction work related to transport, utilities and renewable energy. Consistent with intelligence on investment, the level of activity was also supported by construction work on hotels and retail premises.

Credit conditions

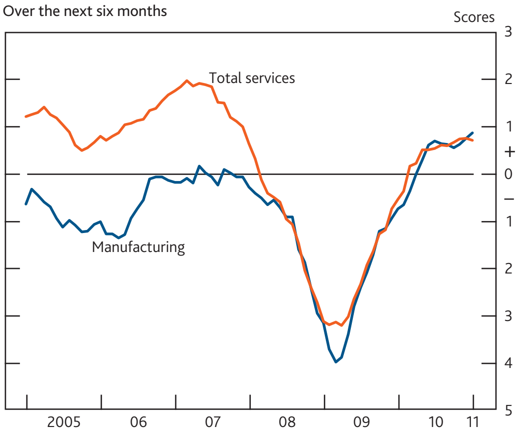
Large firms had seen further improvement in the availability of credit, and increased competition among lenders for business had brought the cost of borrowing down a little. But intelligence gathered from lenders continued to suggest that there would not be a return to the lower level of spreads seen prior to the recession. Some larger firms had taken advantage of an increase in investors' appetite for equity to lower their ratio of debt to equity finance. Among smaller firms, there was still a strong perception that credit for working capital was not available. That was acting as a disincentive to apply for loans. As a result, many firms were trying to preserve undrawn facilities, in case they were needed at a later date. Some contacts reported that more secured credit had become available, but that they lacked the necessary skills, or time, needed to undertake what was felt to be a much more involved applications process. In some cases the amount of collateral required was considered too large, or contacts had been discouraged by having to provide personal guarantees.

Employment

The Agents' scores for employment intentions in manufacturing and services pointed to modest growth in private sector employment over the next six months (**Chart 2**). The score for manufacturing stayed on its gentle upward path, driven by recruitment among exporters. In professional services, employment was expected to continue to grow due to rising activity among law and accountancy firms, financials and IT specialists. In the consumer sector, employment intentions were bolstered by the need to recruit staff for new stores. But rising concerns about the prospects for consumer spending were beginning to weigh on employment intentions. And several contacts hoped that improved management of rosters, along with more flexible attitudes to working, would enable them to meet periods of peak demand without increasing total headcount. It was still easier than usual to find suitable staff. But for some specific skill sets, for instance, in engineering and IT, contacts reported that they were finding it more difficult to recruit.

Chart 2 Employment intentions

Over the next six months



Capacity utilisation

In manufacturing, the level of capacity utilisation remained around normal. A few contacts, particularly among exporters, were facing constraints however, and had begun investing to meet further increases in demand. But most were still able to raise output using existing resources, typically by increasing overtime or implementing additional shifts. There were further reports of supply bottlenecks, in part due to the rapid pace of growth in world activity. In some cases these had been exacerbated by firms' decisions to operate with lower stocks of inputs following the recession. That had focused them on becoming more adept at accommodating fluctuations in demand. And some firms had begun to increase their inventories of inputs in anticipation of hold-ups in the supply chain, or rising prices. By contrast, there was still reported to be considerable slack in services, although a degree of capacity was thought to have been lost in some sectors. For instance, in the airline industry, some of the less fuel-efficient aircraft that had been mothballed during the recession were now unlikely to be brought back into service.

Costs and prices

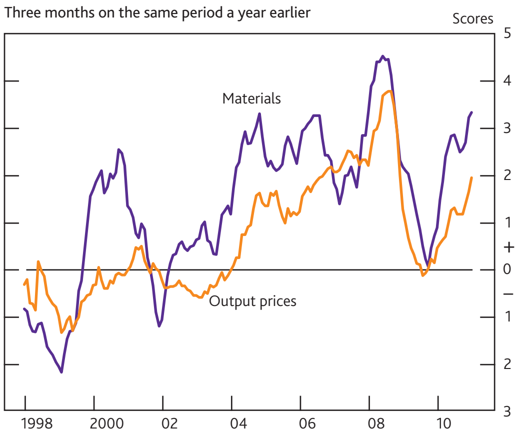
Labour costs

In manufacturing, the Agents' score pointed to a pace of growth in labour costs that was broadly in line with the historical average. A further tick-up in the score on the month reflected rising hours per employee, as well as some increases in pay due to recognition of past wage restraint. In contrast to the pay round the previous year, there were now relatively few reports of wage freezes. In services, where the recovery was not yet as robust, there had been slightly less upward pressure on labour costs, and wage freezes were more common than in manufacturing. Compensation for high inflation over the past year had played a greater role in negotiations in both sectors than during the previous round (the box on page 5 describes the results of a special survey on pay and labour costs).

Non-labour costs

The Agents' score for inflation in the price of raw materials continued to indicate a fairly rapid pace of increase, and rose higher on the month (**Chart 3**). Contacts reported that the recent flooding in Australia had caused a significant increase in the price of coking coal and iron ore, and that was adding to upward pressure on the price of steel. Some cereals prices had also risen as a result of the flooding. Along with weather-related disruptions to supply, global demand was helping to keep the cost of various other raw materials elevated, particularly for agricultural commodities, metals and energy.

Chart 3 Material costs and manufacturing output prices

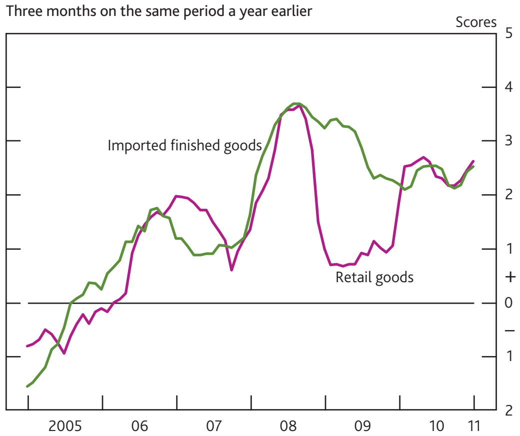


Contacts reported that the costs of imported finished goods were also rising (**Chart 4**). That was partly due to the increases in the price of raw materials, and also because of higher labour costs in some emerging economies. These influences were mitigated to some extent by re-sourcing from other, lower cost, countries.

Output prices

The Agents' score for manufacturing output price inflation increased on the month (**Chart 3**). The start of the year was a key time for reviewing annual price lists, and many contacts were taking the opportunity to pass on some of the rise in their costs. The degree of pass-through was still only partial, however. Suppliers to food retailers found it difficult to pass higher costs on. And in some cases, products had been altered to lower the cost of ingredients or packaging.

Chart 4 Imported finished goods prices and retail goods prices



The Agents' score for business services prices continued to point to a slight fall compared to a year earlier, but the pace of decline had eased further. There was still downward pressure on fees for some professional and financial services. And there was particular weakness in construction, where tenders were often at below cost. But some niche service providers, particularly in IT, had managed to raise their prices. And there were a few reports of firms having been able to pass on cost increases. For instance, hauliers reported a degree of success in adding fuel surcharges for services.

Consumer prices

In line with expectations, most retail contacts reported that the bulk of VAT had been passed on in full, helping to push up the Agents' score for retail goods price inflation (**Chart 4**). There had also been upward pressure from the rising cost of imports of finished goods, particularly food and clothing. Higher fuel and transport costs had also contributed to the increase. Helping to offset that, the snowy weather had left some retailers with more stock during the sales period than they had anticipated, which had caused them to discount more heavily than planned.

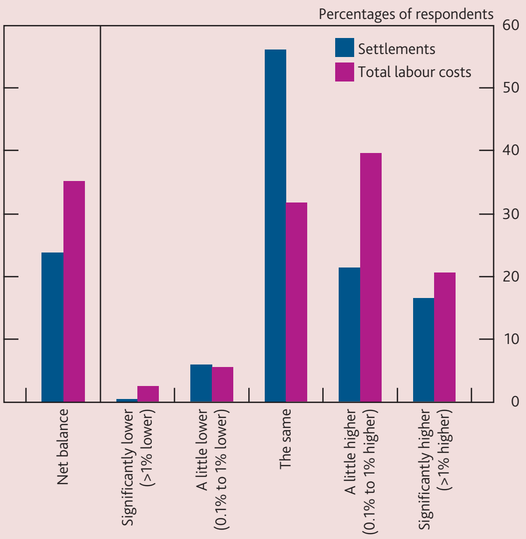
The pace of inflation in consumer services was thought to be similarly elevated and the Agents' score rose on the month. Along with the increase in VAT, that reflected, in part, higher bus and rail fares due to higher fuel costs. Restricted capacity in the airline industry had pushed up on air fares. And the prices of motor and household insurance had continued to rise. Hotels and restaurants had endeavoured to keep prices down by adjusting menus and ingredients, but there was thought to be diminishing scope to cut costs in that way.

Agents' survey on pay and labour costs

Since 1998 the Agents have conducted an annual survey asking contacts in the private sector about expected pay settlements and total labour cost growth, and the key drivers of changes in them. 377 firms responded to this year's survey, with a combined UK employment of 905,000. Unless otherwise stated, the data are weighted by employment.

According to the survey, 56% of contacts expected to award the same pay settlement in 2011 as they did in 2010 (**Chart A**). But there was a skew in the distribution of responses towards somewhat higher settlements than last year, when there was a high incidence of only very small increases and outright pay freezes. Overall, however, the survey tends to suggest a fairly modest increase in the pace of growth of settlements in 2011 compared to 2010.

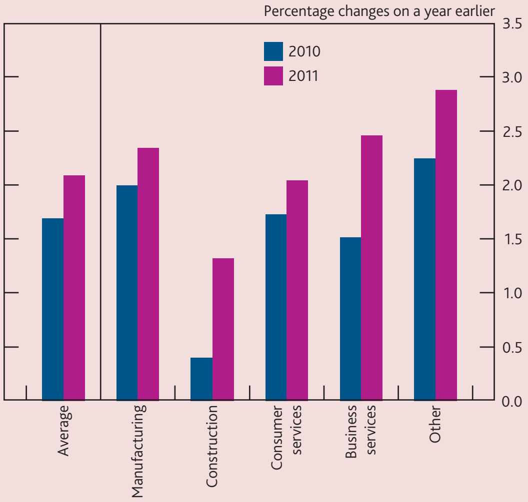
Chart A Net balances of expected settlements and total labour costs in 2011 compared to 2010



Taking the mid-point of ranges specified for respondents, and assuming that 'significantly' was, on average, equal to adding (or subtracting) an extra 2 percentage points to (or from) the settlement awarded in 2010, a simple estimate suggests expected growth in settlements of around 2.1% in 2011 (**Chart B**). By sector, the largest increases in settlements compared to last year were in construction and business services. That is likely to reflect, at least to some extent, very low average settlements in those sectors in 2010.

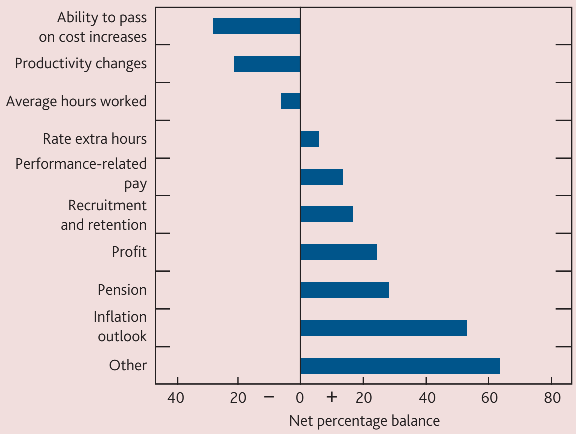
Most of the firms surveyed expected total labour costs to rise more quickly than last year (**Chart A**). In addition to settlements, total labour costs capture, among other things, changes in pay drift and bonuses. And contacts in the sample reported that performance-related pay, overtime payments

Chart B Net balances of expected settlements in 2011 compared to 2010



and rising profitability were all exerting upward pressure on total labour costs (**Chart C**). Somewhat surprisingly, however, given that productivity and average hours might be expected to rise during the recovery, these factors were reported to be exerting downward pressure on total labour costs. That may be because respondents were answering the question based, in part, on expected labour costs per unit of output, rather than per employee.

Chart C Influences on total labour costs per employee



The outlook for inflation also featured prominently among the factors thought to be exerting upward pressure on total labour costs. Comments from some of the contacts in the sample suggested that it was the current rate of inflation, rather than expectations about future inflation, that was the most significant factor. The large positive net balance for other influences captured a range factors, including higher National Insurance contributions and the increase in the National Minimum Wage.