BANK OF ENGLAND

Agents' summary of business conditions

January 2011

- Severe weather conditions had lowered the growth rate of household spending, with consumer services more adversely affected than retail sales.
- In the housing market, concerns about future income growth and the path of house prices were reported to be weighing on demand.
- Investment intentions pointed to a moderate pace of growth over the next twelve months, underpinned by firms' efforts to improve efficiency and the need to replace existing capital.
- The Agents' score for manufacturing export values reached a new series high, driven by trade with emerging markets.
- Services turnover growth continued at a modest pace, supported by rising private sector demand, but there was still downward pressure on fees.
- Foreign demand was providing a boost to manufacturing output, but conditions for domestic-facing firms remained weaker.
- According to contacts, the level of activity in construction was still subdued, and the outlook for growth was thought to be fragile.
- Credit continued to have become more widely available for large firms, but much less so for small ones, many of which were still focused on paying back debt.
- Private sector employment intentions rose further, with contacts in both manufacturing and services expecting to recruit, albeit cautiously.
- Capacity utilisation had returned to normal for many manufacturers. But contacts in services continued to report somewhat larger amounts of slack.
- Labour costs were rising at a rate approaching the pre-recession pace in manufacturing, but were increasing a little more slowly in services.
- Contacts continued to report increases in the cost of raw materials, and that had started to feed through to the price of imported finished goods.
- Higher input costs were apparent to some degree in manufacturing output prices, but the price of services remained under downward pressure.
- The pace of inflation in consumer goods was slightly higher than average, but was broadly in line with the average in 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 November 2010 and late December 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.

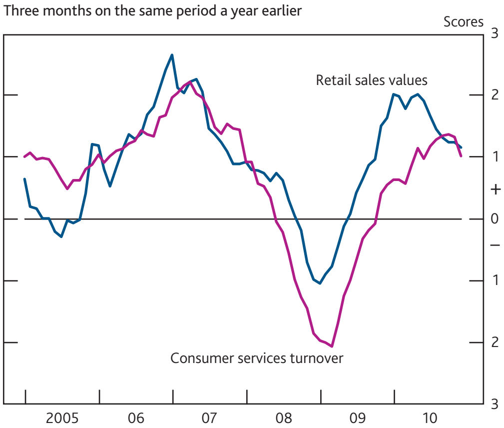
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

The value of retail sales continued to grow at a moderate pace (**Chart 1**). But spending over the festive period had fallen short of expectations overall. There had been little sign of the hoped-for rise in spending ahead of the VAT increase. And the particularly severe weather in December was thought to have reduced the value of sales somewhat. There were likely to have been fewer impulse purchases due to lower footfall. And there were some concerns that distribution problems may have prevented timely restocking, perhaps resulting in some lost expenditure. There had been some offset to lower sales in shops from higher on-line custom, while local retailers were thought to have benefited from disruptions to shoppers' travel plans.

Chart 1 Retail sales values and consumer services turnover



There had been a slightly sharper fall in the Agents' score for consumer services than for goods. Consumer services were likely to have been hit rather harder than retail goods by the cold weather, as householders were thought to be uninclined to make up for missed spending opportunities on things like meals out. Leisure and tourism had been affected the most, with many contacts reporting a significant decline in sales. Spending on services related to the housing market was also thought to have weakened somewhat, though that may have been due to factors particular to that market, rather than the wintry conditions.

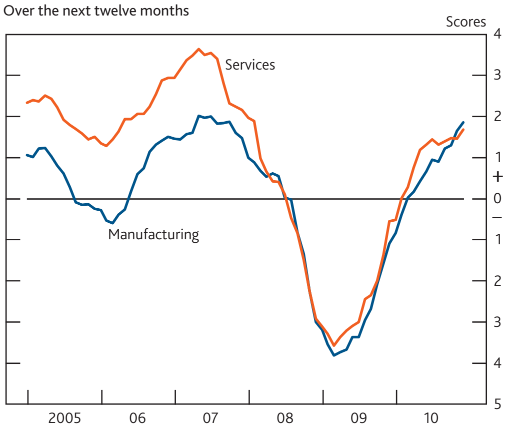
Housing market

Contacts in the housing market reported that the number of transactions continued to fall, beyond what might have been expected on the basis of typical seasonal patterns. Underlying that decline were rising concerns about the outlook for incomes. And there was also thought to be increased cautiousness due to fears about further falls in prices, with some vendors now waiting until their own property had sold before buying another. Access to credit, particularly for first-time buyers, continued to weigh on demand. On the supply side, despite the low level of new housebuilding, and some vendors' decisions to remove properties from the secondary market, stock to sales ratios were rising. House prices were falling as a result, and were expected to fall further.

Business investment

The Agents' score for investment intentions in the manufacturing sector had reached a level that pointed to annual growth rates broadly in line with those seen immediately prior to the recession (**Chart 2**). Firms facing the domestic market were motivated primarily by the desire to make efficiency gains or to replace existing capital. Among exporters, there were more reports of the development of new products to diversify into growth markets. And there were plans to raise capacity to meet still rapid demand growth abroad, though much of this investment would be done nearer to export markets, to reduce both production and transport costs.

Chart 2 Investment intentions



Investment intentions in the service sector were also rising, but remained below pre-recession levels. Investment plans were still driven largely by efficiency and replacement motives. But, in financial services, some contacts were investing in new IT to help them meet coming changes in regulatory requirements. Contacts in ports and shipping planned to increase physical capacity. And there were reports of continued investment in new premises by some large retailers, although the pace of expansion was slowing.

Exports

The Agents' score for manufacturing export growth reached its highest since the start of the series in July 1997. Foreign demand was strongest in emerging markets. Firms in engineering and energy-related sectors had seen particularly robust growth. Contacts reported some success in penetrating new markets and raising shares in existing ones. That was thought to reflect in part the resource spent developing trading relationships around the start of the recession, which was now beginning to yield results. Conditions in mature markets, including the United States and Europe, were still improving only gradually. And there were clear signs of weakness in some of those countries that had been affected most by recent disturbances in sovereign debt markets.

Imports continued to grow quickly. But there continued to be concerns about uncertainties surrounding delivery times, transport costs, and quality. And while many contacts thought that there was little scope to source inputs of materials or components domestically, a few had managed to do so. And there were reports of plans to bring the production of some inputs in-house. That would tend to lower the import intensity of production in the future.

Output

Business services

The Agents' score suggested that the growth rate of turnover in professional and business services remained below average. But financial advisory work had picked up a little compared to last year. And contacts in the IT sector continued to benefit from the current mix of firms' investment projects. Recruitment and advertising were being supported by rising activity in the private sector, but that was dampened by a decline in public sector work.

Corporate travel and distribution services were growing at a modest pace, perhaps thanks in part to the strength of trade. But both had been adversely affected by the bad weather. Contacts in shipping had seen an improvement in activity. And private sector business was supporting hoteliers and providers of commercial premises. But corporate hospitality — which tended to represent discretionary spending — remained sluggish, and had felt the impact of snowy conditions keenly.

Manufacturing

Robust overseas trade continued to support manufacturing output. Contacts all along the automotive supply chain were benefiting from foreign demand. There was strong growth in the aerospace sector. And producers of investment goods reported that their output was growing quickly, with infrastructure, energy and mining sectors all particular sources of growth. Contacts in food production and packaging had also seen a rise in activity.

Construction

The Agents' score for construction had fallen slightly on the month. The extreme weather had weighed on activity in the sector significantly, even though some of the worst conditions had occurred during the pre-Christmas shutdown period. The underlying level of activity was thought to be broadly unchanged compared to last year. Some larger companies continued to benefit from projects in London related to the Olympics and commercial real estate. There were also widespread reports of work on utilities and transport infrastructure, and there continued to be some support from the efforts of certain large retailers to expand their national footprints. But these were not expected to provide a source of much growth in the near term, and there would be a drag from lower public sector work. In the near term, however, there would be some boost to growth as improvements in the weather allowed work to be resumed. And there was expected to be an additional fillip to activity from more repair and maintenance work than usual.

According to contacts in the construction sector, some large customers had been consolidating business with individual contractors, to reduce costs and minimise risk. At the same time, large contractors were more likely than smaller ones to have the financial strength needed to be able to fund projects jointly with developers. That gave them an additional advantage in securing work. And they had been taking on jobs that would previously have been left to smaller firms. These factors were thought to be causing industrial concentration to rise in the sector.

Credit conditions

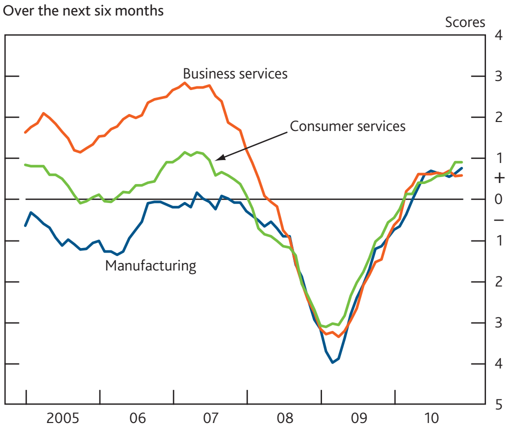
The Agents continued to hear that credit conditions were improving for large firms. Many such contacts reported that the availability of credit was more or less back to normal. But the cost of finance compared to Bank Rate remained significantly higher than its pre-crisis level, and it was still difficult to secure long-term loans. Small firms reported that credit conditions remained tight. There were a few reports of an improvement in access to bank finance, although the ongoing shift towards lower risk and more costly forms of lending was thought to have continued. Many small firms were focused on paying back past borrowing to regain control over their financial arrangements. At the sectoral level, contacts in manufacturing reported that trade credit was becoming more readily available, perhaps reflecting growing confidence among lenders in the recovery in trade.

Employment

Employment intentions in both manufacturing and services pointed to a modest pace of job creation by the private sector over the next six months (**Chart 3**). The Agents' score for

Chart 3 Employment intentions

Over the next six months



manufacturing was now well above pre-recession levels, with employment intentions particularly strong among exporters. Employment intentions in business services were rather weaker than prior to the recession but pointed to some growth nonetheless. Intentions were particularly high in the IT sector. Contacts in consumer services also expected to recruit over the next six months, due in part to the need to staff newly opened stores.

Capacity utilisation

Rising demand for manufactured goods had pushed capacity utilisation in the sector to around normal levels, especially among exporters. Most contacts felt able to meet expected increases in demand over the next six months. But a few were at full capacity, and planned to invest in capital to be capable of meeting additional demand. And there were further reports of shortages of some inputs. Capacity utilisation in the services sector was still somewhat below normal. And contacts could meet a significant pickup in demand with existing labour and capital.

Costs and prices

Labour costs

In manufacturing, labour costs were rising at around the pre-recession average rate. Part of that was due to an increase in hours worked by staff. And there had been a pickup in settlements, in part due to the rise in productivity in the sector. In the service sector, there was rather less upward pressure on labour costs than in manufacturing. More generally, there were further instances of an increase in the use of discretionary awards based on performance. But some employers had also raised pay to reward staff loyalty, particularly if there had been several years of pay freezes. And there were more reports of a degree of compensation for elevated inflation.

Non-labour costs

According to contacts, there had been a further increase in the cost of agricultural commodities due to a combination of higher world demand and supply disruptions, and metals prices had also risen more quickly. The cost of energy had gone up, and higher oil prices were feeding through to plastics and other oil-based products. There were also increases in the cost of paper and packaging. The higher cost of materials had begun to feed through to the price of imports of finished goods. The cost of clothing, for instance, was rising due to higher cotton prices. And higher wages in China were also contributing to inflationary pressures.

Output prices

Rising costs had squeezed manufacturers' margins. Many contacts, particularly those that were higher up the supply chain, reported that they now had to pass higher costs on. Cost pass-through had only been partial so far, but the intention was to pass through more of the past increases going forward.

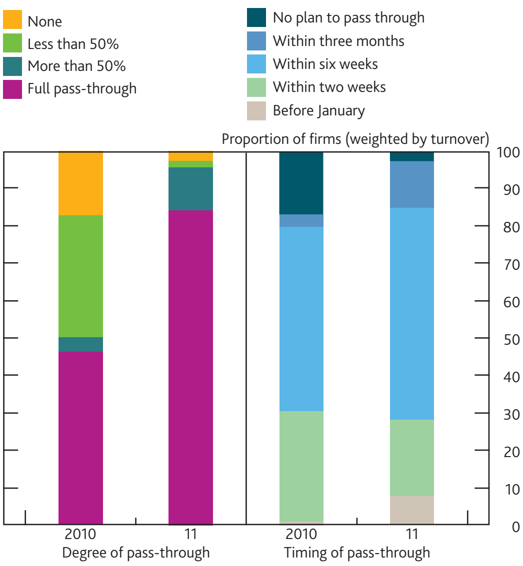
Business services prices continued to fall compared to a year earlier, particularly for services of a standardised nature, and in the corporate hospitality and construction sectors. A few contacts in professional services thought that the downward adjustment represented a normalisation to some extent, profits having been abnormally high prior to the recession. In some growth sectors, like IT, and in certain niche services, firms had been able to raise fees.

Consumer prices

The Agents' score suggested that the annual rate of inflation in consumer goods remained slightly above average, and had risen a little further this month. In particular, higher agricultural commodities prices were feeding through to the prices of bread and meat products. Consumer services inflation was thought to be broadly in line with the historical average. Underlying that, there had been upward pressure from essentials like energy, and motor and buildings insurance. But there had been downward pressure from non-essentials, like meals out and hotel stays, perhaps in response to consumers' efforts to keep tight control of discretionary spending.

According to a survey of retail contacts carried out during December, 84% of respondents intended to pass on the rise in VAT in full, and 11% planned to pass on at least half of it (**Chart 4**). Taken together, that suggested overall pass-through of at least 90%, which is rather higher than suggested by an equivalent survey for the previous VAT increase. Most of that would come through within the first few weeks of the year, although some firms had raised prices already. A number of contacts would take a little longer, however, either to see what competitors did, or until standard repricing periods, like Easter.

Chart 4 Degree and timing of VAT pass-through



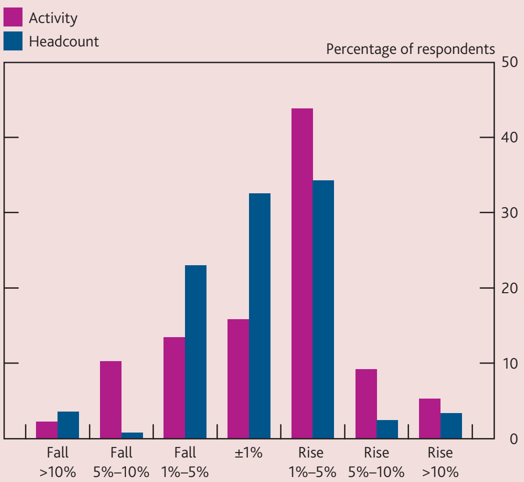
Agents' survey on employment intentions and productivity

According to official data, employment fell by rather less during the recession than GDP. As a result, there was a fall in output per worker relative to its pre-recession level. Some of that decline in labour productivity has since been reversed, as GDP has grown more rapidly than employment during the recovery. But there may still be scope to raise output through further productivity gains.

To investigate the outlook for productivity, the Agents asked contacts about expectations for activity and headcount over the next twelve months, the extent to which additional demand could be met with existing staff, and the factors influencing expected changes in employment. 370 firms responded to the survey. All of the figures shown are weighted by headcount.

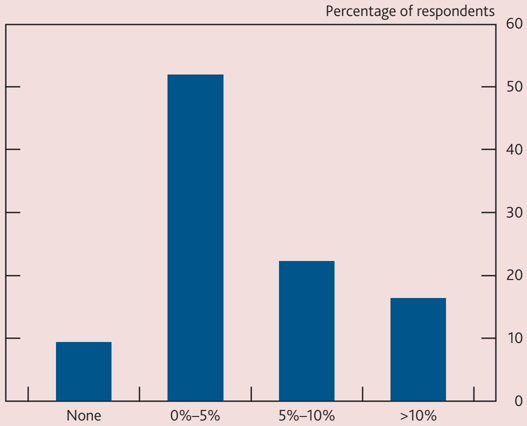
Over the next twelve months, more firms expected their own level of activity to increase than decrease (**Chart A**). The expectations for headcount over the same period were a little more balanced. That suggests that output growth could continue to be more rapid than employment growth, and that there might be some scope for a further rise in labour productivity.

Chart A How do you expect activity and headcount to change over the next twelve months?



Indeed, the vast majority of those surveyed judged that they would be able to meet at least some additional demand using existing labour. A little over half of the sample reported that they could raise output by up to 5% using existing staff (**Chart B**). Less than one tenth of those surveyed had no spare capacity at all by this measure. Smaller firms, employing fewer than 250 people, tended to report that they had more spare capacity to meet additional demand than the sample as a whole.

Chart B How much of an increase in demand could you meet using your existing workforce?



Expected demand was reported to be supportive of employment over the next twelve months (**Chart C**). But, not surprisingly, the scope for firms to raise output through productivity improvements tended to weigh on their recruitment intentions. Nearly half of firms reported that increases in output per worker were a factor serving to reduce expected employment growth over the next twelve months. And a number of contacts reported that uncertainty about the strength of the recovery would hold back employment growth.

Chart C What factors influence expected changes in employment over the next twelve months?