BANK OF ENGLAND

Agents' summary of business conditions

July 2011

- The rate of growth of nominal spending on consumer goods and services remained sluggish.
- Activity in the housing market had softened in recent weeks.
- Overall, investment intentions continued to increase, although some firms had become a little more cautious.
- The rate of export growth remained strong. More firms had begun to switch resources from domestic to export marketing.
- Manufacturing output continued to grow, although more slowly for domestic markets than for export.
- Steady growth in output in the business services sector was also continuing.
- The level of construction output continued to rise very slowly but remained well below pre-recession levels.
- Employment intentions indicated continuing job creation in the private sector in aggregate, though prospects in the consumer services sector were poor.
- The degree of capacity utilisation continued to increase gradually, with slack more evident in services than manufacturing.
- Growth in labour costs remained modest.
- Increases in the cost of raw materials showed signs of moderating, but contacts were concerned by prospects for energy prices.
- Inflation in the cost of imported finished goods was thought likely to persist somewhat longer than that of raw materials.
- Transmission from higher costs to output prices remained limited, putting pressure on firms' margins.
- The rate of inflation for consumer goods and services 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 May 2011 and late June 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

Nominal spending continued to grow, but at a slow pace. Contacts reported that signs of a strengthening in demand in the early spring had been short-lived. Reflecting this change in conditions, levels of stock had risen in some non-food sectors. Discretionary spending had been particularly affected, and demand for many bigger ticket items had softened. Central London retailers, however, continued to benefit from increasing numbers of foreign visitors. Some other retailers had become more pessimistic about the outlook, fearing further downward pressure on household incomes.

Growth of consumer services turnover also remained weak (**Chart 1**). And there had been a fall in discretionary spending on services, such as vehicle maintenance and property conveyancing. Car parking revenues were falling, in part because consumers were economising by using public transport. Spending on domestic tourism was generally expected to match last year's level, although bookings were very late. Premium travel and hotel accommodation, along with concerts and sports events, continued to sell well.

Chart 1 Retail sales values and consumer services turnover

Three months on same period a year earlier

Housing market

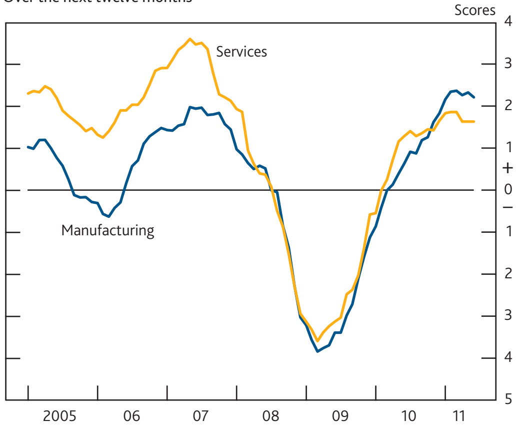
Contacts reported that, overall, activity had softened in recent weeks. The level of stock had begun to pick up and prices were expected to decline somewhat. Many prospective first-time buyers continued to be unable to purchase. That was supporting the lettings market, which continued to attract investors, particularly in locations with a high proportion of younger people. Construction of new homes for sale was, in general, flattening off. With builders focusing on homes for buyers with existing equity, there was increasing demand for sites suitable for such properties. Uncertainty about public sector financial support and expectations of reduced grant funding were restraining construction of social housing.

Business investment

Investment intentions continued to rise but the overall rate of investment growth was thought to have moderated slightly (**Chart 2**). Growth tended to be strongest for exporters, including those in the aerospace and automotive sectors, for example. Parts of the agricultural sector were also reported to be investing strongly, encouraged by high prices for arable commodities. Capital expenditure growth in service sector firms was expected to continue increasing at a modest pace. Spending on ICT was rising, to achieve efficiencies and provide additional marketing capability. Reports of other plans included increased private investment in public transport systems. According to contacts, growth in retail floor space was slowing a little.

Chart 2 Investment intentions

Over the next twelve months



There continued to be reports of investment schemes, which previously had been deferred, being implemented. But some such projects had now been completed, and a number of contacts had become more cautious about spending on capital. Some contacts described overseas investment as offering a greater competitive advantage than spending at home, but others were bringing production back in-house to reduce supply risk.

Exports and imports

Manufacturing exports continued to grow at a brisk pace, though for some firms the rate was now slowing slightly (**Chart 3**). And more firms had begun to switch resources from domestic to export marketing, including contacts in mining, construction and property-related professional services. Demand for exports of capital goods, such as precision engineering and construction equipment, remained strong, as did demand for industrial chemicals and certain luxury consumer goods.

Geographically, demand from Germany, thought to be predominantly for re-export, remained firm but other European markets were generally less so. And exports to countries affected by concerns surrounding sovereign debt tended to be particularly weak. Emerging markets had continued to provide opportunities for strong growth, although policy tightening in some of these countries had begun to slow orders. The impact of disturbances in the Middle East remained slight.

Contacts reported that growth in the volume of imports had slowed a little. This was thought to reflect both supply issues and softer domestic demand. Imports of cars from producers affected by the tsunami had weakened. But some contacts had been able to overcome disruptions to supplies of Japanese finished and semi-finished goods by sourcing them from the United Kingdom. Japanese firms themselves had also begun to source more goods from UK suppliers, both for plants here and in their home market.

Output

Business services

Overall, turnover was thought to have continued to grow slowly. For professional and financial services firms, there was still little sign of recovery in transaction-related work, although some contacts believed that overseas investors were becoming more active. The demand for many standardised professional services had been more than usually price-sensitive, but output of some higher margin advisory functions was picking up, which was supporting turnover.

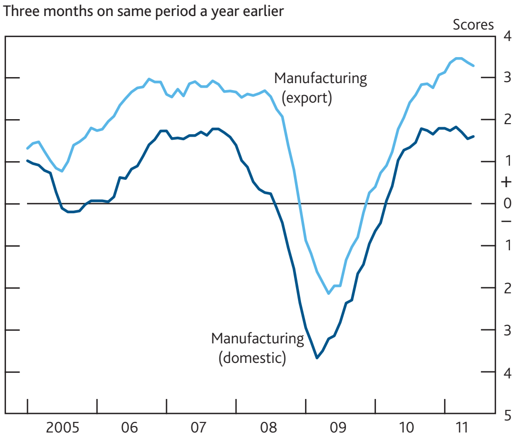
Suppliers of ICT systems and travel and marketing services continued to report an improvement in business conditions. Activity was still strengthening among freight forwarders and others associated with export logistics. But there had been reports of weaker domestic demand for haulage of consumer goods, and carriage of construction industry inputs remained weak.

Manufacturing

Domestic manufacturing output growth remained broadly stable (**Chart 3**). Supply difficulties continued to affect some firms, but import substitution by, for example, customers seeking alternatives to recently disrupted Japanese supply, was enabling certain other producers to raise their output. A

Chart 3 Manufacturing output

Three months on same period a year earlier



number of contacts reported that they had begun to see growth soften a little, as business customers completed replenishment of stocks. Producers of consumer durables were feeling the impact of weaker household spending. And suppliers to the public sector reported softening activity. Growth in output for export continued to be at a faster pace than for domestic demand, but some contacts reported that it had slowed a little.

Construction

Output continued to rise slowly and remained well below pre-recession levels. Investment in new commercial office space remained weak outside of London. And beyond the capital, prospects were generally thought to be poor. Large firms were pursuing smaller contracts than usual and some had begun to look overseas for new business. But the construction of new retail space and budget hotels was continuing, if a little more slowly than before, and utility companies' spend on infrastructure was said to have increased. There had been a decline in public sector capital spending, but repairs, maintenance and refurbishment had picked up.

Credit conditions

Contacts at larger firms were typically able to access bank finance if required, but for small and medium-sized enterprises credit conditions remained more variable. A number of contacts felt that borrowing costs had begun to decline a little. But firms renegotiating older facilities continued to see some overdraft facilities replaced by asset-based finance and spreads over reference rates increase. Lenders continued to report that some firms were reluctant to borrow. A number of contacts had observed that debtor days were growing, and that was squeezing cash flow.

Employment

Employment intentions indicated that jobs would continue to be created at a modest pace. The findings of a special survey on the prospects for private sector employment are summarised in the box on page 5. Some contacts suggested that recruitment of technical and managerial labour was being hampered somewhat because potential appointees were unusually immobile, both because of a difficult mortgage market and the fear of falling victim to 'last in, first out' policies once in new employment. There had been little news of further changes to the level of public employment, but weaker public and consumer spending were resulting in job shedding by charities.

Capacity utilisation

Capacity utilisation had continued to rise at a steady pace. Exporters were absorbing spare capacity more quickly than firms facing the domestic market. Some manufacturers that were operating at close to capacity reported that capital investment, increased multi-skilling among their staff, and the opportunity to flex either working hours or input from temporary labour, would provide additional scope to raise output. But not all were willing to commit resources to creating additional capacity at present, and some displacement to overseas production facilities was taking place. For a few contacts, constraints in supply chains had become more problematic.

Spare capacity in the services sector remained significant. Generally, contacts in the sector were not yet facing capacity constraints, although these were now approaching for some firms. The degree of price competition in business services continued to suggest a below-normal level of activity. In consumer services, weakening demand had resulted in rising spare capacity within some firms.

Costs and prices

Labour costs

Pay awards were typically reported to be around 2%–3%, with contacts continuing to report little pressure for settlements that were in line with inflation. And in sectors other than manufacturing, a significant minority of firms still had pay freezes in place. In addition, a number of firms had recently deferred their 2011 settlement until the outlook became clearer. More contacts were linking a proportion of their pay award to productivity targets or other performance measures. Rises in the National Minimum Wage and employers' National Insurance contributions continued to add to total labour costs.

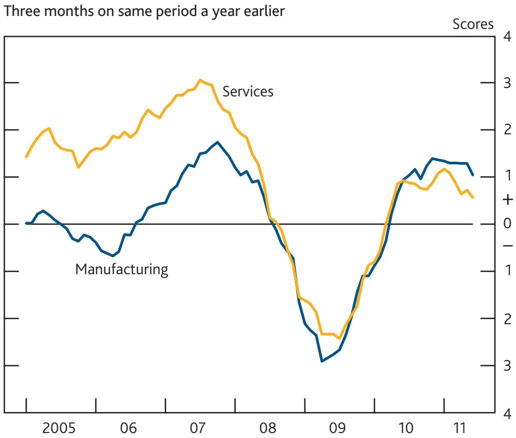
Non-labour costs

The price of commodities remained very high, although contacts thought that the pace of further cost increases was likely to slow, due to additional supply and softening world demand. Wage inflation and rising domestic demand in China and some other developing economies were adding to the costs of finished goods imported from those countries. Contacts expected such cost increases to take longer to moderate than the prices of commodities. The large fall in the value of sterling from around the middle of 2007 was judged to have had its full effect on input costs. But the recent decline in sterling was a concern for some importers. For a majority of contacts, increases in the cost of gas and electricity were also a worry, particularly where fixed-price contracts were about to expire.

Output prices

The Agents' scores for output prices suggested broadly unchanged inflation on the month. For manufacturers, the slow pass-through of cost increases was putting downward pressure on profitability (**Chart 4**). The problem was particularly acute for those selling predominantly to the domestic market. And food producers continued to report that supermarkets were very resistant to price increases. Overseas markets were felt to be an easier environment in which to achieve higher prices. Some firms were also finding that it was easier to rebuild margins by introducing new products than by renegotiating prices for existing ones.

Chart 4 Pre-tax profitability



Construction industry tender rates were reported to have fallen close to cost in some cases. There remained strong downward pressure on the prices of many standardised business services, lowering margins. And commercial rents continued to be weak, although they had shown signs of stabilising. Prices were increasing for some specialist business services, along with some banking, telecommunication and distribution services.

Consumer prices

Price promotions and earlier than usual summer sales of clothing, footwear and durables had partially offset upward pressure from VAT, duty increases and rising input costs. Some price increases were said to have been postponed or scaled back because of the recent weakness of consumer spending. Retailers continued to react to changing consumer demand by modifying their product ranges, to offer goods at price points that would represent better value for money.

Consumer services prices presented a mixed picture. Travel and transport prices continued to increase, in part because public subsidies were being scaled back, but also because of inflation indexation agreements. Some air fares had risen. And more utility companies had announced increases in the price of energy. But for services such as holiday accommodation and catering there was less scope to raise prices and discounting was common. Housing rents remained high but appeared to have stabilised.

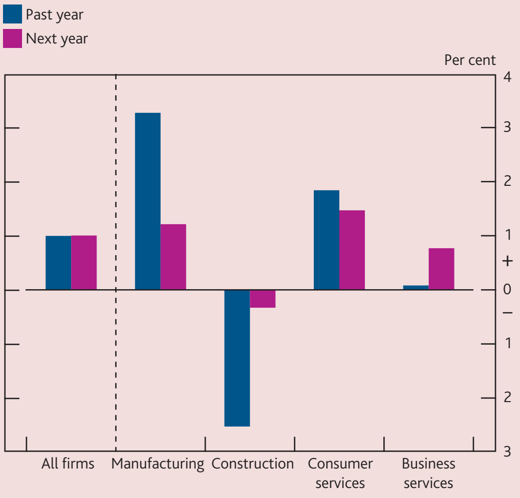
Agents' survey on employment

Employment has grown over the past year, despite subdued output growth and the likelihood that some companies have been operating with unusually high levels of spare capacity following the recession. The Agents conducted a survey of contacts during May and June 2011, asking them about changes in the size of their workforce and the factors affecting hiring decisions. 468 firms responded, with a combined UK employment of about 457,000.

Employment in the sample was reported to have risen by about 1% in the past year, a similar rate of increase to that shown by official data on private sector workforce jobs in the year to the first quarter. Overall, employment was expected to rise at a similar pace over the coming year, but there were some differences in expectations between the main sectors of the economy (**Chart A**).

Manufacturers reported the biggest increase in jobs over the past year, but expected growth to slow over the next year. Construction employment was, on average, expected to be broadly flat, following large falls over the past year. Business services employment, which had been flat in the past year, was expected to pick up somewhat.

Chart A Average past and expected changes in employment by sector(a)



(a) The following midpoints were used to estimate the average change: remain the same (0%), fall/rise 1% to 5% (3%), fall/rise 5% to 10% (7.5%), fall/rise more than 10% (12.5%).

Among the factors that were cited as influencing employment changes, expected demand was the most significant, leading firms both to increase employment in the past year, and to

Chart B Factors influencing employment over the past year

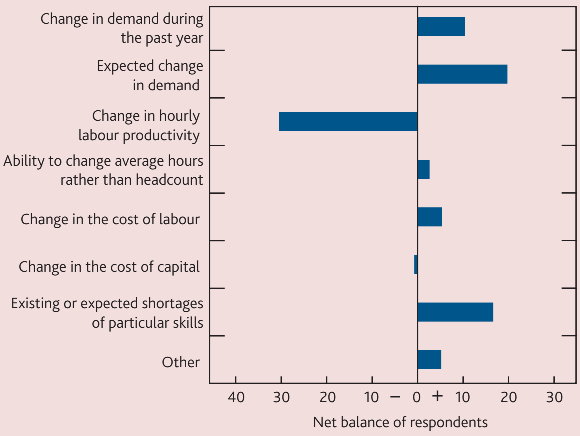
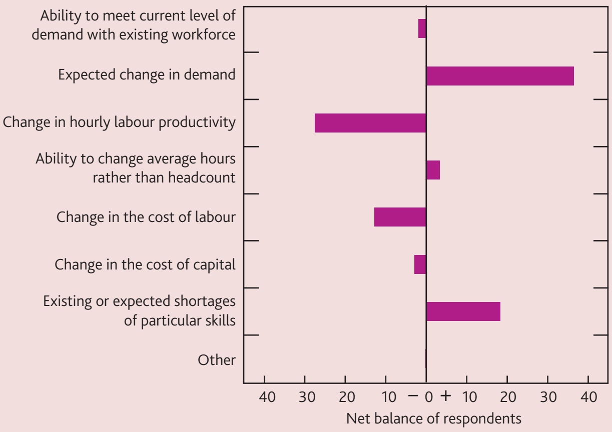


Chart C Factors influencing changes in employment over the next year



expect to over the coming year (**Charts B** and **C**). Existing or expected skills shortages were also motivating some recruitment.

The most important factor cited as reducing employment, both over the past year and in the year to come, was changes in productivity. This suggested that, among the respondents to the survey at least, continuing efficiency improvements were reducing demand for labour — in stark contrast to the picture painted by the official data, in which productivity growth had been weak over the past year.

Changes in labour costs had helped to support employment growth over the past year. But they were expected, on balance, to reduce employment over the next year, suggesting that firms anticipated an increase in the cost of labour going forward.