



BANK OF ENGLAND

Agents' summary of business conditions

June 2011

- The growth rate of nominal spending on **consumer goods and services** remained sluggish.
- Difficulties obtaining mortgages, concerns about future incomes, and uncertainty about the path of house prices continued to weigh on activity in the **housing market**.
- **Investment intentions** indicated that capital spending was likely to continue to grow at a reasonably steady pace over the coming year.
- The growth rate of goods **exports** remained robust, due to rising world demand and the competitive level of sterling.
- **Manufacturing output** continued to expand at a steady pace.
- The recovery in the **business service sector** remained fairly modest, with slowing government spending offsetting much of the growth in business-to-business demand.
- The level of **construction output** was thought to have picked up slightly compared to a year earlier, but declining public sector orders were expected to weigh on the growth rate of activity going forward.
- **Employment intentions** indicated that there would be further job creation over the coming six months.
- There was still some **spare capacity** in the service sector, but most manufacturing businesses were operating at broadly normal levels of capacity utilisation.
- The growth rate of **labour costs** remained modest, with settlements reflecting a degree of compensation for past wage restraint, and some recognition for the rising cost of living.
- There had been rapid inflation in the prices of various **raw materials**, but contacts thought that there had not been a further acceleration in the pace of increase.
- Inflation in the price of raw materials had contributed to higher prices of **imported finished goods**, along with higher wages in some emerging markets and rising transport costs.
- There had been some pass-through of higher input costs to domestic **output prices**.
- The rate of **inflation** of consumer goods and services prices 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 April 2011 and late May 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.

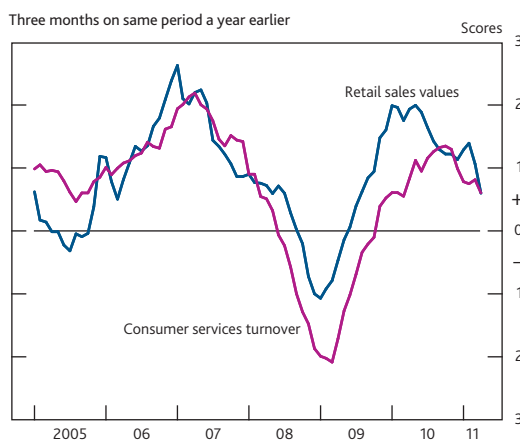
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: www.bankofengland.co.uk/publications/inflationreport/index.htm.

Demand

Consumption

The growth rate of nominal spending on retail goods remained sluggish (**Chart 1**). There had been a modest boost to sales due to fine weather and the incidence of bank holidays, reflected in increased spending on clothing and footwear, food and drink and outdoor goods. But some of this represented spending that had been brought forward, and contacts thought it unlikely to persist. Rather, the underlying driver of slow growth in consumption — weak growth in real personal disposable income — was expected to remain the dominant factor in households' spending decisions. This continued to be evident in falling sales of big ticket items, retailers' reliance on promotions to drive volumes, and the rising market shares of discount brands.

Chart 1 Retail sales values and consumer services turnover



Similar forces were at work in consumer services, where turnover growth continued to be weak. The leisure industry had benefited from the warm weather, but heavy discounting was required to stimulate spending on a range of discretionary services. Shifts in market share towards less expensive consumer services were also apparent, for instance in increased spending on camping holidays. Demand for public transport had risen, as consumers sought to make less use of their cars. Spending on essential services, such as housing rent and insurance, continued to grow, in large part due to rising prices.

Housing market

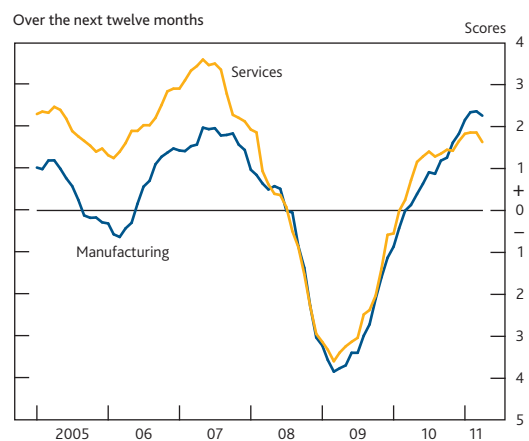
The level of activity in much of the housing market remained very subdued, although there had been an improvement at the top end of the market, especially in London. Many first-time buyers were still finding it difficult to raise a sufficiently large deposit to be eligible for a mortgage. And concerns about future incomes and possible declines in house prices continued to weigh on the market in general, both on demand, and on supply, deterring many prospective sellers that might otherwise have considered trading up. Some homeowners

were also reluctant to move if unable to carry over their mortgage to a new property. Some contacts worried that an increase in Bank Rate might simultaneously reduce demand, and cause a rise in forced sales, as the finances of some households became over-stretched. And those forces might precipitate a further downwards adjustment in prices. A buoyant rental market was attracting buy-to-let investors towards the type of smaller properties favoured by frustrated would-be homeowners.

Business investment

Manufacturing investment intentions continued to point to steady growth in capital spending in the sector (**Chart 2**). Investment plans were strongest among exporters, which often reported that they were spending to expand capacity. Among firms supplying the domestic market, spending tended to be on repair and maintenance, or replacement. Attention had become more focused on improving waste management, reflecting rapid inflation in the prices of various raw materials and the cost of disposal. And there was also greater emphasis on energy efficiency and use of renewables in response to rising energy prices. But some of this latter investment was on hold due to uncertainty about government policy.

Chart 2 Investment intentions



The Agents' score for investment intentions in the service sector suggested that growth in capital expenditure would continue at a modest pace (**Chart 2**). Spending was motivated largely by firms' efforts to find efficiencies and cut labour costs. There had been some investment in additional capacity in ports and shipping, and in distribution and logistics, reflecting the recovery in world trade. Among consumer-facing firms, intentions in the main were fairly weak, although some large supermarkets, discount retailers and budget hotels continued to expand in an attempt to gain market share. And many firms were investing in IT to target the on-line market.

Exports and imports

Manufacturing exports continued to grow quickly, due to rising world demand and the past depreciation of sterling. There had

been a shift in the focus of many businesses towards meeting foreign demand, and there were further reports from contacts that had successfully won market share in both existing and new markets abroad. Export growth had been strongest to emerging markets, and parts of Europe, especially Germany, and some contacts reported rising demand from the United States. The aerospace and pharmaceutical sectors were sources of particular strength. Exports of vehicles had slowed somewhat, which was thought to have been largely due to reduced output of the sector following the earthquake in Japan.

There continued to be relatively few reports of firms switching away from foreign suppliers of components towards domestic ones, despite the rises in import costs over recent years, in large part because of a lack of domestic supply. This would take some time to develop, and even at the current exchange rate, domestic production in some industries might not be competitive. But there was a trickle of reports of production that had previously been off-shored being brought back in-house, very tentatively suggesting that domestic supply was responding in some industries. And established UK suppliers of goods to the domestic market often did recognise that market share had improved at the expense of foreign competitors.

Output

Business services

While private sector activity had been growing, a slowing in public sector work was being felt very widely. The Agents' score for turnover in professional and financial services pointed to a gradual recovery, particularly in legal and accountancy work, IT and recruitment. Turnover growth in other business services remained muted. There had been a slight improvement in conditions for providers of corporate facilities, travel and marketing, albeit at very competitive prices. Hauliers and wholesale distributors of consumer durables noted a slowing in activity, although there had been an increase in export business. And contacts in ports and shipping confirmed that shipments for export were growing steadily, while there had been a slowing in inbound ones. Across the service sector, there were reports of delays to decision-making and hold-ups in processes due to the incidence of bank holidays.

Manufacturing

The Agents' score for manufacturing output pointed to solid growth, with the strongest reports from suppliers of components to exporters. Manufacturers of capital goods were benefiting from domestic firms' investment spending. Producers of goods for the domestic consumer reported mixed fortunes. Suppliers of big ticket items were facing a challenging environment, as households reined in spending on durables. By contrast, some food and drink producers, and

clothing manufacturers, reported a small pickup in output. Output in the automotive sector was significantly below normal following the earthquake in Japan and the consequent impact on the supply of some key components. And there had been reports of disruption to output in other areas reliant on Japanese electronics. The incidence of bank holidays in April was likely to provide an additional source of volatility in monthly output data.

Construction

The Agents' score suggested that construction output had grown a little compared to a year earlier. Building of new retail outlets, budget hotels and warehousing continued to support the level of activity, along with some large public sector infrastructure and transport projects. There had been a small pickup in house building and there was a significant increase in new office space under construction in London. Elsewhere there was very little property being built that had not already been pre-let. Most contacts had seen a fall in public sector orders, and that was expected to weigh on the growth rate of activity going forward, although there had been some increase in repair and maintenance work on government property.

Credit conditions

Large firms and some medium-sized businesses reported that they were typically able to borrow if needed. Small firms generally perceived credit conditions to be very tight. And many small firms were reluctant to approach banks in case it led to an increase in the cost of existing borrowings, or reductions in overdraft limits. There had been an increase in the use of asset-based finance for investment. And some small firms were slowly making greater use of different types of financing for working capital, such as invoice discounting, that were available in place of overdrafts.

Employment

Private sector employment intentions pointed to further modest employment growth over the coming six months. In manufacturing, robust export growth was leading to additional hiring of temporary workers. And past hires of temporary staff were increasingly being made permanent, reflecting confidence in the new level of activity. Historical shortages of certain skills, especially in engineering, were becoming a source of concern again, prompting some firms to offer more apprenticeships. In services, some recruitment was planned among firms serving the manufacturing sector, particularly in distribution. And modest hiring was expected in the professional and financial sector. Employment intentions were weaker among consumer-facing firms than for those facing business. A few firms, which were already at minimum staffing levels, were considering shorter opening hours, should consumer demand fail to pick up.

Capacity utilisation

Capacity utilisation in the manufacturing sector was, on balance, around normal, with constraints on production greatest among exporters. There were a few instances of firms supplying the domestic market that were nearing capacity, but most could raise production by implementing additional shifts if required. They remained reluctant to do so, however, because of uncertainty about the outlook for demand. In the service sector, slack was gradually dwindling among professional and financial firms, due to rising demand and competitive pressures that had raised the amount of effort required to secure a contract. Among providers of other services to the corporate sector, such as conferencing, there was still considerable scope to undertake more work, whereas those with close links to the manufacturing sector were beginning to face constraints. There was significant spare capacity in consumer-facing businesses.

Costs and prices

Labour costs

Labour costs continued to rise at a moderate pace in the manufacturing sector. Growth in settlements largely reflected compensation for past wage freezes and the wish to pass on improvements in profitability, as well as some recognition of the higher cost of living. And there were a few instances of quite generous settlements for those staff with skills that were in particularly short supply — some engineers and niche legal or financial services professionals, for instance. Efforts to expand production were also leading to a rise in average hours and overtime payments, and bonuses for strong performance. In the service sector, labour costs were rising at a slightly slower pace than in manufacturing, with pay freezes remaining fairly common. As in manufacturing, there had been more use of performance-related pay, and targeting of awards to retain key individuals. Across sectors, there was little pressure from staff or unions for above-inflation settlements. But some contacts were concerned that if inflation remained elevated, wage demands would strengthen.

Non-labour costs

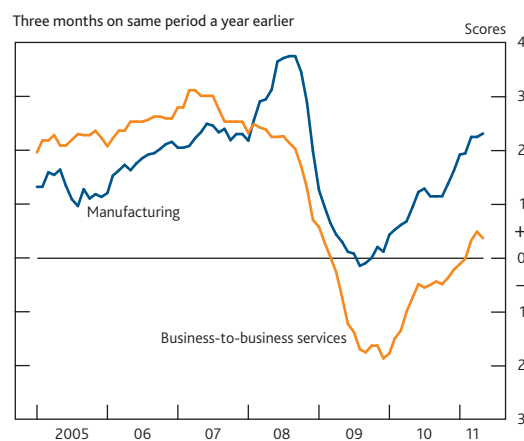
The prices of a range of materials, such as timber, metals and oil-based products, continued to rise rapidly compared to a year earlier. And the price of various food commodities, including milk, butter and meat, had also been increasing quickly. But the pace of increase in materials costs was thought not to have accelerated any further. Finished goods price inflation remained elevated, due to the rise in the price of raw materials, higher transport costs, and rising wages in some emerging markets.

Output prices

Manufacturing output prices continued to grow at a steady pace (Chart 3). But rising costs had only been passed on in

part. That was sometimes because the domestic demand environment remained weak, or because firms were price takers from large buyers. And some firms had re-engineered products to make less use of materials that had risen sharply in price, or had invested to reduce waste, to try to offset rising costs. Food producers continued to experience strong resistance from supermarkets to price increases. Among contacts in the service sector, prices were growing only very gradually, reflecting slack in the sector and relatively weaker demand conditions than in manufacturing (Chart 3). This was especially true of professional and financial services, and in other business services serving the corporate market, for instance in conferencing and hospitality. In transportation and logistics some firms had been able to invoke fuel escalator clauses to pass on increased costs.

Chart 3 Manufacturing and business-to-business services prices



Consumer prices

The Agents' score continued to point to an elevated pace of consumer goods price inflation over the past twelve months. Contacts attributed the increase in prices to the rise in VAT, and the higher cost of transportation, materials and finished goods. But there remained considerable use of promotions to drive footfall, and discounting of big ticket items had been deeper than usual. Downward pressure on high street prices from on-line retailers had intensified. Looking ahead, some contacts thought that margins on clothing had become very thin, due to increases in the cost of fabrics, and suggested that there would be a rise in the price of autumn ranges if demand conditions permitted.

The increase in VAT had also added to the pace of inflation in consumer services. And higher fuel costs had pushed up the prices of travel and transportation. The prices of various essential services had also risen quickly, including for housing rent and insurance. But for businesses in those sectors where expenditure was largely discretionary, for instance in the hotel and restaurant trades, inflation remained muted.