BANK OF ENGLAND

Agents' summary of business conditions

March 2011

- The annual growth rate of real consumer spending had slowed for both consumer goods and services.
- There had been a slight improvement in activity in the housing market, but it remained depressed.
- Among manufacturers, investment plans pointed to steady growth in capital spending over the coming year.
- Goods exports continued to rise rapidly, driven primarily by demand from emerging markets and some European countries.
- Business services turnover was reported to be growing at a gentle pace.
- Domestic manufacturing output was rising steadily, partly reflecting increasing demand for investment goods.
- The level of activity in the construction sector was a little higher than a year earlier, but declining public sector work was expected to weigh on growth going forward.
- Firms with significant holdings of fixed assets had increasingly been able to secure bank loans, but most small companies did not perceive much of an improvement in the availability of credit.
- Employment intentions in the manufacturing sector had picked up, reflecting rising output, but had remained broadly flat in services.
- Capacity utilisation was reported to be around normal in manufacturing, but there was still significant spare capacity in the service sector.
- Raw materials prices had continued to increase at a rapid pace. Along with higher wage costs abroad, that was pushing up on the price of imported finished goods.
- Manufacturing output price inflation had risen further, as firms passed on some of the increase in input prices.
- Consumer goods inflation had increased further, reflecting both higher VAT and a degree of pass-through of recent rises in the cost of imports and raw materials. Services inflation had also picked up.

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 January 2011 and late February 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.

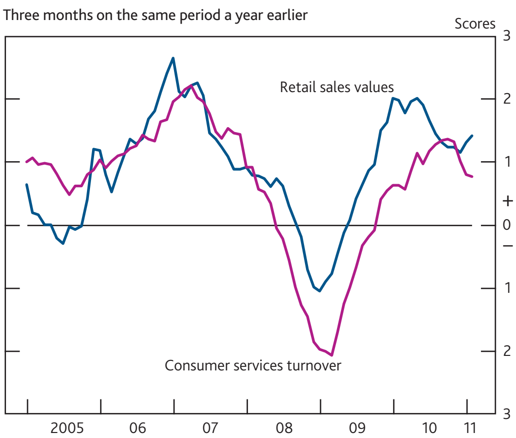
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

Retail sales turnover continued to rise at a modest pace in February (**Chart 1**). But the rise in turnover was in large part due to relatively rapid increases in prices. The annual growth rate of volumes of sales was thought to have slowed. In light of increasing concerns about inflation, and its impact on real income, consumers were thought to have redoubled their efforts to obtain value for money. There was less scope for shoppers to make price comparisons with new or improved products, however, which afforded firms some opportunity to rebuild their margins. And some contacts had begun to focus on delivering product innovations, rather than discounts, to stimulate demand.

Chart 1 Retail sales values and consumer services turnover



The annual rate of growth in turnover in consumer services had been fairly sluggish, and the Agents' score had fallen further (**Chart 1**). Taken together with a rise in inflation, that signalled a fairly marked slowing in volumes growth. There had been a fall in demand for short breaks and second holidays. Hoteliers were struggling to maintain occupancy levels. And spending on leisure activities had weakened. But there had been a small boost to spending in restaurants and pubs, due to Christmas-related spending that had been postponed as a result of the wintry weather during December.

Housing market

Activity in the housing market had been quite volatile during recent months. Lately, some contacts had reported that activity in the housing market had picked up somewhat. There had been a small rise in visitor numbers to newly built property, which was thought to have been helped by the increasing availability of financing products offered by home builders themselves. And enquiries and viewings had increased in the secondary market. But first-time buyers continued to be hampered by a lack of mortgages at high loan to values. And there had been a rise in cancelled transactions, due to concerns among buyers about further falls in prices, and disappointment with surveyors' valuations. The rental market remained buoyant.

Business investment

Investment intentions in the manufacturing sector pointed to solid growth in capital spending over the next twelve months. New investment was being driven primarily by expectations of further increases in demand, particularly among exporters, with reports of investment in additional capacity becoming more widespread. Efficiency and the resumption of replacement cycles continued to account for a large part of planned investment. But some contacts noted that the imminent completion of investment projects that had been on hold during the recession would tend to weigh on investment growth going forward. For them, the peak rate of growth in investment may now have passed.

Investment intentions in the service sector pointed to a more restrained pace of growth than in manufacturing. Investment was still motivated in large part by the need to replace existing capital, or achieve efficiency gains. The pace of expansion of several large retailers had started to slow and that was now detracting from the rate of aggregate investment growth. Moreover, those plans might be scaled back if the outlook for consumer spending became more uncertain. But certain sectors were likely to benefit, as consumers increasingly focused on value for money. Some leisure attractions planned to invest in facilities in anticipation of another year of support to demand from UK residents holidaying at home. And budget hotel and restaurant chains were expanding capacity.

Exports

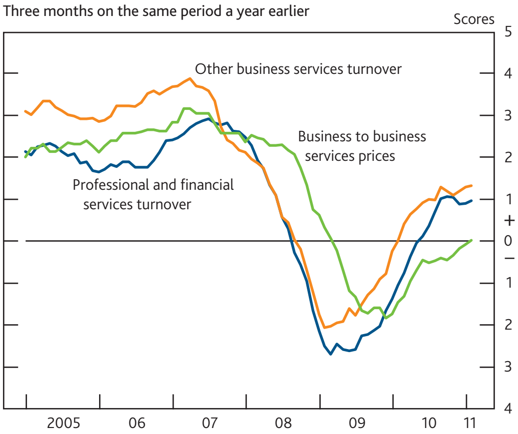
The Agents' score pointed to rapid growth in the value of goods exports, and rose further on the month, thanks to rising demand from emerging markets and a strengthening of demand in some European countries, especially Germany. Exports to the United States were also thought to have been growing at a gentle pace. And a few more contacts reported having successfully accessed new markets. Demand had continued to rise for components related to the aerospace and automotive sectors. Reflecting the rapid growth in manufacturing and rising investment in rapidly growing economies, there had also been a rise in demand for capital goods. And higher energy prices had supported growth in demand for equipment used in the sector.

Output

Business services

Contacts in professional and financial services continued to see fairly restrained growth in turnover (**Chart 2**). And there had been a growing drag on underlying activity from declining public sector work. But the private sector was providing a source of some growth. An increase in corporate financing business had helped to support legal and accountancy

Chart 2 Business services turnover and business to business services prices



practices. Solicitors had been undertaking a little more work on joint ventures and product licensing, which was perhaps a reflection of a gradual shift in the focus of clients towards foreign markets. And there had been a slight rise in property leasing, as firms sought to make the most of low rents, or took plans for office moves off hold.

The pace of growth in turnover in other business services also pointed to a relatively gradual recovery in the sector (**Chart 2**). The experience of hoteliers and conferencing facilities providers was fairly typical, with rising corporate sector spending being offset to a significant degree by a fall in revenues from work for the public sector. But there had been a rise in shipping and haulage volumes, reflecting the strength of manufacturing output, as well as a rise in imports of capital goods, consistent with the pickup in firms' investment plans.

Manufacturing

Manufacturing output continued to grow steadily. Producers of capital goods reported that they had seen a rise in activity, reflecting investment intentions both abroad and at home. By contrast, output of consumption goods had weakened, as overhangs of stocks and uncertainty about the outlook for household spending had induced retailers to reduce order levels. And there was reported to have been a fall in public sector orders of consumable goods.

Construction

Having been depressed by the extreme weather in December, activity in the construction sector had picked up. And some of the time on site that had been lost before Christmas had now been recovered. The Agents' score suggested that the level of construction output during the past three months was broadly unchanged compared to the same period a year earlier. But there were concerns about the outlook, and there had been a marked increase in the intensity of competition, placing further downward pressure on already slender margins. There had been an increase in enquiries from manufacturers regarding new sites for production and distribution facilities. But falling public sector work was expected to begin to weigh heavily on growth from next year as outstanding projects reached completion. As a result, many contacts expected a rise in the number of insolvencies in the sector going forward.

Credit conditions

Large firms reported that credit was readily available. The rate of interest on loans had declined a little more, due to increased competition among lenders and the improving health of the corporate sector, although fees remained fairly high. Firms with significant holdings of fixed assets tended to be offered the most favourable terms. That was true also for a small minority of small and medium-sized companies. But, generally, smaller firms did not report much, if any, improvement in credit conditions. And rather than provide personal guarantees, which was increasingly a requirement, some contacts had opted instead to rely on their own finances rather than use bank credit facilities.

Employment

Contacts in the private sector thought that employment would continue to grow at a modest pace over the next six months. Unsurprisingly, recruitment plans were strongest among exporters, although there were reports of a change in the mix of new staff, with increased hiring of sales people, to try to make more of rapidly growing markets. Firms continued to make use of temporary contracts, given uncertainty about future demand.

Contacts in professional and financial services reported that there were plans for a small amount of recruitment over the next six months. There was also expected to be further hiring in the IT sector and shipping. But employment intentions among consumer-facing firms were weakening. And as the pace of expansion of some of the larger retailers slowed, that would tend to lower the growth rate of employment.

Capacity utilisation

According to contacts, capacity utilisation was around normal in manufacturing, particularly among exporters, and that had prompted some to invest in capacity. However, there were also several reports this month from firms that considered themselves to be operating at full capacity, but which could raise supply quite readily by bringing on additional shifts. Those firms remained reluctant to raise their capacity, however. That was partly because it would increase costs, but also because of uncertainty about the prospects for demand. Contacts in the service sector tended to report that they had significant scope to increase supply. This reflected a surplus of both labour and physical assets, such as office space, warehouses and hotel rooms.

Costs and prices

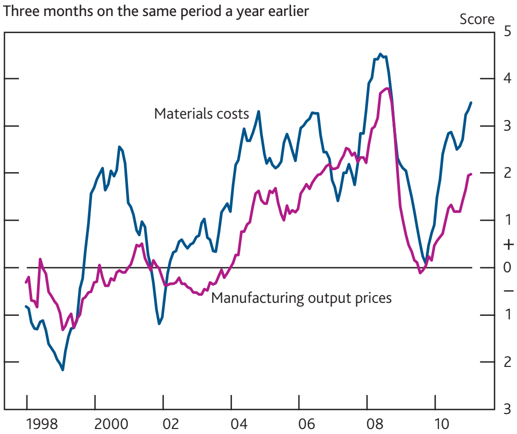
Labour costs

In manufacturing, total labour cost growth had risen to around its historical average rate, often reflecting improved profitability, or recognition of staff loyalty following several years of wage freezes or muted pay growth. And there had been some partial compensation for elevated inflation, especially among some of the more heavily unionised workforces. In services, where profitability had yet to recover as much, there had been less of an increase in the growth rate of total labour costs. And, generally, contacts reported that their employees' expectations for pay increases in 2011 were only a little higher than a year earlier. Labour cost growth was reported to have been particularly weak among firms with significant exposures to construction and the public sector.

Non-labour costs

Materials costs continued to rise quickly, and there had been a further increase in the Agents' score for annual inflation (**Chart 3**). Inflation in materials was being driven by higher prices of agricultural commodities, fabrics, and fuel. The use of hedging and annual contracts was expected to mitigate the impact on firms in the near term. The pace of inflation in the price of imports of finished goods was also elevated (**Chart 4**). Imported finished goods prices had been pushed up by the higher cost of materials and transportation, as well as an increase in wage pressures in Asia.

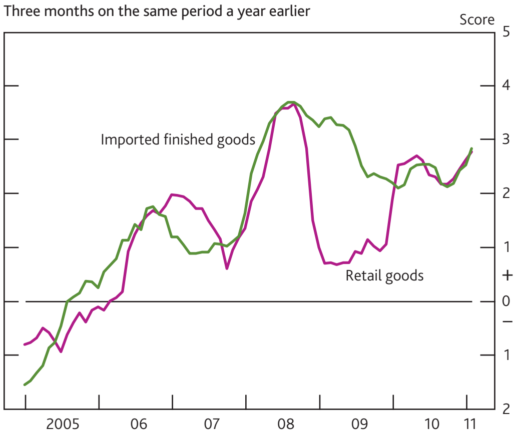
Chart 3 Material costs and manufacturing output prices



Output prices

The Agents' score indicated that manufacturing output price inflation had edged upward on the month (**Chart 3**). Some firms reported that they had managed to pass on part of the rise in materials costs, and a few were beginning to rebuild margins. Retailers were only very gradually allowing the rise in the cost of agricultural commodities to be passed on by food suppliers, however. Manufacturing firms that had been unable to pass on much of the rise in the cost of inputs had tried to preserve their margins by reducing other costs.

Chart 4 Imported finished goods import prices and retail goods prices



There had been significant downward pressure on fees paid to suppliers of business services. But the Agents' score for total business services prices indicated that they had now stabilised, with the level of fees at around the same level as a year earlier. Nevertheless, firms exposed to the public sector continued to face a particularly challenging pricing environment. There were signs of renewed falls in the fees charged by professional and financial services. And the suppliers of services related to the construction sector continued to report falling prices. By contrast, charges for transportation, logistics, haulage and distribution had all risen due to higher fuel costs.

Consumer prices

Consumer goods price inflation had risen further (**Chart 4**), driven in large part by the recent increase in VAT, as well as higher import prices and transportation costs. But, while list prices were rising, some of that was reported to have been offset by further discounting. For clothing and footwear, further increases in prices were expected as spring and summer lines arrived, since these would reflect recent rises in the cost of fabrics more fully than had winter fashions.

The annual rate of inflation in consumer services prices was also somewhat higher than its historical average. That was in large part due to the recent increase in VAT. Insurance premiums for motor and buildings cover were also rising quickly due to increases in the value of claims, and insurers rebuilding their reserves, which had been eroded. Hoteliers were discounting room prices in order to maintain occupancy levels, however. And holiday operators were lowering prices in response to disappointing bookings of winter and summer holidays.