BANK OF ENGLAND

Agents' summary of business conditions

May 2011

- The annual growth rate of retail sales values continued to slow, despite the elevated rate of inflation.
- Nominal spending on consumer services weakened further.
- Activity in the housing market had softened somewhat, attributed mostly to households' concerns about further falls in house prices and uncertainty about earnings.
- Investment intentions pointed to a moderate pace of growth in capital spending over the next twelve months.
- Goods exports continued to grow quickly, driven by robust demand from emerging markets and developed economies, including Germany and the United States.
- Manufacturing output for the domestic market was growing more slowly than for exports.
- Demand for business services was growing at a modest pace.
- Construction output appeared broadly in line with a year earlier. Contacts remained downbeat about the outlook.
- Employment intentions pointed to continued job growth, but plans for further recruitment in consumer services were being revised down.
- Manufacturers were operating with normal levels of spare capacity, but there remained a degree of slack in the service sector.
- Total labour costs were rising at a moderate pace in both manufacturing and services.
- The cost of raw materials continued to rise rapidly, due to growing world demand and persistent supply shortages.
- The increase in the cost of raw materials — along with rising wages in Asia and higher transport costs — was pushing up the price of imported finished goods.
- Some of those increases in costs had been passed on in output prices, but many contacts felt that they had limited pricing power to do so.
- 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 March 2011 and late April 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

There had been a further weakening in consumer demand (**Chart 1**). Consumers remained focused on obtaining value for money and increasingly required promotions to induce them to spend. And discount retailers continued to benefit from consumers 'trading down' at the expense of mid-range products. Some contacts observed signs that spending patterns based around paydays had become more accentuated. Shoppers were also making smaller, more frequent purchases. And more households were choosing to pay by cash rather than credit, to help them stay within a fixed budget. The top end of the retail sector continued to show some resilience, although there were reports of increased use of discounting there too.

Chart 1 Retail sales values and consumer services turnover

Demand for consumer services had also softened (**Chart 1**). While nominal spending on non-discretionary services, such as car insurance, had increased somewhat, often due to rising prices, spending on discretionary services had been squeezed. There had been a fall in spending per person on a range of recreational activities. And promotions were still considered essential for many service providers to generate demand. Holiday bookings had strengthened a little compared to last year, but holidaymakers were increasingly opting for all-inclusive packages, to keep better control of costs.

Housing market

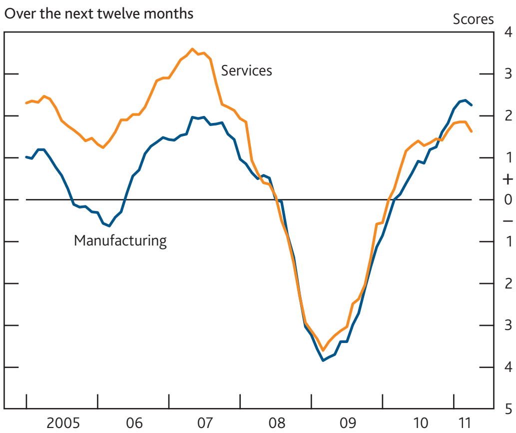
Demand had weakened further, reflecting concerns that house prices might begin to fall more quickly, and households' uncertainty about earnings. At the lower end of the market, many would-be first-time buyers were still struggling to save a deposit, with an increasing number of transactions involving some form of shared equity. The middle and upper segments of the market had been faring a little better, helped in part by greater use of house-builders' part-exchange schemes, although these programmes were expected to become more limited due to constraints on builders' balance sheets.

Buy-to-let investors remained active buyers, particularly for smaller properties favoured by frustrated first-time buyers.

Business investment

Spending on capital was expected to continue to grow at a reasonable pace over the coming year (**Chart 2**). Investment was typically to help find efficiencies, although such plans often had the ancillary benefit of raising potential productive capacity. And some exporters were actively investing in additional capacity. Firms were also investing in new products to try to exploit growth markets both at home and abroad. The deterioration in the outlook for household spending had led some firms to reassess their investment plans.

Chart 2 Investment intentions



Investment intentions among services contacts pointed to a somewhat more moderate pace of growth than in manufacturing, reflecting the relatively larger degree of spare capacity in the sector. Firms continued to invest in measures to lower costs, for instance on alternative sources of energy or more efficient distribution facilities, and in IT to raise productivity. Resumption of routine investment that had been on hold was also helping to support spending. Some consumer-facing firms had become more cautious in their plans, with food retailers slowing the pace of store expansion programmes.

Exports

Exports of goods had grown rapidly over the past twelve months, due to the strength of demand in both emerging markets and some developed markets, including Germany and the United States (**Chart 3**). The pace of export growth relative to domestic demand had led some firms to shift their focus overseas, and some had been successful in penetrating new markets or winning a greater share of existing ones. The aerospace, automotive, energy and infrastructure sectors were all sources of particularly solid growth. Some services firms in these sectors, as well as in legal and accountancy work, had also reported a pickup in foreign demand. So far, the impact of civil unrest in the Middle East and North Africa had not had much impact on exports.

Output

Business services

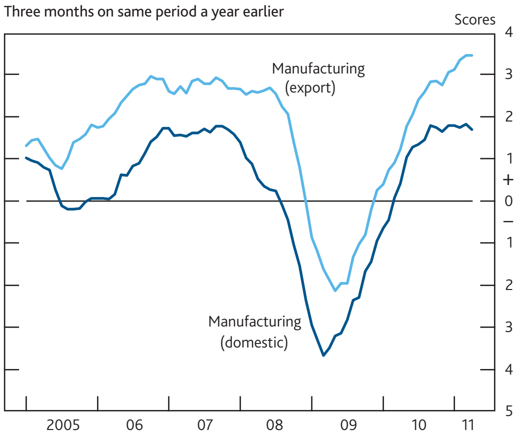
Turnover in professional and financial services continued to grow at a modest pace. That reflected positive growth in demand from the private sector, while public sector work continued to decline. Accountancy and legal firms reported a small improvement in activity, particularly for clients that served overseas markets. Corporate finance had strengthened a little, due to a rise in mergers and acquisitions activity. And new office lettings were on the rise. Advertising companies had seen a steady decline in the use of traditional media, but work for on-line campaigns was providing some offset. This, along with firms' ongoing efforts to find efficiencies, was also helping some IT companies.

Among other business services, the gradual recovery in turnover continued. That was partly due to success in pushing through price increases. Hauliers and transport providers, for instance, had been able to pass on some of the recent rises in fuel prices. But they had also benefited from rising activity in the manufacturing sector. Revenues from the public sector had declined significantly, although some hoped that there would be an increase in outsourcing work in the future.

Manufacturing

The manufacturing sector continued to grow at a steady pace (**Chart 3**). Suppliers of intermediate and capital goods to the export sector reported that conditions had improved further. And there was also some growth in the supply of investment goods to domestic firms, reflecting their efforts to find efficiencies. Producers of consumer goods for the home market tended to report that activity was growing fairly slowly, and some noted that conditions had deteriorated in recent months. Firms exposed to the public sector also reported that government orders continued to fall.

Chart 3 Manufacturing output



Following the disaster in Japan, some car manufacturers had announced plans for significant, temporary, cutbacks in output, due to expected shortages of some components. Because of lags in the supply chain, which sometimes extended for a number of months, further material disruption to production was anticipated during the second quarter, and perhaps beyond. For firms in other sectors, the impact of events in Japan had so far been small. But many contacts felt poorly sighted on the origins of some imported electrical components. Given lags in their respective supply chains, there was a risk that shortages of some inputs could yet become apparent over the coming months. The extra bank holiday for the royal wedding in April was expected to cause some additional volatility in production.

Construction

Overall, activity in the construction sector over the past three months was thought to be broadly in line with that a year earlier. The level of output continued to be supported by work on infrastructure and energy projects, along with office building in London. And there had also been a small pickup in residential housing construction. The slowing pace of openings of new stores by some large retailers was weighing on the growth rate of construction output, but this was offset by increased work on warehousing and distribution centres. Many contacts reported a fall in public sector work, and there was expected to be a more marked drag on output from lower government spending from 2012 onward.

Credit conditions

Large firms, and profitable businesses with relatively little outstanding debt, tended to report that they had access to credit if required. A few small and medium-sized enterprises also reported that loan terms had become a little more favourable. But most did not perceive a material improvement in conditions. In some cases this was expected to restrict growth plans, while some firms expressed concerns about the lack of availability of funds for working capital. A few contacts did note that there had been a pickup in marketing activity by lenders. But some banks themselves commented that lenders might be focusing their attentions on the same, low-risk, borrowers. New lending to firms in property-related sectors remained scarce.

Employment

In services, employment intentions reflected differences in activity across sub-sectors. Business services companies planned to increase headcount at a gradual pace, in line with the gentle recovery in corporate demand. Employment intentions among firms serving the public sector were typically weaker than for those facing the private sector. Firms operating in the construction industry generally anticipated flat or declining employment over the coming year. And there had been a further dip in intentions among retailers and consumer services firms, reflecting rising uncertainty about the outlook for household spending.

Contacts in the manufacturing sector expected employment to continue to grow at a steady pace, particularly among firms exposed to foreign demand. Intentions among suppliers of manufactured goods for the domestic market were often rather weaker. Recruitment was generally reported to be fairly easy for low-skilled positions. But in both manufacturing and services, for instance among engineering and IT companies, and in risk management and compliance, there were rising instances of skill shortages.

Capacity utilisation

Manufacturers were operating with levels of spare capacity that were reported to be broadly normal. That was in part due to rising demand, particularly for exports. But it was also a function of steps taken by firms to lower productive potential in response to the sharp decline in activity during the recession, for instance, by reducing the number of shifts, or mothballing capital. However, contacts were often reluctant to reverse measures that had been implemented only on a temporary basis, given the often significant costs of doing so and uncertainties about the durability of the recovery.

In the service sector, most firms reported that they had significant amounts of spare capacity. This was falling slowly for those business services firms that were benefiting from rising private sector activity. Firms serving the consumer and public sectors often still had substantial amounts of slack, and some were revising down their plans for headcount to keep spare capacity from growing.

Costs and prices

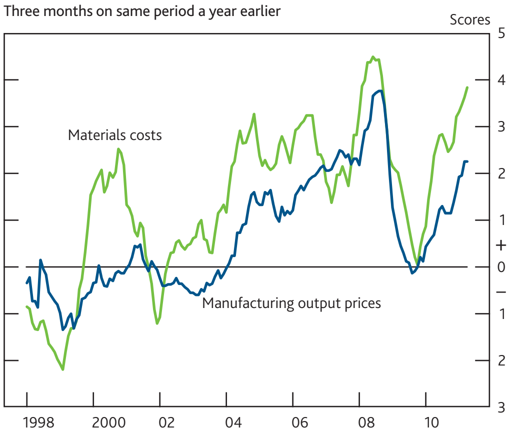
Labour costs

Labour costs were rising at a moderate pace in both manufacturing and services. Settlements were typically reported to be between 2%–3%, slightly higher than a year earlier, reflecting rising profitability over the past twelve months. Above-inflation settlements were rare, and in some instances employees were entering a third year of pay freezes. Negotiations over pay with unions were generally reported to have gone smoothly. The additional bank holiday associated with the royal wedding in April was expected to generate a temporary increase in labour costs for some firms.

Non-labour costs

Contacts continued to face rapid increases in the prices of a range of raw materials (**Chart 4**). These included commodities, metals, energy and oil-based products. A number of firms were experiencing sharp increases in costs due to the expiry of long-term contracts made prior to the latest surge in prices. The rising cost of raw materials was feeding through to various processed inputs. Together with rising wages in Asia and higher transport costs, the increase in the cost of raw materials was putting upward pressure on the price of imports of finished goods.

Chart 4 Material costs and manufacturing output prices



Output prices

Manufacturing output prices were rising at a moderate pace (**Chart 4**). Firms had managed to pass on some of the increase in input costs, particularly in markets where demand was strengthening, or when inputs that had risen sharply in price comprised a large proportion of the cost base. But even then, pass-through of higher costs was typically only partial, and often with a substantial lag. Some firms were now repricing output more frequently, to try to pass on increases in costs more quickly. But many contacts felt that they had little pricing power, and the squeeze on margins was forcing them to focus increasingly on measures to reduce costs, such as consolidating back-office functions across different worksites.

Overall, business services price inflation remained subdued. Spare capacity in much of the sector continued to keep fees from rising, particularly in construction-related services, and among providers of professional and financial services of a standardised nature. Suppliers of some niche services had been able to raise their prices, however, due to rising demand. And some firms in the haulage and transport sectors had managed to pass on some of the increase in fuel costs, often through the use of escalator clauses in contracts.

Consumer prices

According to contacts, the pace of retail price inflation remained elevated. That reflected a combination of the rise in VAT, an increase in transport costs and the rising cost of imported finished goods. But while list prices were rising quite quickly, contacts reported that the weakness of consumer demand meant that discounting was much heavier than would typically be expected for this time of year.

Consumer services price inflation had also been boosted by pass-through of the increase in VAT. And the prices of essential services, including rents and car insurance, continued to rise fairly rapidly. Higher fuel costs had also been passed on, at least in part, in the price of travel and public transport. But there remained considerable downward pressure on the price of discretionary services, reflecting the weakness of demand.