BANK OF ENGLAND

Agents' summary of business conditions

November 2011

- The annual growth rate of nominal spending on consumer goods and services remained very weak.
- The level of activity in the housing market remained subdued, with less of a pickup than usual after the summer.
- Investment intentions pointed to a further modest increase in spending on capital over the coming year.
- Exports of goods continued to grow steadily, although there had been some slowing in orders reflecting both softer world demand and rising uncertainty.
- Manufacturing output was still growing compared with a year earlier, but the pace of growth had been declining for some months.
- The growth rate of business services turnover had also fallen over the past few months, due to weakness in professional and financial services.
- There had been a slight contraction in construction output, compared with a year earlier, and activity was expected to fall further.
- Firms in a strong financial position could access credit on competitive terms, but small businesses often reported that conditions remained tight, and in some cases had become tighter.
- Employment intentions had softened recently, with increasing uncertainty leading to greater caution in some cases.
- The level of capacity utilisation was around normal in manufacturing, but had fallen a little over the past few months. There remained a degree of slack in services.
- Total labour cost growth remained modest, and slowing activity had lessened upward pressures on pay.
- Raw materials costs inflation continued to fall back.
- Import price inflation had levelled off, albeit at a high rate, following the easing in materials cost inflation.
- Manufacturing output price inflation continued to rise steadily, while inflation in business services was more restrained.
- Annual inflation for consumer goods and services 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 September 2011 and late October 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 growth remained very weak. Contacts reported that households were budgeting ever more keenly, trading down to avoid overspending, or simply going without, and increasingly deferring expenditure on durable goods until replacement became unavoidable. Consumers' focus on value was apparent in the rising market share of online and discount retail, though even here there were beginning to be signs of weakening. Promotions remained essential to drive volumes and keep levels of inventory manageable. Contacts anticipated that the Christmas period would be broadly flat compared to last year, and there were rising concerns about future failures in the sector, if demand fell short of even these modest expectations.

The rate of growth of nominal demand for services had edged down a little further. Spending on a number of non-discretionary services, such as rent and transportation, had been pushed up by price increases. And that had reduced the amount of disposable income left over for discretionary services. For example, households were reported to be taking fewer, shorter holidays, and shopping around for the cheapest deals on hotels and restaurants. There had been a rise in passenger numbers on public transport, as higher fuel prices discouraged car use.

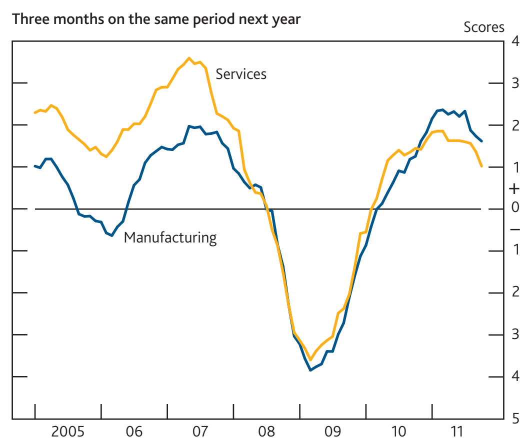
Housing market

There had been less of a seasonal pickup in transactions than usual following the traditional summer lull. A small improvement in mortgage availability had encouraged a few first-time buyers back into the market, along with the Government's FirstBuy initiative and shared equity schemes offered by some house builders. But the inability to secure credit continued to constrain many would-be homeowners. That was in turn supporting demand for rental property, and encouraging some buy-to-let investors back to the market. Many existing homeowners were discouraged from trading up by rising uncertainty about future incomes and house prices. Meanwhile, the top end of the market had shown some resilience, with buyers tending to be better able to raise finance. And the supply of new homes was increasingly focused on meeting the needs of this segment.

Business investment

According to contacts, a further modest increase in capital spending was planned over the coming year, although intentions had softened somewhat since the summer (**Chart 1**). Across sectors, rising uncertainty about the outlook for demand had led to a renewed emphasis on cost containment and efficiency improvements. At the margin, some firms had postponed spending for the time being, with cash preservation taking precedence (see the box on page 5 for the results of a recent survey on investment intentions). But plans had typically not been shelved altogether, and firms continued to spend on routine maintenance and replacement. Across sectors, contacts emphasised the importance of continual investment in their products, to maintain demand in a highly competitive environment. And regulatory compliance necessitated a degree of capital spending, particularly on IT. Plans for investment in additional capacity were cited less frequently now, as past projects came to fruition.

Chart 1 Investment intentions



Exports

Exports of goods continued to grow at a steady rate, helped by ongoing product innovation, and entry into new markets. But there had been a further moderation in the pace of expansion, reflecting slowing world demand. There had also recently been some shortening in order books, and increased volatility in the flow of new orders, making it harder to gauge future demand. Firms typically reported that activity in emerging markets remained robust, although there were a few reports of a slowing in exports to China and India. Exports to the euro area had also slowed somewhat, particularly to countries most affected by concerns about sovereign debt.

Output

Business services

Professional and financial services turnover was growing at a modest pace, but had slowed materially over the past few months. And some contacts believed that their clients had delayed decisions due to heightened uncertainty about the outlook. Suppliers of services to industry continued to benefit from rising activity in manufacturing, though this had been weakening. And energy and environmental services had been supported by the efforts of businesses in the wider economy to cut costs and minimise waste. But some contacts had seen a deterioration in conditions, reflecting softer demand and worries about future growth, and firms continued to leave the haulage sector and construction-related services.

Manufacturing

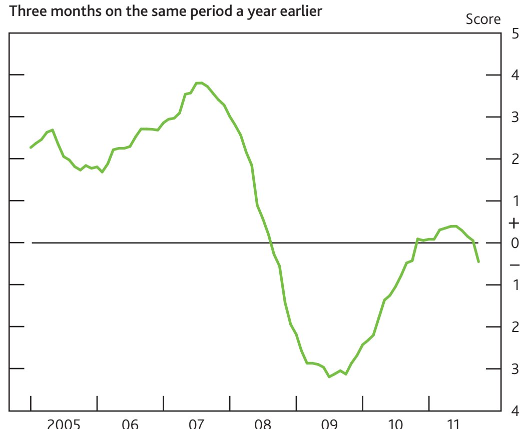
The pace of expansion of manufacturing output had declined further on the month, and reports had become more mixed. A number of contacts had experienced a fall in order books, and there were growing concerns about the prospects for demand, both at home and abroad. Suppliers of goods destined for the domestic household sector, and particularly producers of durables, typically reported fairly flat, or falling, activity in recent months. Food production had shown some resilience, although to some extent this reflected improvements in market share following consolidation in the sector. Producers of goods destined for the public sector reported falling orders, as cuts had begun to take effect. And suppliers to the construction industry had also seen a further decline in activity.

Construction

The Agents' score indicated that activity in the construction sector had begun to contract, compared with a year earlier (**Chart 2**). The decline in output was in part due to the completion of large public sector projects, and there had also been a fall in repair and maintenance work for local authorities. This was expected to continue for some time. And forward-looking indicators pointed to lower private sector activity as well. That tended to suggest that construction output would contract further over the coming months. House building was being managed very tightly to ensure that supply did not outstrip demand.

Chart 2 Construction output

Three months on the same period a year earlier



Credit conditions

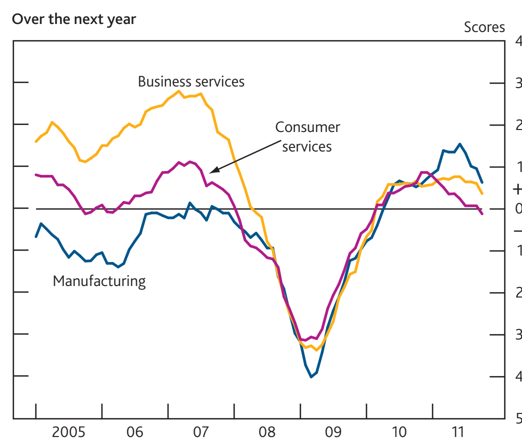
Firms with strong balance sheets, cash flow and profits continued to report that they were able to access credit on competitive terms. But smaller firms typically found it more difficult to access credit than larger ones. And they were often reluctant to commit to asset-backed forms of lending, instead of overdrafts, which continued to be withdrawn. There were also reports from some small and medium-sized companies, in particular, that credit conditions had tightened further in recent months. On the demand side, firms were often avoiding drawing upon overdraft facilities in case they were required as a last resort. And there had been a renewed focus on preserving cash due to a growing squeeze on liquidity. Reports of a rise in debtor days had become more frequent, and higher costs had increased firms' working capital requirements. Some firms also reported a hardening in the stance of HM Revenue and Customs on the collection of tax arrears.

Employment

Private sector employment intentions pointed to further growth in jobs over the coming year, but had been softening over the past few months (**Chart 3**). And rising uncertainty about the outlook was causing some firms to revise down their plans for recruitment. In manufacturing, contacts still expected a modest increase in headcount, reflecting the relatively strong performance of the sector during the recovery. But intentions had naturally fallen back as employment had caught up with activity. Firms continued to make greater use of apprenticeships, to ensure that individuals with key skills were in place in the medium term.

Chart 3 Employment intentions

Over the next year



Employment intentions in the service sector had also begun to soften. Recruitment was driven by advisory firms in engineering, IT, and financial risk compliance. But banks were often considering reductions in headcount. And for a number of small professional services firms, the lack of a robust recovery in demand, combined with increased fears about the outlook, was leading to downward revisions in staffing needs. Businesses in the construction and property sectors were contemplating fresh rounds of redundancies, while contacts in retail typically reported that staffing levels were already as low as they could be, if minimum standards of customer service were to be maintained.

Capacity utilisation

In manufacturing, capacity utilisation had fallen back a little, due to a softening in demand conditions, and past investment

and recruitment, which had begun to generate some slack. There was variation across sectors, however, with exporters, and their suppliers, tending to be operating at fairly high levels of utilisation. By contrast, producers of consumer goods for the domestic market tended to exhibit rather larger amounts of spare capacity, and could bring temporarily mothballed productive capacity on stream relatively easily, if demand were to pick up.

In the service sector, businesses in growth areas, such as IT, were often reporting high levels of capacity utilisation. But in a variety of sectors, for instance in standardised professional services, firms often reported being very busy competing for new contracts, even though they were winning relatively few, and labour productivity was often very low as a result. Consolidation was beginning to reduce oversupply in some sectors, such as haulage and construction. And firms were increasingly considering how business models might be changed to reduce the underutilisation of staff. In the consumer sector, for instance, there was substantial spare capacity, due to minimum staffing requirements, leading some contacts to shorten opening hours, or close underperforming stores, to lower the labour input.

Costs and prices

Labour costs

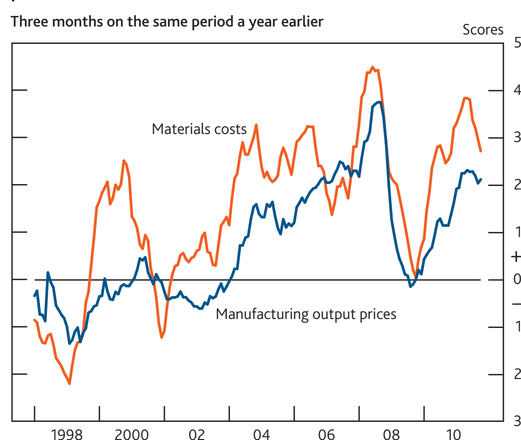
The Agents' scores suggested that there had been a slight slowing in the rate of growth of labour costs in recent months. There was generally very little upward pressure on settlements. And for many firms, weaker-than-expected performance and rising uncertainty had reduced what was considered affordable, while staff had become more concerned about job security than pay. Awards were typically between 2%–3%, and reflected a combination of improved profitability and a degree of compensation for past wage restraint and increases in the cost of living. There continued to be moves away from linking pay to official measures of inflation, with use of performance-related pay and bonuses becoming more widespread. Higher awards tended to be concentrated in growth sectors, or for staff with particular skills, with lower settlements more common in sectors where final demand was especially weak. In the consumer-facing sector, and construction, for instance, pay freezes remained common, with increases largely driven by changes to the minimum wage.

Non-labour costs

The rate of inflation in materials prices had fallen back in recent months, as the cost of a wide variety of inputs had begun to level off, and even fall in some instances — related to the recent decline in the prices of many commodities, including some foodstuffs and base metals (**Chart 4**). And some contacts reported that weakening world demand had enabled them to resist further increases for some materials. But higher energy prices continued to be passed on as firms renewed fixed-term contracts. And higher energy prices were feeding through to energy-intensive intermediate products. Inflation in the price of imports of finished goods had also stopped gathering pace, reflecting less upward pressure from increases in the cost of materials. Wage increases in emerging economies continued to push up on prices, although some contacts had been able to mitigate the impact on costs, by switching to supply from other, lower cost, countries.

Chart 4 Materials costs and manufacturing output prices

Three months on the same period a year earlier



Output prices

Manufacturing output price inflation remained elevated, although most contacts believed that it had peaked, reflecting moderation in the pace of inflation in input costs (**Chart 4**). Where firms continued to pass on higher costs, this was typically only partial, and firms continued to seek efficiencies and strip out unnecessary outlays. In services, prices were rising gradually, driven by some of the larger providers of niche professional services, and use of fuel escalator clauses in travel and transport services. Fees often remained under downward pressure in sectors where there was still oversupply, particularly for standardised legal and accountancy services, and corporate hospitality.

Consumer prices

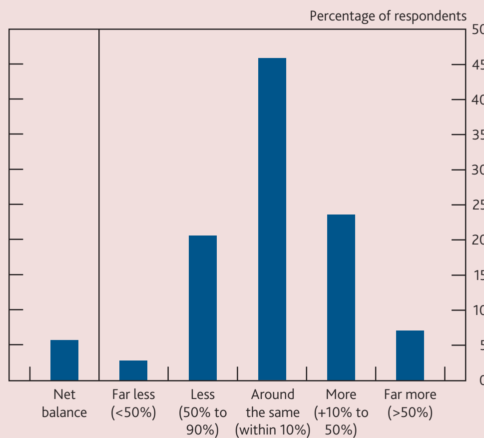
Inflation in the price of consumer goods continued to pick up, largely due to higher energy prices. Heavy discounting meant that prices paid for goods were often materially lower than list prices. But even then, the discounted prices were often rising quickly, compared to a year earlier. And while price points were sometimes maintained, despite higher costs, that was often achieved through a reduction in pack size or quality. In consumer services, the high rate of inflation was largely due to increases in the prices of certain essential services, either because they were fuel-intensive, or because of links to official measures of inflation, for instance in transportation and rent. By contrast, the price of discretionary services remained under downward pressure, with increasing use of promotional activity to generate demand.

Agents' survey on investment

In light of recent weakness in demand, and rising uncertainty about the outlook, the Agents carried out a survey to try to assess the possible effects of these developments on businesses' investment plans. Contacts were asked about their plans for investment over the next twelve months, compared with the past twelve months, and the drivers of those plans. They were also asked about whether their intentions for investment had been revised over the past three months, and, if they had, what had led to those revisions. 270 firms responded, with a combined turnover of £63 billion.

Weighting the data by turnover, firms expected a modest increase in investment over the coming year compared with the past year (**Chart A**). Subtracting intentions for a reduction in the level of investment from those for an increase in investment produced a positive net balance of 6%. This broad pattern was consistent across small, medium-sized and large companies. But at the sectoral level there was rather more variation. Among consumer-facing businesses, and those in construction, the modal response among firms was for very little change in investment. By contrast, in manufacturing firms either expected a material increase or decrease in capital spending. In services, there was a clear positive skew towards an increase in investment.

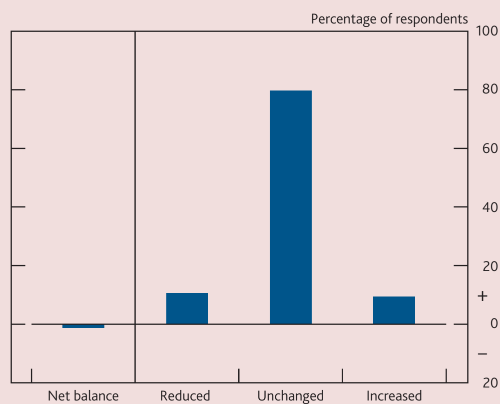
Chart A Expected change in investment over the next twelve months compared with the past twelve months



Across firms, efficiency gains and productivity improvements were cited as a core driver of investment. Investment aimed at maintaining or raising the share of the domestic market was also important for many firms in the services, consumer and construction sectors. And services firms were more likely than those in other sectors to be investing in expanding export activity, consistent with the rising focus of services firms on external demand. Manufacturers, meanwhile, tended to be more focused on essential maintenance, perhaps because many of them had already undertaken investment in export capacity during the recovery, and now needed only to maintain existing capital.

Despite the recent weakness of activity, and the uncertain outlook for growth, the overwhelming majority of contacts reported that they had not made any changes to investment plans recently (**Chart B**). That may be because, for many firms, levels of investment are already very low, making it difficult to scale them back further. Also, investment decisions are often made over long time horizons and, as such, may be less likely to be postponed due to perceived short-term shocks. And many contacts report that continuous investment — in product innovation, finding efficiencies, and so on — is required simply to survive in the current environment. It remains to be seen whether firms will reappraise plans in the coming months, if demand weakens further.

Chart B Changes to investment plans made over the past three months



At the margin, however, a handful of firms had revised their plans in recent months. For those companies whose investment intentions had fallen, external and internal finance were the main causes, reflecting both tighter credit availability, and pressure on internal sources of funding. For those firms that had revised their plans upward, demand from emerging market economies was a key driver, along with a range of other factors, including environmental tax and credit incentives, and legal and regulatory requirements (**Chart C**).

Chart C Factors influencing recent changes made to investment plans made for the next twelve months