BANK OF ENGLAND

Agents' summary of business conditions

October 2011

- Annual growth in nominal spending on consumer goods and services had slowed to a very gradual pace.
- Subdued activity in the housing market reflected continued difficulties of first-time buyers to secure a mortgage and households' rising concerns about incomes.
- Investment intentions had softened in recent months. Some capital spending that had been resumed after the recession had now been completed, and some plans had been put on hold because of increased uncertainty about the outlook.
- Manufacturing exports continued to grow steadily, although the Agents' score had fallen back from recent highs, due to less-favourable base effects and a slowing in orders.
- Manufacturing output for the domestic market continued to grow, although the rate of expansion had declined in recent months.
- Business services turnover growth remained modest, with some niche service providers raising fees, and firms in the transport sector passing on higher fuel prices.
- Construction output was broadly flat compared to a year earlier, and slowing public sector orders and early indicators of private sector demand pointed to a contraction in activity over the coming year.
- Employment intentions in the private sector pointed to further growth in employment over the coming year. But the pace of recruitment was expected to slow somewhat, reflecting both past hiring, and downward revisions to the outlook for demand.
- Capacity utilisation remained a little above normal in manufacturing and somewhat below normal in services.
- There was reported to be little upward pressure on private sector total labour costs, in part because of employees' rising fears about job security.
- The annual rate of increase in raw materials costs continued to flatten off, but higher energy prices were still feeding through as fixed-term contracts expired.
- Increased materials costs combined with higher labour costs in some emerging market countries continued to push up on the price of imports of finished goods.
- The pace of inflation in manufacturing output prices had slowed a little in recent months, while fees for services gradually edged upward.
- Annual inflation in the price of 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 August 2011 and late September 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 annual growth rate of nominal demand remained sluggish, and the Agents' score for retail sales values had fallen further on the month (**Chart 1**). Households remained focused on value for money, with discount and online retailers, and value products performing relatively well. Spending on food remained the strongest component of demand, but even here promotional activity was essential to drive sales. Consumers were increasingly conscious of avoiding waste, and some contacts thought that promotions involving bundles of products had become less effective. In non-food, spending on durables was particularly weak.

Chart 1 Consumer spending

Three months on the same period a year earlier

The growth rate of spending on services was also fairly slow (**Chart 1**). Nominal demand growth for essential services, such as housing, transport and motor insurance, had remained relatively strong, reflecting higher prices. But that had squeezed the amount of income left for more discretionary services, causing a decline in spending on a range of leisure activities. And there had been shifts in the mix of services used, as households tried to maintain broad patterns of consumption. For instance, summer holidays had become shorter, and were spent closer to home, and free visitor attractions had risen in popularity, while paid-for ones had seen footfall weaken. Services related to the housing market, such as conveyance and removals, reported difficult trading conditions, while countercyclical legal services, such as employment litigation, were seeing some growth.

Housing market

The level of activity in the housing market remained depressed, due to concerns about job security, as well as a continued lack of mortgage availability, particularly for first-time buyers. There had been some increase in the number of high loan to value products being offered by lenders, but take-up had been low. Demand for newly built properties had begun to rise, thanks largely to shared equity schemes and the Government's FirstBuy initiative. And buy-to-let investment had also been picking up, encouraged by strong rental demand. Nonetheless, some contacts expressed a concern that if the low overall level of transactions persisted for much longer, there would be an increase in closures of estate agents and solicitors reliant on the market.

Business investment

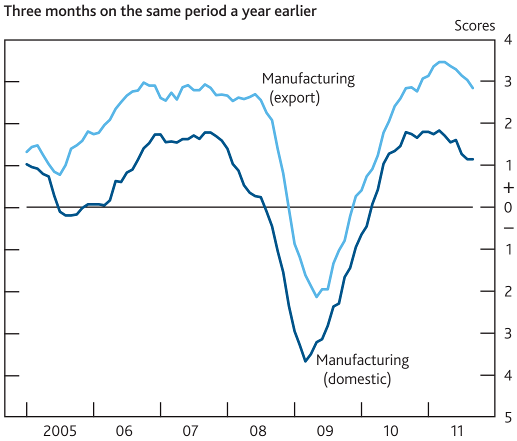
Contacts planned to increase investment over the coming year, but the pace of growth was expected to slow. A number of firms had now completed investment that had been restarted after the recession, and intended to meet further increases in demand with existing labour and capital, rather than by increasing capacity. In manufacturing, some contacts reported having scaled back investment plans due to heightened uncertainty about the prospects for demand. And persistent slack in the business services sector was beginning to depress investment, with some firms using cash reserves to buy competitors, rather than go for organic growth. Across sectors the replacement of old equipment continued to support investment, along with spending on labour-saving IT and plans to cut energy use. Product development and innovation was also seen by many as essential to remain competitive.

Exports and imports

Exports of goods continued to grow at a fairly rapid pace, although the Agents' score had fallen back from recent highs (**Chart 2**). That was in part due to less-favourable base effects in the annual comparison of the level of exports. It also reflected slowing in demand in the United States and parts of Europe, and a small impact from civil unrest in the Middle East. But exports to Germany and various emerging economies remained robust, helped by both the level of sterling and product innovation. Firms were increasingly seeking to offset weak domestic demand by shifting attention towards exports, and continued to report success in entering new growth markets. Some contacts had also won market share as firms around the world diversified supply following the earthquake and tsunami in Japan. Despite increased uncertainty about the outlook for world demand, many contacts expected exports to

Chart 2 Manufacturing output

Three months on the same period a year earlier



continue to support growth over the coming year (see the box on page 5 for the results of the Agents' latest survey on exports).

Output

Business services

Turnover continued to grow at a modest pace in the service sector, with slowing public sector work offset by a gradual rise in private sector activity, although the picture was very mixed across subsectors. For instance, contacts in IT, telecommunications and energy-related businesses reported a steady improvement in conditions, in part due to the mix of investment in the wider economy. In contrast, in haulage, contacts were seeing some deterioration in conditions, reflecting softening in the manufacturing sector. There was a growing sense in some sectors, particularly standardised legal and accountancy services, that despite remaining some way below pre-recession levels, demand was likely to remain subdued for some time. That had encouraged a further round of cost cutting, as well as defensive mergers and acquisitions.

Manufacturing

Manufacturing output growth continued at a restrained pace, but had slowed in recent months (**Chart 2**). Sources of growth reflected the broad pattern of spending in the economy as a whole. Producers of capital goods were still benefiting from investment by domestic firms. And suppliers of intermediate goods ultimately bound for export were growing steadily. But output of consumer goods, especially durables, had been declining. And some contacts reported that de-stocking by customers had weighed on output, or led to a rise in inventory. Food production had also slowed a little, which some contacts thought reflected households' efforts to economise and cut waste. Output of goods for the public sector had been weakening, particularly in defence, although long-term contracts meant that work had held up for some.

Construction

The Agents' score suggested that construction output was broadly unchanged compared to a year earlier and remained at a low level. Activity continued to be supported by projects related to energy, utilities and transport infrastructure, and the expansion of some national retailers. In London, there were some large commercial developments under way, along with work on the Olympics, although that was now declining. Looking ahead, large-scale government schemes were often nearing completion, with relatively little in the pipeline to replace them. And indicators of future private sector work, such as architects' orders and council planning applications, had also begun to point to a possible decline in activity.

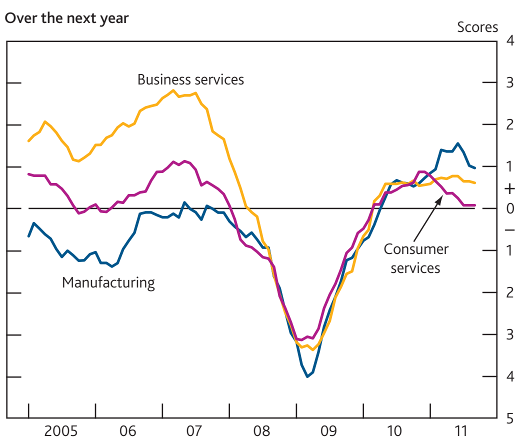
Credit conditions

Large and medium-sized firms with strong balance sheets typically reported that they had access to credit if required. But fear of repricing or withdrawal of existing facilities continued to discourage many small businesses from approaching lenders altogether. So far there were only very scattered reports of a tightening in conditions as a result of recent financial market turbulence, although a few contacts had postponed some investment, in case a further deterioration in the economic outlook led an offer of bank finance to be withdrawn at a later stage. And lenders themselves reported an increase in the number of borrowers delaying decisions on, or declining, offers in principle. While bad debts remained under control, corporate liquidity was under pressure, as suppliers tightened up payment terms and customers pushed for extensions. Some firms also reported that cash flow had been affected by a stricter approach by HM Revenue and Customs. And there were concerns that increased use of asset-based forms of finance, such as invoice discounting, instead of overdrafts, could lead to funding constraints should there be a sharp decline in orders.

Employment

Private sector employment intentions remained positive, but continued to edge down (**Chart 3**). Hiring plans were strongest in manufacturing, particularly in the export sector, but increased uncertainty about the economic outlook had led to greater caution about future recruitment, and increases in headcount were typically achieved through greater use of temporary contracts. Intentions had also been softening because for some firms, headcount had caught up with demand, and further increases in output were expected to be achieved through higher labour productivity. Use of apprenticeships was increasingly widespread, to avoid future skills shortages.

Chart 3 Employment intentions



Employment intentions in the services sector also pointed to continued modest recruitment. Some of the bigger accountancy firms were reinstating graduate recruitment programmes, to maintain key skills for when activity began to grow more robustly. And employment intentions also remained strong in growth areas such as IT. But some large financials and marketing companies planned to reduce staff numbers. And some smaller firms in accountancy and law were contemplating redundancies, as demand remained weak, or in anticipation of regional consolidation. There was widespread concern among contacts about the burden of forthcoming employment legislation.

Capacity utilisation

Capacity utilisation was slightly above normal in the manufacturing sector, with some firms now reporting that past investment and recruitment was beginning to deliver some additional slack. And there were signs that some temporary supply constraints had eased off, as supply chains of engineered products had now caught up with demand, and training of past recruits was delivering productive new staff. But some firms reported that concerns about the sustainability of growth had made them less inclined to bring mothballed capacity back on stream than they were a few months ago.

Service sector firms tended to have somewhat more spare capacity than in manufacturing. Many firms reported being busy, as there had been a shift in staff resource away from the delivery of services, towards business development. And they were often competing across a greater range of services, or over a wider geographical area than usual. But persistent low labour productivity, and now a recent further softening in demand conditions, were leading some companies to reappraise employment levels, and oversupply had prompted consolidation in certain sectors. In growth areas, such as IT, and some niche professional services, there was relatively little slack, however.

Costs and prices

Labour costs

Contacts continued to report that labour costs were growing at a moderate pace. There was relatively little upward pressure on settlements, and pay increases were often skewed towards younger, lower-paid staff. Awards in manufacturing tended to be higher than in services. There continued to be greater use of performance-related pay and bonuses, rather than across-the-board increases, with high bonuses this year usually reflecting better-than-anticipated profitability in 2010. Across sectors contacts reported a pickup in the incidence of pay freezes. And few were now expressing nervousness about the coming pay round, as renewed uncertainty had led job security to again take primacy over pay for most workers.

Non-labour costs

Contacts reported that the pace of inflation in materials prices continued to fall from recent peaks, as a range of commodities and processed input prices began to level off. But higher energy costs continued to be felt as fixed-term contracts expired, and some firms were attempting to offset that by reducing their energy usage. Some contacts reported that it had become more difficult to enter into fixed-term contracts for some inputs, and volatility in spot prices had made it more difficult to price outputs. The price of imports of finished goods continued to rise, due to past increases in raw materials costs and an increase in production costs in China, in particular, although some firms were offsetting this by re-sourcing production to other, lower cost, emerging market producers.

Output prices

Manufacturing output prices continued to rise at a steady pace, although there had been a fall in the Agents' scores for annual output price inflation in recent months. Some contacts had managed to increase prices to offset rising input costs, although the degree of pass-through was typically partial. Contacts' difficulties in passing on higher costs had caused them to increasingly focus on efficiency of production and improved purchasing. Among business services, output prices were rising gradually, although there was considerable variation between sectors. Reflecting the highly competitive environment in many professional and financial services, corporate hospitality, and property-related businesses, fees were often still under significant downward pressure. But there had been some increase in the prices of travel, transport and haulage, reflecting higher fuel costs, and in fees for certain essential services.

Consumer prices

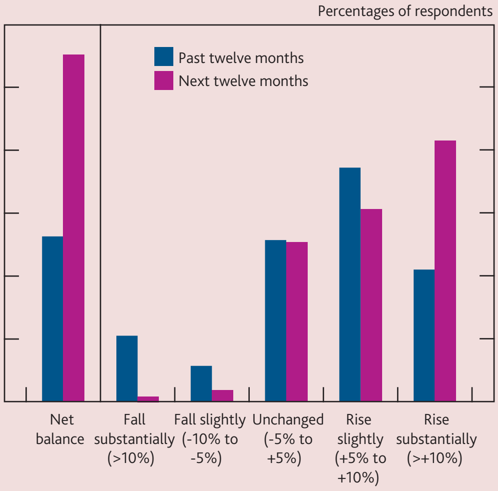
High annual inflation in consumer goods prices reflected rises in energy prices, the increase in VAT at the start of the year, and inflation in the price of food and imports of finished goods. Promotional activity had been widespread, however, offsetting some of the hit to household spending power. Some retailers suggested that multi-buy promotions were becoming less effective — perhaps because consumers had become more focused on containing spending, or reducing waste — and were increasingly using straight discounting instead. Inflation in the price of consumer services was also elevated, largely reflecting increases in the prices of non-discretionary services, such as rent and transportation. But a squeeze on spending power had led to downward pressure on the prices of non-essentials, such as hotel stays and meals out.

Agents' survey on exports

To try to gauge the degree to which export growth was expected to support the recovery over the coming year, the Agents conducted a survey on the outlook for foreign trade. Contacts were asked about export growth over the past twelve months, their expectations for export growth over the next twelve months, and the drivers of those changes. 257 firms responded, with a combined turnover of £40 billion.

Weighting the data by export shares, a large positive net balance of the sample reported that export volumes had continued to grow over the past year, in many cases quite strongly (**Chart A**). Looking ahead, an even larger net balance of contacts anticipated strong growth over the next twelve months. This was somewhat surprising, given rising concern about the outlook for world growth.

Chart A (Expected) change in the volume of exports over the past (next) twelve months

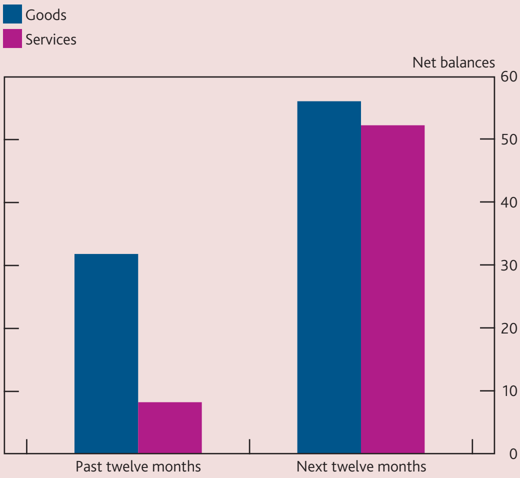


According to respondents, exports of goods had performed better than services over the past twelve months (**Chart B**). But both manufacturers and services sector firms expected exports to pick up over the next twelve months. And there appeared to have been a particularly marked improvement in expectations among services firms.

Part of that might have been due to a skew towards high-growth markets among the sample of services exporters. In contrast, goods exports tended to be towards more mature markets. A number of service sector contacts reported that they had only quite recently shifted their focus toward external markets, in light of persistent weakness of domestic demand. And they often focused on meeting rising demand for legal, accounting and engineering expertise in emerging economies in Asia and the Middle East in particular.

Across sectors, contacts often attributed growth over the past twelve months to product innovation, the supply of niche products, and previous efforts at building distribution channels, all of which had helped to open up altogether new markets. And a simple unweighted net balance showed that moving into new markets was the most commonly cited driver of expected export growth over the next twelve months (**Chart C**).

Chart B (Expected) change in the volume of exports over the past (next) twelve months, split by goods and services



On the demand side, contacts were most optimistic about the prospects for emerging markets in Asia and the Middle East over the coming year (**Chart C**). And the outlook for demand from the United States was thought to have improved. Euro-area demand was expected to provide less support to growth over the next twelve months than the past twelve, but the net balance remained positive. Price competitiveness appeared to have done relatively little to support export growth over the past twelve months, although the level of exports may already have benefited from the earlier depreciation of sterling.

Chart C Drivers of export growth over the past twelve months and the next twelve months