BANK OF ENGLAND

Agents' summary of business conditions

September 2011

- The growth rate of nominal spending on consumer goods and services had weakened further.
- The housing market remained subdued, in part because many first-time buyers continued to struggle to get on to the property ladder.
- Investment intentions suggested further modest growth in spending on capital, although there had been a slight decline in the Agents' scores.
- The growth rate of manufacturing output for export remained robust, but had slowed a little in recent months.
- Growth in manufacturing output for the domestic market had also slowed recently.
- There had been further modest growth in business services turnover, largely due to rising fees for some specialist professions, and pass-through of past increases in fuel prices.
- The level of activity in the construction sector was broadly in line with that a year earlier, as public sector work had held up slightly better than expected.
- Private sector employment intentions had weakened somewhat in recent months and now pointed to only modest job creation over the coming year.
- Capacity utilisation was around normal in manufacturing, with rather more in services, although there was significant dispersion across subsectors.
- Private sector total labour costs continued to grow at an annual rate of around 2%–3%.
- Raw materials costs appeared to have levelled off, although for some contacts the cost of energy was expected to pick up as contract renewals fell due.
- Along with rising production costs, the higher cost of materials continued to feed through to the price of imported finished goods, although there were tentative signs of a slowing in the pace of import price inflation.
- Output price inflation continued to reflect only partial pass-through of the higher costs of materials and imports of finished goods.
- Annual inflation in the price of consumer goods and services remained elevated, largely due to the rise in VAT, and the increases in the prices of energy and imported goods.

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 July 2011 and late August 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

Contacts in retail continued to report very difficult trading conditions. Spending on food and other essentials had shown some resilience, but promotions were often necessary to generate demand. Sales of big ticket household items and non-essentials continued to weaken. And in various markets, mid-range products were being squeezed by value items and sales at discount stores, while demand for higher-end products and luxury brands had performed reasonably well. Spending patterns remained volatile, and had been disrupted by the recent public disturbances in some areas. Real expenditure growth was expected to remain sluggish over the rest of the year, as increases in the prices of utilities and public transport eroded real incomes further.

Nominal demand for consumer services had held up slightly better than that for goods. Spending on certain non-discretionary services such as fuel, rent and public transport, had increased, in large part due to higher prices, while demand for discretionary services had been falling. Within the discretionary element of spending, households continued to search for value to maintain their broad pattern of consumption. That was evident in increased use of promotional restaurant offers and a focus on price over quality. It was also apparent in uptake of late deals on package holidays for those going abroad, and the continued popularity of 'staycationing', which had supported domestic leisure and tourism.

Housing market

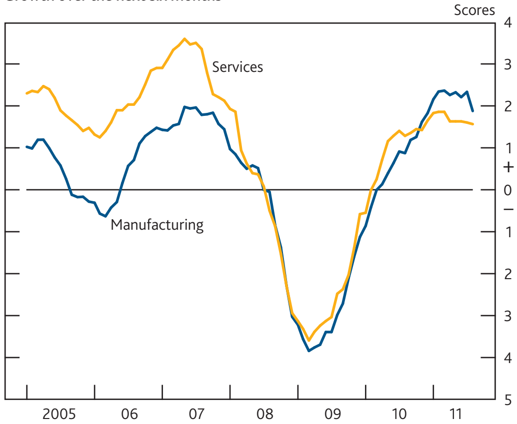
The housing market showed little sign of improvement. Many first-time buyers continued to find it difficult to raise sufficient funds for a deposit, and the subsequent increase in demand for rental property had contributed to a rise in the cost of rented accommodation. Higher rents had attracted more buy-to-let investors into the housing market, and they accounted for an increasing share of demand. London remained a bright spot, helped by foreign buyers, but the usual ripple effect to surrounding areas had yet to materialise. The market for new housing was also generally better than the secondary market, partly because newly built properties were often family homes, tailored to meet the needs of existing homeowners, who had sufficient equity to move house. Some contacts also suggested that house builders were more flexible on price than private vendors of existing property. There were further reports of chains having broken down, as mortgage offers 'in principle' had been withdrawn.

Business investment

Contacts in both manufacturing and services continued to anticipate further modest growth in capital expenditure, although there had been a slight weakening in investment intentions over the past few months (**Chart 1**). Investment was typically motivated by the need to replace existing kit, develop new products, and find efficiencies to offset rising input costs. Much of firms' investment was also geared towards labour saving equipment to boost productivity. Some firms planned to expand capacity, particularly goods exporters, although intentions had been dampened somewhat by the worsening outlook for the global economy. In an environment of sluggish domestic demand growth, some firms with cash reserves were expanding via acquisitions, and business integration was supporting investment in IT. Supermarkets and discount stores continued to expand their national footprints. And there had been investment in transport infrastructure and in the renewable energy sector.

Chart 1 Investment intentions

Growth over the next six months



Exports and imports

There had been some slowing in the pace of export growth, although the rate of expansion remained robust (**Chart 2**). The most buoyant conditions were reported by exporters of capital goods and intermediates related to construction, the renewable and traditional energy sectors, automotive, aerospace and electronics. Producers of consumer goods, especially food, also reported that exports were growing at a steady pace. Foreign demand remained strongest in emerging markets and Germany, while exports to other parts of the euro area had softened somewhat. Exports to the United States

Chart 2 Manufacturing output

Three months on the same period a year earlier

were also reported to have weakened. Few contacts now mentioned disruption to trade arising from the earthquake and tsunami in Japan. There were further reports from service sector contacts that were now looking to foreign demand to support revenues.

Output

Business services

Professional and financial services continued to grow at a modest pace, although rising private sector activity had been offset to some degree by a fall in public sector work. An increase in mergers and acquisitions in the wider economy had supported a range of functions in advisory, corporate finance, accountancy and law. Some IT firms were also growing steadily, reflecting the mix of investment across sectors. And advertising companies reported that while overall activity was weak, online marketing was picking up. Recruitment agencies continued to see a steady flow of demand for temporary employees as many firms remained reluctant to take on permanent staff.

Among providers of other business services, there had been some improvement in corporate hospitality and conferencing, although events were usually small, and also some pickup corporate travel. Haulage and logistics companies continued to benefit from rising activity in the manufacturing sector, and shipping contacts had seen a rise in volumes of food and capital goods exports. Plant hire had also picked up, as firms remained cautious about investing in equipment themselves. Firms associated with the domestic construction industry continued to report very difficult business conditions.

Manufacturing

The growth rate of manufacturing output for the domestic market had slowed over the past few months (**Chart 2**). The pattern of output reflected the changing mix of expenditure in the wider economy. Manufacturers of investment goods, particularly for firms geared towards the export market, continued to report relatively robust growth. Producers of energy saving equipment and suppliers of goods to the renewable energy sector were benefitting from the efforts of firms in the wider economy to reduce costs. And the output of food producers was growing steadily. But there had been a noticeable softening in activity among non-food consumer goods manufacturers. And there had been a marked fall in the supply of products to the public sector, particularly those related to defence. Producers of materials for the domestic construction industry also reported weak demand.

Construction

The level of activity in the construction sector was thought to be broadly in line with a year earlier. Construction had been supported by some large projects in London and the south east related to infrastructure, the Olympics, and some large commercial developments. Projects related to the energy sector, both in nuclear and traditional energy, and in renewables, were also supporting activity. And public sector work had held up better than had been feared by some contacts, although the impact of lower government spending had been quite different across regions, and the pipeline of new contracts had fallen significantly. House building had risen a little compared with a year earlier, but contacts reported that the current planning process and new energy reduction targets would tend to slow the pace of growth.

Credit conditions

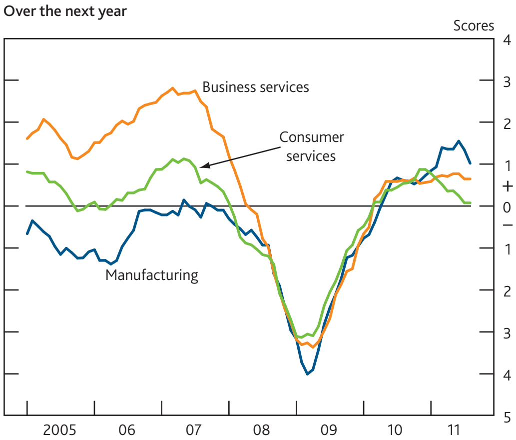
Credit conditions had continued to ease for large and medium-sized firms, especially those in the manufacturing sector, possibly reflecting improvements in the health of corporate balance sheets. But increased nervousness about the outlook had led some firms to scale back investment plans, and switch their focus back to paying off outstanding debts. Small businesses and start-ups still found it difficult to gain access to credit, and where loans were available, fees remained elevated and the applications process was often drawn out. Concerns about the withdrawal of overdraft facilities at short notice had led some small firms to run permanent sizable cash balances, inhibiting investment. And contacts in sectors such as retail, which faced weak demand conditions, also often struggled to secure finance.

Employment

Overall, further modest job creation in the private sector was expected over the coming year, but the pace of employment growth was likely to slow (**Chart 3**). In manufacturing, employment intentions had fallen in recent months, as productivity gains from investment were expected to be realised. And some firms had scaled back their plans in response to weakening prospects for demand. The pace of growth in manufacturing had caused some structural skill shortages to reassert themselves, particularly for engineers. But it remained easy to recruit for low-skilled positions.

Chart 3 Employment intentions

Over the next year



In services, firms tended to have more spare capacity, and there was less upward pressure on headcount. But some professional and financial services firms continued to expect further modest job growth, and planned to employ more graduates in the coming recruitment round. There were also reports of rising recruitment and retention difficulties in sectors exhibiting the greatest resilience, such as IT, leading to increased churn in the labour market. But job losses were anticipated in the financial sector, and among services related to construction. Taken as a whole, the consumer-facing sector did not expect to employ more staff over the next year, despite increased hiring by some large national retailers.

Capacity utilisation

Manufacturing firms tended to report that they were operating with broadly normal levels of spare capacity. But many were now benefiting from past investment in additional capacity. And most manufacturers had scope to increase the use of overtime to meet periods of peak demand. There were, however, some reports of constraints on production due to a lack of staff with particular skills. And some changes in production patterns had effectively reduced the potential for economies of scale. For instance, some manufacturers of consumer goods reported that customers often now demanded shorter production runs, to help manage inventories. And competition among supermarkets had led them to demand more unique products and package sizes.

There remained a significant degree of slack in much of the service sector, with variation reflecting demand in the broader economy. For example, in the provision of standardised legal and accountancy work, there tended to be considerable spare capacity, whereas IT firms were often busy helping corporates find efficiencies. Consolidation was under way in some industries with excess capacity, and was supporting activity among professional firms specialising in mergers and acquisitions, restructuring and change management. But despite such consolidation, many business services contacts continued to describe oversupply in their respective sectors, with numerous firms chasing the same contracts, and very low labour productivity.

Costs and prices

Labour costs

Labour costs continued to grow at a moderate pace, with settlements generally between 2% to 3%. In manufacturing, they were more likely to be towards the top of that range, reflecting rising labour productivity and profit growth. And there were some awards targeted at those specialisms where skills shortages were beginning to emerge. In services, the relatively more modest pace of expansion meant that pay increases were typically towards the bottom of the range. But, again, there was significant variation between sectors. In IT, for instance, some firms had been able to give awards that were somewhat higher than the average, while in retail and construction, pay freezes were still fairly common. Across sectors, pressure from unions remained muted. And heightened economic uncertainty had led to a marked softening in wage demands, with consideration of job security once again trumping pay for most workers.

Non-labour costs

There had been a slight change in the tone of contacts' intelligence this month. There were reports of food commodities and fuel prices having fallen back from recent highs, and of a levelling off of the prices of a range of metals. While this moderation was expected to continue over the rest of the year, contacts anticipated a significant rise in the price of energy and utilities in the coming months, as contracts were renewed. The pace of inflation in the price of imports of finished goods remained elevated, although there had been some tentative signs of slowing. That was attributed to several factors: softer world demand; some switching away from imports from countries, including China, where labour costs were rising quickly, towards other, lower cost locations; and falls in international shipping charges.

Output prices

Contacts were usually only able to pass on part of any increase in materials costs. Manufacturers of niche and highly differentiated products tended to have the most success, which placed a premium on product innovation and the development of higher margin lines. By contrast, producers for the consumer sector faced the most resistance to price rises, as supermarkets continued to compete for ever more value-driven households. To rebuild margins, some firms reported that they had redesigned products to eliminate some more costly inputs. The price of business services was rising only gradually. Many transport and distribution companies had been able to pass on rising fuel costs, and some specialised services had been able to raise their fees. But competitive pressures continued to bear down on the prices of standardised professional and financial services.

Consumer prices

Contacts reported that annual retail goods inflation remained elevated, pushed up by the increase in VAT, the rise in the price of imports and higher food prices. But higher list prices were often offset by extensive discounting. Some contacts reported that consumers were now buying goods only on promotion, so loss-leaders were failing to generate sales elsewhere. Others suggested that multi-buys were losing their ability to support volumes, and were moving towards greater use of straight price reductions. The price of consumer services also continued to rise at a fairly rapid pace. Inflation was most marked in non-discretionary services, including transport, insurance and energy. By contrast, inflation in the price of discretionary services tended still to be under downward pressure, particularly in leisure and tourism.