BANK OF ENGLAND

Agents' summary of business conditions

April 2012

- Consumer demand growth remained modest, although there were some reports of an improvement in trading conditions over the past few months.
- There had been tentative signs of a rise in activity in the housing market, although demand was still significantly below its pre-recession level.
- Investment intentions pointed to a gradual rise in capital spending over the coming year, and plans had strengthened a little recently.
- Export growth remained robust, and had edged upward on the month.
- There had been an increase in the rate of growth of business services turnover.
- Contacts reported a modest increase in manufacturing output for the domestic market.
- Output in the construction sector was thought to be lower than a year earlier.
- Contacts reported that there had been some tightening in credit conditions, primarily in terms of the cost of finance. Most firms still had access to credit if required.
- Private sector employment intentions suggested that employment was likely to be broadly flat over the next six months.
- Levels of capacity utilisation were typically somewhat below normal, with rather more slack in services than manufacturing.
- Labour costs were rising at a moderate pace.
- Non-labour costs continued to grow steadily, but the pace of inflation had slowed in recent months, and was now around its historical average.
- Manufacturing output price inflation had begun to decline, reflecting slowing inflation in input costs. The prices charged by business services were broadly flat on a year earlier.
- Consumer price inflation continued to edge down, but 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 February 2012 and late March 2012. 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/Pages/agentssummary/default.aspx.**

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/Pages/inflationreport/default.aspx.**

Demand

Consumption

Consumer demand growth remained modest, although there were some reports of an improvement in trading conditions over the past few months. Spending on goods had been supported by a slight rise in demand for big-ticket items. Sales of furniture and white goods had also picked up a little, perhaps related to a rise in activity in the housing market. Demand for food and clothing remained heavily dependent on discounting, however, with online retail continuing to gain market share from the high street. There had also been a modest tickup in activity in consumer services, partly due to increasingly widespread promotional activity. Some contacts also reported that consumers had become more willing to pay for one-off events, although spending on some regular activities such as visits to the gym, had been squeezed.

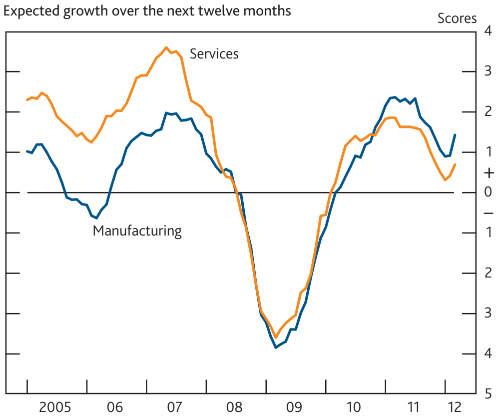
Housing market

There had been a rise in the number of viewings, offers and transactions in recent months, although demand remained significantly below its pre-recession level and a few Agencies detected little sign of recovery. Contacts suggested a number of reasons for the improvement in conditions. The Government's FirstBuy scheme and construction companies' own initiatives had bolstered demand for newly built property. Growth in buy-to-let demand, partly in response to past increases in rental yields, had also helped to put a floor under prices. And there was thought to have been a rise in confidence among prospective buyers, some of whom had been holding back in case of a further weakening in the housing market. Part of the recent increase in activity was also likely to have been demand which had been brought forward, ahead of the end of stamp duty relief. Some contacts also suggested that vendors were becoming a little more realistic about asking prices.

Business investment

Investment intentions pointed to a gradual rise in expenditure on capital over the coming year, and plans had strengthened a little in recent months (**Chart 1**). That reflected a slight improvement in sentiment, as contacts' worst fears concerning the euro area had not materialised. And some firms had decided to press on with investments despite continued uncertainty about the outlook. Across sectors, spending plans were typically underpinned by replacement and maintenance, efficiency gains, or for compliance purposes. Among manufacturers, there had also been a slight pickup in reports of investment in additional capacity, usually from those in the export sector. And there were a few reports of plans to bring parts of the production process back to the United Kingdom, instead of buying components from abroad. Contacts in services tended to have more modest investment intentions, as demand was often still weak.

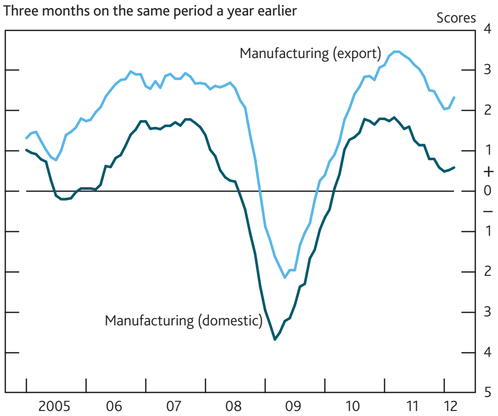
Chart 1 Investment intentions



Exports and imports

Export growth remained robust, and the Agents' score for exports of goods had edged up a little on the month (**Chart 2**). That reflected both rising world demand, and an increase in the market share of UK suppliers in foreign markets. There were continued reports of strong demand growth in the automotive, aerospace, energy and IT sectors. Activity was particularly buoyant in emerging market economies, which were importing investment goods and, increasingly, luxury consumer products. But demand was very weak in European countries at the centre of concerns over government debt.

Chart 2 Export and domestic goods manufacturing volumes



Many manufacturing contacts continued to try to lower production costs by off-shoring, particularly for low-value, high-volume components. But there were further reports from firms which had brought part of a previously outsourced production process back to the United Kingdom, in response to rising costs abroad, or to concerns about quality and reliability of supply.

Output

Business services

There had been a slight increase in the rate of growth of business services turnover, often spurred by sources of growth in the wider economy. Professional and financial services had seen some rise in corporate transactions, in part, as concerns about risks stemming from the euro area had receded somewhat. There had been a pickup in corporate litigation and work on restructuring and recovery. Logistics companies had benefited from rising trade and increased spending online by households. And some IT firms were growing quite quickly, buoyed by the mix of corporate investment.

Manufacturing

Contacts reported a modest increase in manufacturing output for the domestic market (**Chart 2**). In large part, rising activity reflected increased output by firms in export supply chains, particularly among producers of intermediate and investment goods for other businesses in the aerospace, automotive and energy sectors. Repatriation, or 'localisation', of production was also providing some support to activity, and some firms were gaining domestic market share at the expense of foreign competition. But suppliers which served the domestic government or household sectors tended to report that conditions were difficult. For instance, firms in the defence industry, and producers of consumer goods, often reported flat or falling demand. Suppliers to the construction sector were also often facing a challenging environment. Food production was rising gradually, although volume growth was often secured only by participating in retailers' promotions.

Construction

Output in the construction sector was lower compared with a year earlier but there had been little sign of a significantly larger fall in activity than usual over the winter period. The gradual pace of contraction reflected a steady decline in public sector contracts, combined with subdued private sector activity. There had been some improvement in private housing construction, however, encouraged by rising demand for newly built homes. Although, contacts reported that the planning process remained a constraint on some projects. Work on infrastructure was also supporting the level of output, along with some commercial property development in London. But a slowing in the pace of expansion of some large national retailers was beginning to weigh on growth. Looking ahead, some firms involved in the early stages of the construction process, such as architects and engineers, reported a rise in preparatory work, though this would not feed through to construction output for some time.

Credit conditions

Contacts reported that there had been some tightening in credit conditions in recent months. Existing facilities had often been made more costly on renewal, arrangement fees had risen, and collateral requirements on new lending had become more stringent. But few contacts had observed a reduction in the quantity of credit available. Exceptions to this tended to be in the construction and retail sectors, where banks had become more reluctant to lend. (See the box on page 5 for a discussion of the latest Agents' survey on credit conditions.) The focus of many businesses remained on deleveraging, while others sought to build up precautionary buffers against unanticipated funding needs, or to finance investment without recourse to the banks. And some firms were also looking to non-banks to secure finance — insurers and wealthy individuals, for instance.

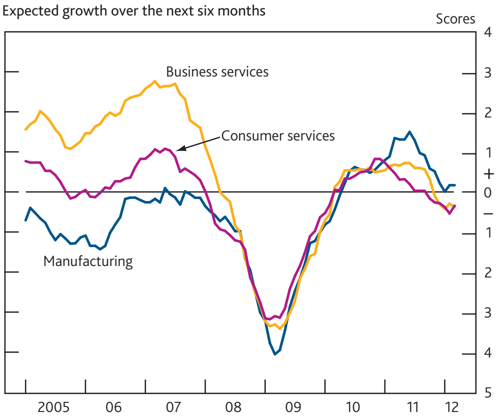
Small and medium-sized firms typically found it more difficult than large ones to secure credit. And they continued to be encouraged to use asset-backed forms of lending rather than overdrafts, which many were reluctant to do. Smaller businesses also often reported that corporate liquidity was being squeezed by larger business partners: suppliers were tightening up on payment terms, while customers pushed to extend them.

Employment

Private sector hiring plans suggested that employment was likely to be broadly flat over the next six months (**Chart 3**). Among manufacturers, there were further reports of an increase in apprenticeship schemes, to address current, or anticipated shortages of key skills, particularly among engineers. But many firms had now caught up with past increases in activity, and felt able to meet demand growth with existing labour in the near term. In business services, there was expected to be a slight decline in headcount overall, in light of still subdued activity. But companies in the IT sector continued to take on staff. And some large professional firms had increased graduate recruitment in anticipation of future growth. A number of others reported that they were hanging on to existing employees, having found it difficult to rebuild staffing levels after downsizing during past recessions. There were expected to be further job losses in the banking sector and retail, reflecting branch and store closures.

Chart 3 Employment intentions

Expected growth over the next six months



Capacity utilisation

In the manufacturing sector firms could typically meet expected increases in demand with existing labour and capital.

And some slack had opened up recently, due to slowing output growth, combined with past investment and recruitment. Some firms were stretched, however, particularly in the export sector, or were facing constraints due to shortages of specialist engineering staff. In the business services sector, meanwhile, there was usually rather more spare capacity, and contacts often reported that there were too many firms chasing the available work. That was particularly the case in areas where the service was of a standardised nature, leading to significant downward pressure on prices. Capacity had also increased a little in some of the larger firms, as a result of recruitment in anticipation of future growth. But a few specialised businesses had very little slack, in IT and engineering advisory firms, for instance, where contacts sometimes reported difficulties finding particular technical skills. Retailers could typically meet a substantial pickup in demand with existing staff and were sometimes closing underperforming stores.

Costs and prices

Labour costs

Labour costs continued to rise at a moderate pace, with settlements tending to be between 2% and 3%. Above-average settlements were usually in growth industries, such as IT, or the export sector, due to both higher profitability and rising labour productivity, or to retain staff with niche skills. In contrast, pay freezes were still common in the most subdued areas — construction and retail, in particular. There was typically little upward pressure on pay to compensate for past inflation, although there were a few instances of a degree of catch-up, usually in heavily unionised workforces, where inflation-linking remained more prevalent than in other businesses. An element of performance-related pay was becoming increasingly widespread, although bonuses were usually lower this year than last year. Employers' concerns about the possibility of having to make increased contributions to employees' pensions were beginning to feed into considerations for settlements in future rounds.

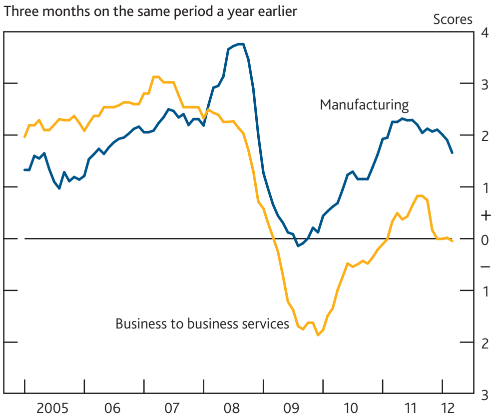
Non-labour costs

Non-labour costs continued to grow steadily, but the pace of inflation had slowed in recent months, and was now around its historical average. The prices of various raw materials, such as cotton and food, were beginning to level off, or decline. But some prices, particularly for oil and oil-related products, energy, and some metals, had come under renewed upward pressure. And there was thought to be some upside risk to food prices due to drought, particularly for domestically produced crops. Inflation in the price of imports of finished goods had been slowing in recent months, due to falling inflation in the cost of raw materials. But rising production costs in emerging market economies, particularly China, and recent increases in transport costs, were offsetting this to some extent.

Output prices

Manufacturing output price inflation had begun to slow (**Chart 4**), reflecting declines in input cost inflation. Where margins had been eroded by past increases in costs, some firms continued to attempt to pass those higher costs on, but domestic demand conditions often prevented them from doing so. In response, suppliers were often attempting to incorporate contractual clauses which would enable them to pass on future increases in costs more readily. At the same time, suppliers to supermarkets remained under considerable pressure to pass on any recent reductions in costs, or to participate in pricing promotions. Despite the weak demand environment, however, many firms had been able to preserve, or rebuild, margins through efficiency gains and rising productivity.

Chart 4 Output price inflation



Meanwhile, the prices charged by business services were reported to be broadly flat on a year earlier (**Chart 4**), against a backdrop of intense competitive pressure in a number of sectors, particularly for relatively standardised legal and accountancy services. And sizable increases in transport charges due to higher fuel costs last year were beginning to fall out of the annual comparison of the price level. But there had been an increase in fees for some specialist services, particularly in growth areas, such as IT.

Consumer prices

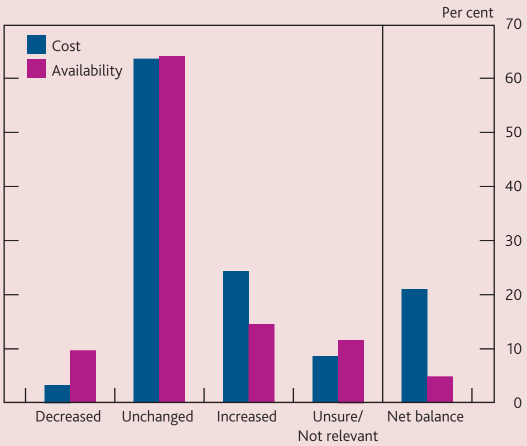
Consumer goods price inflation remained elevated, but had edged down a little on the month, after some fairly rapid declines. The recent slowing in the pace of inflation was partly due to the effect of the increase in VAT at the start of 2011, which was no longer contributing to annual growth in the price level, along with a slight reduction in inflation in imported goods prices. Consumer services inflation had also slowed a touch. The prices of some essential consumer services continued to rise quite quickly, including for transportation and rent, in part due to links to official measures of inflation. But the weakness of demand for non-essential services had limited the extent to which contacts had been able to raise prices, and promotional activity was becoming more common.

Agents' survey on credit conditions

Between February and March 2012 the Agents conducted a survey to assess whether increases in the cost of bank funding during the second half of 2011 had fed through to corporate credit conditions. Businesses were asked about changes in credit conditions and their use of credit over the past six months, and the drivers of those changes. 469 businesses participated in the survey. All of the charts in the following discussion are weighted by turnover.

Nearly two thirds of firms reported that the cost and availability of credit was unchanged (**Chart A**). That may have been because many firms have only infrequent interaction with their lender. As a result, it may take some time for changes in credit conditions to be felt. Nevertheless, a significant positive net balance of those surveyed did report that the cost of finance had risen, suggesting that lenders had passed on some of the increase in the cost of funding. But there was also a small positive net percentage balance of firms which had experienced an increase in the availability of finance. The results were very similar for small and medium-sized enterprises (SMEs), although the cost appeared to have risen by a touch more for SMEs than for large firms.

Chart A Total cost and availability of finance[a]

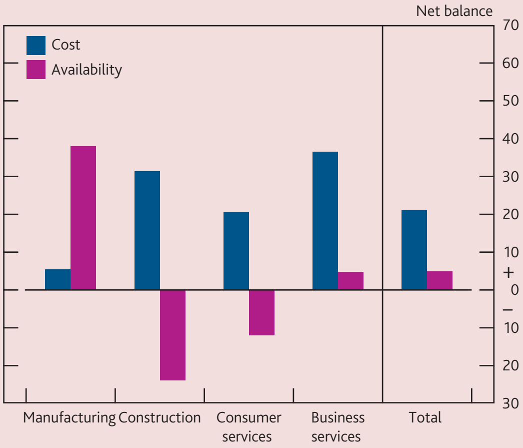


(a) An increase in costs suggests tighter credit conditions; an increase in availability suggests looser credit conditions.

Across sectors, manufacturers had seen the least tightening in the cost of credit, and reported an increase in overall credit availability (**Chart B**). In contrast, businesses in the construction and consumer-facing sectors reported an increase in the cost of finance, along with reduced availability of credit. This probably reflects the less upbeat prospects for growth in those sectors compared with manufacturing. Availability was broadly unchanged for business services firms, although costs were reported to have risen a little.

In addition to the question about changes in credit conditions, respondents were asked about changes in their demand for credit, and their use of credit. Perhaps surprisingly, despite tighter conditions, a positive net balance of around 25% of construction firms reported an increase in their demand for credit. But borrowing had actually declined, suggesting that there was unmet demand in the sector. Among consumer-facing companies there had been a reduction in both the demand for credit and the use of external finance. Demand for credit and the amount of borrowing had risen in the manufacturing and business services sectors. Across the sample as a whole, increased use of finance was largely confined to large firms.

Chart B Credit conditions by sector



Finally, contacts were asked whether, and how, recent changes in credit conditions had affected their behaviour. In aggregate there was little reported impact on behaviour, consistent with the relatively modest reported changes in credit conditions. But, looking at just those firms which had experienced a tightening in credit conditions, there was a tendency for them to have reduced their holdings of cash (**Chart C**). In contrast, other firms had tended to have raised their cash balances — perhaps as a precautionary buffer, or to finance future investment. A very similar pattern of responses was apparent for both investment and employment plans.

Chart C Changes in cash balances