BANK OF ENGLAND

Agents' summary of business conditions

August 2012

- The rate of growth of spending on consumer goods and services had slowed further.
- The housing market had weakened somewhat in recent months, but contacts were uncertain whether that reflected temporary factors.
- Contacts' plans for capital spending had softened and the level of investment was expected to grow only very modestly over the next six months.
- Export growth had moderated significantly, largely due to weakness across the euro area.
- The pace of growth of turnover in the service sector had slowed further.
- Manufacturing output growth had eased and the level of activity was only slightly higher than a year earlier.
- Construction output continued to contract, due in large part to the dwindling pipeline of public sector work. Recently, temporary factors had also pushed down on the level of activity.
- Credit conditions remained polarised between those able to borrow at reasonable rates and those unable to secure finance at a cost that was acceptable.
- Employment intentions remained fairly flat. In an uncertain environment, businesses were hesitant about committing to changes in payroll until the outlook became clearer.
- Capacity utilisation in the manufacturing sector was a little below normal, while there was a significant degree of spare capacity in services.
- The rate of growth of labour costs per head remained restrained and had fallen in recent months.
- Inflation in the cost of raw materials continued to moderate, in large part due to weakening demand growth in the rest of the world.
- The pace of inflation in manufacturing output prices was declining in response to softening cost pressures. Taken as a whole, fees for business services were broadly unchanged from a year earlier, in large part due to persistent spare capacity in much of the sector.
- Consumer price inflation continued to fall back towards the 2.0% target.

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 June 2012 and late July 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

The rate of growth of spending on consumer goods and services had slowed further, with nominal demand now only moderately higher than a year earlier, entirely due to higher prices. Spending patterns continued to be more volatile than usual, in an environment of broadly flat demand overall. Recent weakness was thought to be, in large part, a reflection of poor weather, which had particularly depressed demand for clothing and footwear, outdoor furniture and leisure equipment, and discouraged shopping more generally. Households continued to economise wherever possible. And the market remained characterised by shifts in market share, with internet sellers and destination shopping centres continuing to win custom from the high street, and cheaper products benefiting as a result of ongoing trading down from mid-range ones.

Housing market

The housing market had weakened somewhat in recent months, but contacts were uncertain whether that reflected temporary factors. The wet weather, Euro 2012, the Diamond Jubilee and the end of stamp duty relief, were all likely to have weighed on search activity. But some contacts thought that there may have also been a loss of confidence due to worries about the economy. In addition, transactions were reported to be taking even longer and there were more instances of mortgage offers being withdrawn as a result of lower-than-expected property valuations by lenders. Demand at the top end of the market had slowed noticeably and downsizing had become a more prominent driver of moves than in the past. Buy-to-let demand continued to support activity at the lower end of the market.

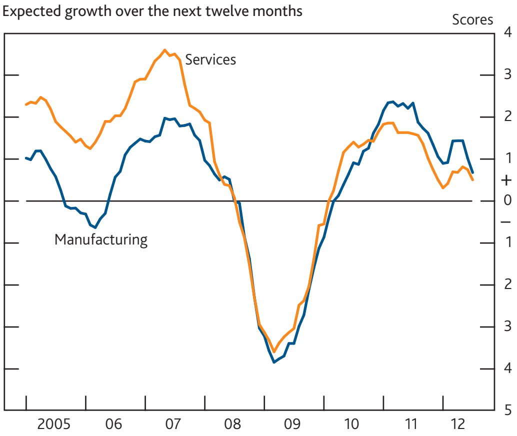
Business investment

Contacts' plans for capital spending had softened (**Chart 1**) due to the increasingly uncertain demand environment both at home and abroad. Firms continued to undertake routine replacement investment and repair and maintenance work. Other projects typically had to pay for themselves within a shorter period than prior to the recession, leading to an emphasis on investment which generated a rapid return, such as energy and labour-saving technologies, or product development to reduce costs. Compliance with new regulations was also a key driver of investment in a number of sectors.

Exports

Export growth had slowed significantly in recent months, largely due to weakness across the euro area, and some softening in the United States. Export growth to emerging market economies had moderated somewhat, mainly due to weaker demand from China. Nevertheless, contacts often remained optimistic about future opportunities for growth through gains in market share and entry into new markets. The Middle East and South America were still buoyant and Africa was increasingly mentioned as a source of robust growth. So far, there had been few reports of a negative impact on demand arising from the recent appreciation of the pound against the euro, but some firms had seen margins narrow as sterling prices had been allowed to fall.

Chart 1 Investment intentions



Output

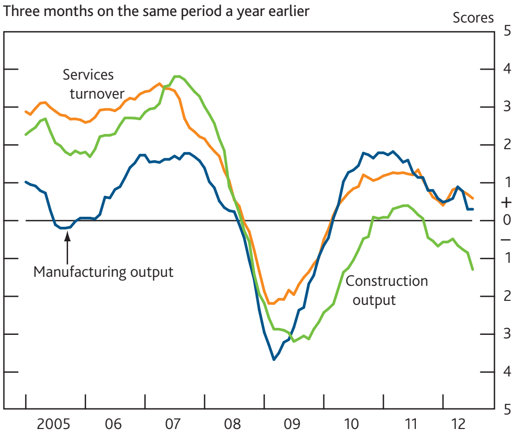
Business services

The pace of growth of turnover in the service sector had slowed further (**Chart 2**). Activity continued to be supported by corporate investment, with IT firms often busy helping other companies with their efforts to raise productivity and develop an online profile. And legal and accountancy practices were frequently involved in assisting with regulatory compliance work across a range of sectors. In contrast, logistics firms reported that output had weakened on the back of slower domestic demand and trade, while corporate demand for non-essential services such as hotel accommodation, hospitality and conferencing facilities had fallen further. Advisory work on mergers and acquisitions, and commercial property transactions, had also weakened as uncertainty had induced businesses to postpone expansion plans.

Manufacturing

Manufacturing output growth had eased and the level of activity was only slightly higher than a year earlier (**Chart 2**). The primary source of final demand had been from abroad, helping to support firms throughout the domestic supply chain. But a weakening in foreign markets was weighing heavily on growth. Firms supplying the domestic market typically continued to report that activity was broadly flat on a year earlier, reflecting sluggish consumer demand and declining public sector spending, particularly on defence. Furniture makers corroborated stories of weakness in the

Chart 2 Growth in construction and domestic manufacturing output and services turnover



housing market, having seen demand fall away recently. Where there were reports of growth, that was often the result of gains in market share — in food production, for instance, where there was still surplus capacity.

Construction

Construction output continued to contract (**Chart 2**), due in large part to the dwindling pipeline of public sector work. Activity on utilities and renewable energy projects had also slowed. Recently, temporary factors had added to downward impetus in the sector. The very wet weather in many parts of the country had disrupted work on some sites and travel restrictions related to the Olympics had caused activity to be suspended on some large developments in London. There was some support to activity from the construction of student accommodation, care homes, house building, and infrastructure development in energy and transport. Work on refurbishment of retail premises had also picked up a little, as some of the larger supermarket chains scaled back their expansion plans to focus more closely on existing property portfolios. Across the industry, contacts continued to report that the sector was being held back by a number of factors, with uncertainty about government policy, planning issues and funding constraints foremost among them.

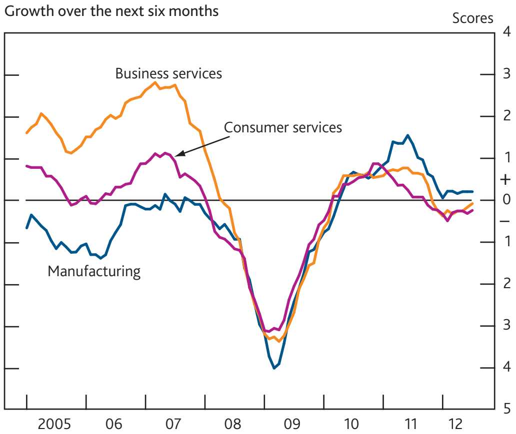
Credit conditions

Credit conditions remained polarised. Businesses with strong balance sheets, cash flow and assets typically had access to funding at reasonable rates. But firms failing to meet those criteria often found it difficult to obtain loans at terms that were acceptable. Banks remained very wary of lending to the property sector, or to businesses exposed to the weakness of household spending. And small companies sometimes struggled to secure credit at all. The tendency for banks increasingly to seek collateral against which to secure loans was also often discouraging owners of small businesses from borrowing, as they were reluctant to use personal assets as security. In response to tight credit conditions, some firms were building up cash reserves to finance investment internally, or to generate a precautionary buffer in the event of a sudden decline in demand. Some businesses were refraining from applying for loans due to a perception that they would be unavailable, but many contacts reported that they had no need to borrow because there was a lack of opportunity for investment. Bad debts generally remained under control, although there had been a pickup in reports of difficulties securing payment from customers in some countries in the euro area.

Employment

Employment intentions remained fairly flat (**Chart 3**). In an uncertain environment, businesses were hesitant about committing to any changes in payroll until the outlook became clearer. There continued to be significant variations within sectors, reflecting the shifting mix of demand in the wider economy. Suppliers to the public sector and to households were often trimming headcount, while those benefiting from foreign demand growth and corporate investment were more likely to be hiring. And while supermarkets and discount retailers were taking on staff, jobs were being lost as a result of store closures on the high street. Across sectors, a number of factors, including changes to the regulatory landscape, and issues surrounding pensions and employment law, continued to support job creation for various different types of specialist professional staff — in risk management and compliance, for instance.

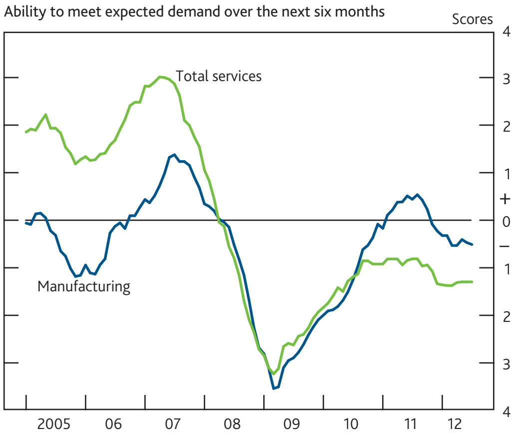
Chart 3 Employment intentions



Capacity utilisation

Capacity utilisation in the manufacturing sector remained a little below normal (**Chart 4**), reflecting recent softening in the pace of growth of demand, as well as past investment and employment growth. But while those supplying the domestic market often had a significant degree of slack, exporters were frequently at near to full capacity, with some facing constraints due a lack of skilled engineers. However, weakening demand abroad had eased staffing pressures recently. In services, many firms were operating with a rather larger amount of spare capacity than in manufacturing (**Chart 4**). But employees were often busy working on tenders or had been moved into regulatory and compliance-related activities. In retail, staff were often underemployed and contacts were responding by adopting more flexible working patterns to tailor total hours to customer numbers, or were closing stores altogether.

Chart 4 Capacity utilisation



Costs and prices

Labour costs

The rate of growth of labour costs per head remained restrained and had slowed somewhat in recent months. Settlements had fallen back across industries, reflecting a combination of weakening demand, rising uncertainty about the outlook and easing inflationary pressure. And there had been an increase in the number of reports of pay freezes, particularly in construction and retail. Firms were increasingly moving away from across the board settlements towards individual performance-related pay, or to focus on the retention of key personnel, while some employers had skewed pay awards towards those at the lower end of the scale. There was also more widespread use of bonuses in an attempt to avoid locking in permanent increases in the wage bill. Contacts frequently reported that significant management effort was being devoted to pensions, either to cope with the challenge posed by deficits on legacy funds, or to prepare for pension auto-enrolment.

Non-labour costs

Inflation in the cost of raw materials continued to moderate, in large part due to slowing demand growth in the rest of the world, which had caused various commodity prices to fall back from recent highs. But the expectation of poor harvests abroad had begun to push up the prices of some basic foodstuffs, such as wheat, soya and maize. The appreciation of sterling against the euro had lowered the price paid for some imports. And a number of contacts had seen a decline in the cost of energy, although for many businesses on fixed-term contracts it would take some time for this to take effect. The price of imports of finished goods had begun to level off, reflecting slowing cost inflation for foreign producers, as well as the rise in sterling. Softer world demand for imported final goods had also put some downward pressure on prices.

Output prices

The pace of inflation in manufacturing output prices continued to decline, reflecting softening cost pressures. Some firms reported that they had now fully passed on past increases in input costs, while others felt that further price increases would be very difficult given the weakness of demand both at home and in foreign markets. But even among businesses where cost increases had not been passed on in full, margins were often not far from normal, considerable lengths having been taken over the past few years to find efficiencies and squeeze production costs wherever possible. Turning to the service sector, fees for business services were broadly unchanged from a year earlier, in large part due to persistent spare capacity in much of the industry. But specialised service providers, in IT for example, were often able to secure significant price increases.

Consumer prices

Consumer price inflation continued to fall back towards the 2.0% target. That was, in part, the result of reductions in fuel prices, and wet weather had led to earlier discounting than usual for a range of seasonal products. Some retailers expected food inflation to begin to pick up going forward, however, due to poor global harvests for some crops. Very weak demand continued to weigh on the prices of discretionary services, particularly in leisure and tourism, prompting widespread discounting and increased use of promotions. But inflation had been supported by price increases earlier in the year for various regulated services, such as transport and social housing, which were often linked to official measures of inflation.

Agents' survey on consumer demand

The agents asked businesses about the prospects for household spending over the rest of 2012, and the likely drivers of expected changes. 248 companies participated in the survey, with combined turnover of around £171 billion. The following results are weighted by turnover.

Firms reported that there had been a very modest rise in turnover between 2012 H1 and the same period a year earlier, with a small positive net percentage balance of businesses reporting that turnover had increased (**Chart A**). There was some variation across industries, however, with contacts in the service sector typically having seen a significantly stronger performance over the period than other businesses (**Chart B**). Given these sectoral differences, it is important to note that the survey sample was considerably underweight in services providers on a turnover-weighted basis. If greater weight was placed on services, the survey results would point to a rather stronger improvement in turnover during the first half of the year.

Chart A Change in turnover in 2012 H1 and expected change in turnover in H2

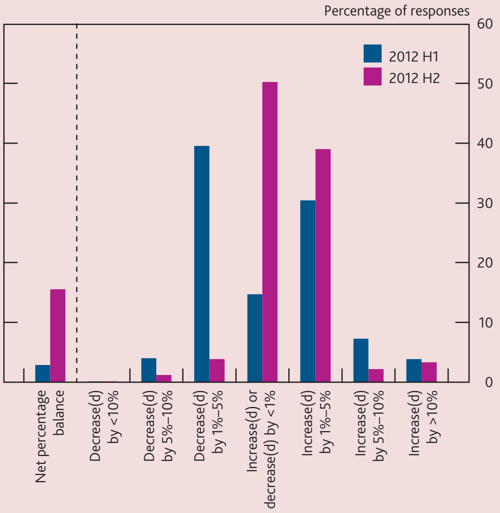
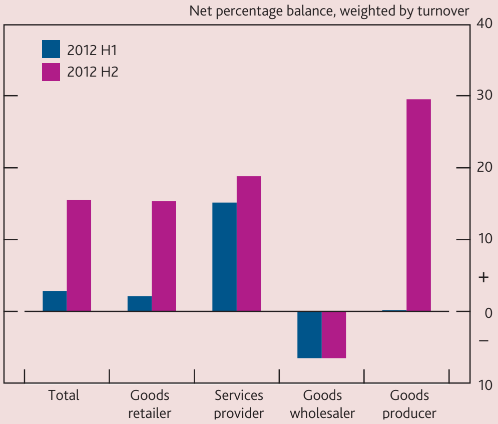


Chart B Change in turnover in 2012 H1 and expected change in turnover in H2, by sector



Looking ahead, respondents expected slightly stronger growth during 2012 H2, compared with 2011 H2 (**Chart A**). This improvement is reflected across most sectors (**Chart B**), with retailers in particular appearing to be more optimistic about the second half compared with the first half. Nevertheless, the relatively stronger balance for goods producers suggested that there might be some stockbuilding over the coming six months. Wholesalers remained gloomy, as small businesses were expected to struggle over the rest of the year.

Broadly, firms reported that the expected change in turnover in 2012 H2 was likely to be driven by rising prices, rather than volumes (**Chart C**). But given the relatively small weight of the service sector in the sample, it may be reasonable to expect more of a spur to turnover from growth in volumes, and less from higher prices, than suggested by the weighted totals. In terms of behavioural drivers of demand, businesses were often optimistic about their own ability to tailor strategies to stimulate spending, either through changes to their products or pricing (**Chart D**). But they were generally pessimistic about the prospect of improvements in household spending power, confidence, and access to credit.

Chart C Drivers of expected change in turnover between 2012 H2 and the same period a year earlier

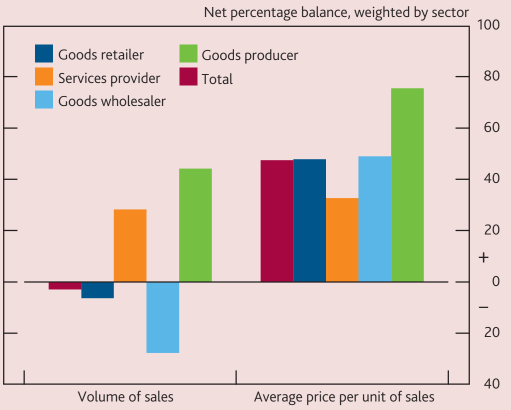


Chart D Drivers of expected change in demand in 2012 H2