BANK OF ENGLAND

Agents' summary of business conditions

December 2012

- There was a further gentle pickup in retail sales growth. Growth in consumer services slowed marginally, in part reflecting a slight fall back following the Olympics-related boost.
- Housing market activity was flat to slightly up on a year earlier.
- Investment intentions remained slightly positive within manufacturing and services.
- The slowdown in export growth had eased marginally, and sales remained slightly higher on a year earlier.
- Business services turnover growth remained modest, constrained by subdued demand and intense competition, which was restricting pricing power.
- Annual manufacturing output growth remained marginally negative. Production for export continued to outperform that for domestic markets, although weakening in the euro area was affecting volumes.
- Construction output continued to decline through 2012, and remained at low levels.
- The Funding for Lending Scheme appeared to be having a more immediate impact on the mortgage market than on business lending. Demand for bank borrowing among smaller firms remained weak.
- Employment intentions over the next six months remained broadly flat.
- Firms in manufacturing and services were operating at slightly below normal levels of capacity utilisation.
- Labour costs per employee continued to grow at a modest rate in both manufacturing and services.
- Non-labour cost inflation on average remained benign, but the picture was very mixed across different commodities and other inputs.
- Manufacturers' output prices were increasing modestly. Pricing power was generally weaker in services.
- Consumer goods price inflation had picked up marginally. Consumer services price inflation had also increased a little.

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 October 2012 and late November 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.**

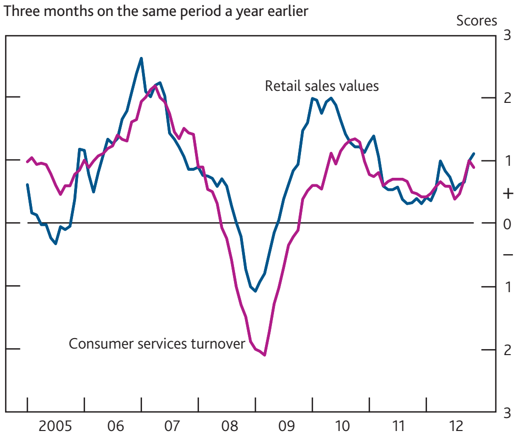
Demand

Consumption

There was a further gentle pickup in retail sales growth, but the rate of growth remained well below trend (**Chart 1**). Consumers remained cautious in their spending decisions. Internet and value retailers were the main beneficiaries, while the mid-market appeared to be feeling the brunt of the squeeze more than the low and high ends. Retailers reported stronger sales of own-label products versus branded, and there were fewer impulse purchases. Demand for large ticket items remained weak as a result of fragile consumer confidence, but sales of high-tech goods and some luxuries were showing strong growth. Retailers remained cautious about the Christmas period, and stocks were being controlled tightly to mitigate the need to discount if sales proved sluggish. Growth in consumer services turnover slowed marginally (**Chart 1**), in part reflecting a slight fall back following the Olympics-related boost. Demand at outdoor attractions was still struggling due to the wet weather, but footfall at indoor venues was more buoyant, although revenue growth was restricted as consumers economised on secondary spending.

Chart 1 Consumption

Three months on the same period a year earlier



Housing market

Housing market activity was flat to slightly up on a year earlier. The London market was markedly stronger — buoyed by overseas demand. Sales in both the new build and secondary markets remained below pre-recession levels. Most activity was at the lower end of the market, while increases in stamp duty were bearing down on demand at the top end. New build was performing broadly in line with the overall housing market, but activity was being supported by government assistance schemes and house builder incentives. Continued strength in the rental market was driving steady growth in buy-to-let demand. Mortgage availability was still a significant constraint where deposit levels were low, which particularly affected first-time buyers.

Business investment

Investment intentions remained slightly positive year on year within manufacturing and services. Uncertainty about the economic outlook was often holding back investment, and the preference to bolster cash balances or pay down existing debt was a priority for some. For manufacturers, the main drivers of spending were improved efficiency and regulatory requirements. UK capacity expansion plans were usually restricted to those aiming to increase overseas sales or introduce new products, and there were further reports of firms directing investment outside the United Kingdom to be closer to end customers. In services, investment in IT to improve efficiency and customer service, or to ensure regulatory compliance, remained strong. While investment in new retail outlets was moderating, the need for consumer-facing businesses to refurbish or to expand their online presence was expected to continue to support spending.

Exports

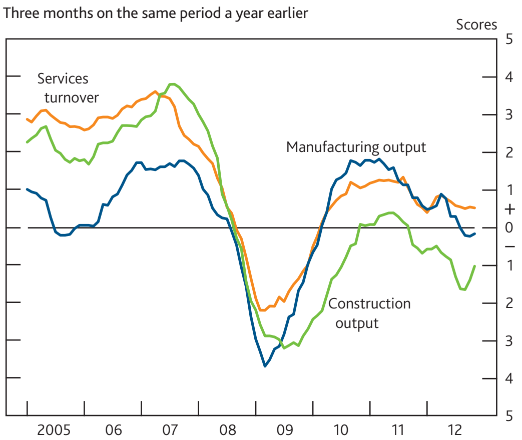
The slowdown in export growth had eased marginally, and sales remained slightly higher on a year earlier. Contacts continued to report falling demand from the euro area, both the periphery and core. Some firms were offsetting this weakness by increasing market share in declining markets or by penetrating new markets; those producing niche or high-tech products were often the most successful. Despite further reports of slowing in the global economy (eg Australasia), a number of firms were still achieving healthy growth, as relatively new entrants to those markets. In particular, there was continued strength in sectors such as oil and gas extraction, and food and drink.

Output

Business services

Business services turnover growth remained modest, constrained by subdued demand and intense competition, which was restricting pricing power (**Chart 2**). Contacts involved in IT and outsourced services continued to report healthy growth, particularly where solutions offered increased efficiency, although public sector demand remained subdued. Activity for services firms involved in marketing was supported by clients increasing their focus on branding and promotional activity. Reasonable growth was also being seen in engineering consultancy services. There were some indications of a slight pickup in corporate transactions in accountancy and legal, but activity was still well below pre-recession levels. Corporate recovery and insolvency work, outside of retail, also remained muted. There were continued reports of weakness in property and construction services, although some firms noted a tentative pickup in valuation work related, for example, to refinancing of assets. Bookings for conferencing facilities remained soft and, in a few regions, were falling on a year earlier. Activity within logistics and distribution remained

Chart 2 Annual growth in manufacturing output, construction output and services turnover



subdued, although some firms were growing market share as a result of industry consolidation.

Manufacturing

Annual manufacturing output growth remained marginally negative (**Chart 2**). Production for export continued to outperform that for domestic markets, although weakening in the euro area was affecting volumes. Across the sector generally, order sizes were declining and delivery cycles shortening, perhaps reflecting lower confidence levels and pressure on working capital among customers. The most buoyant growth was being seen by firms supplying to the energy and aerospace sectors. Output for the automotive sector was more mixed, with weakening demand in Europe bearing down on some manufacturers. Suppliers to the construction sector were still facing declining volumes on a year earlier, although a slight pickup in house building activity was providing respite for some. Reports from consumer goods manufacturers were mixed; output was generally flat year on year, with a few reports either side of this average.

Construction

Construction output continued to decline through 2012, and remained at low levels. Some regions, however, were starting to see a moderation or stabilisation in the rate of decline (**Chart 2**). This tended to reflect a modest improvement in private sector activity in some areas, which was partially offsetting continued contraction in public sector demand. There was some improvement in infrastructure projects, particularly those related to energy and rail. Weak confidence levels and access to credit were, however, constraining new-build commercial activity outside London. Repair and maintenance workloads continued to be buoyed by refurbishment of retail and public sector buildings. House building activity had improved slightly, but substantive growth was limited to London. Social housing development was still ongoing, but was being constrained by tightening in the supply of grant funding.

Credit conditions

There was some further evidence of the Funding for Lending Scheme (FLS) leading to modest improvements in mortgage availability and lower lending rates. There were regional variations, however, and mortgage availability was still a constraint for some house builders. In terms of the corporate lending market, there had been less evidence of traction from the FLS to date. Awareness of the Scheme among businesses was gradually growing, but it was still under the radar of many. Demand for bank borrowing among smaller firms remained weak, with many preferring to pay down existing debt or build cash reserves. And larger firms were often able to access long-term credit on very favourable terms via corporate bond markets or private funds. Working capital facilities remained an issue for some, and there were reports of more firms being moved away from overdrafts to invoice discounting. Forbearance by banks continued and insolvency levels remained relatively low. There were some reports though of larger firms increasing financial support to their supply chain and customers, in response to working capital pressures.

Employment

Employment intentions over the next six months remained broadly flat, with headcount cuts in some areas (eg construction and consumer sectors) being offset by job creation elsewhere (eg aerospace, some business services). There was little evidence that a shakeout of employment was planned, with firms indicating they intended to retain skills in anticipation of a pickup in growth over the next year. Many firms were maintaining their apprenticeship and graduate schemes, to address skill shortages or to aid succession planning. There was also continued growth in support roles, such as regulatory compliance and credit control. Intentions were marginally weaker for consumer services firms, relating in part to consolidation of some national retail networks. Otherwise, consumer-facing firms could often not cut headcount further without affecting customer service or their breadth of offer. Recruitment conditions remained generally easier than normal, but skill shortages still existed in areas such as IT and engineering, and economic uncertainty was leading to lower than normal mobility within the labour market generally.

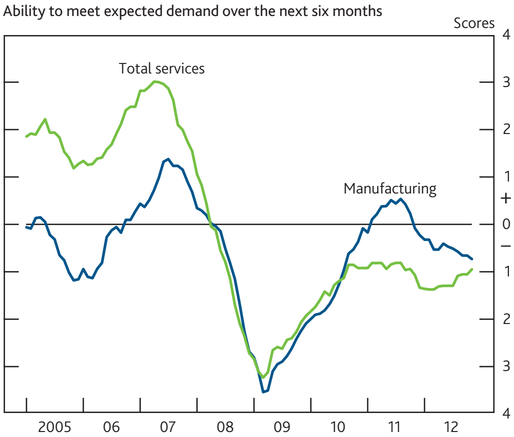
Capacity utilisation

Firms in manufacturing and services were operating at slightly below normal levels of capacity utilisation (**Chart 3**). The recent weakening in domestic and overseas demand, along with investment by some (eg exporters) in additional capacity over the past couple of years, meant that most firms could accommodate an increase in output fairly quickly and easily. A few bottlenecks still existed in certain production processes though, and skill shortages were a constraint for some sectors.

Utilisation within services had improved slightly, in part due to continued consolidation within the sector. Some firms had redeployed labour resources from less busy areas to functions such as business development, but these could easily be redirected if demand picked up. There was, however, still a significant surplus of physical capacity evident, for example, in rising vacancy rates in retail and secondary office space.

Chart 3 Capacity Utilisation

Ability to meet expected demand over the next six months



Costs and prices

Labour costs

Labour costs per employee continued to rise at a modest rate, and no material pickup was anticipated over the next twelve months. Pay settlements were primarily in the 1%–3% range, with a significant number of pay freezes still in place (apart from national minimum wage increases), particularly in consumer-related sectors. Where higher awards were made, these tended to be as a result of skill shortages, or where pay freezes had been in place previously. There was a continued movement away from across-the-board settlements to merit-based increases, and in some cases bonuses were awarded instead of pay rises. In terms of non-pay labour costs, the greatest concern among firms related to pension fund deficits on defined benefit schemes. Auto-enrolment was now in effect for some larger firms, but the impact on labour costs was as yet unclear, as much would depend on take-up of the new scheme by employees.

Non-labour costs

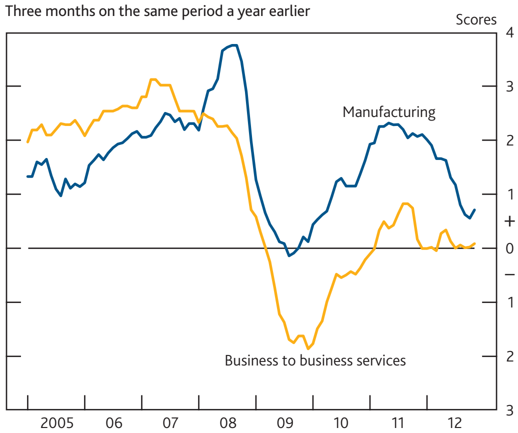
Non-labour cost inflation on average remained benign, but the picture was very mixed across different commodities and other inputs. Inflation on many raw materials had moderated, and some were lower on a year earlier (eg metals, cotton). This was largely as a result of softer global demand, but also reflected a slightly stronger sterling exchange rate. The main exception was foodstuffs. Poor harvests were adding considerably to farmers' feed costs, and the cost of other crops, including fruit and vegetables, was also up substantially on a year earlier. Far East wage cost pressure and increased shipping costs were still contributing to higher imported goods prices, albeit there was some offset from weaker demand and exchange rate effects. Energy costs were a frequently mentioned concern, with some firms experiencing a lagged effect from previous price rises as long-term contracts expired.

Output prices

Manufacturing output prices were increasing modestly year on year (**Chart 4**). Firms that were innovating or operating in niche markets often had relatively strong pricing power. Other firms (eg consumer sector suppliers), however, struggled to pass through cost increases into output prices, and hence the trend to re-engineer products or reduce packet sizes to maintain margins was increasing. Greater competition from European competitors, who were focusing on the UK market as domestic demand weakened, was adding further pressure to some firms' margins. Output prices in services were broadly flat on a year earlier (**Chart 4**). Professional fees were often under downward pressure due to intense competition, particularly for standardised services (such as audit), but selective fee increases in other areas meant overall prices were flat. Some cost pass-through was being achieved in the haulage and distribution sector.

Chart 4 Annual output price inflation

Three months on the same period a year earlier



Consumer prices

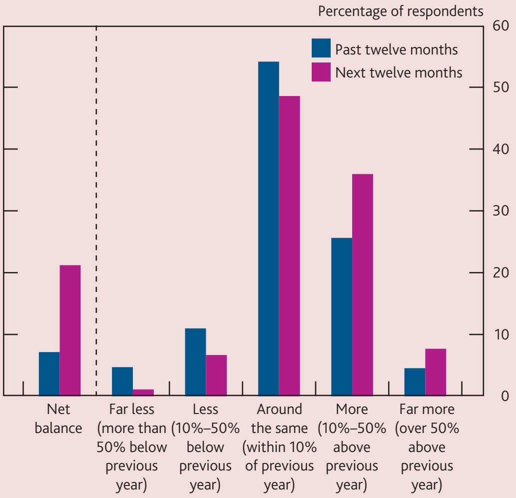
Consumer goods price inflation had picked up marginally. Announced utility price rises had started to filter through, and would continue to do so over the next couple of months. Some food prices had started to rise as a result of poor harvests (eg fresh fruit, vegetables and bread), with inflation in other foodstuffs (eg meat) expected to feed through over the next few months. Retailers' promotional activity was likely to continue to dampen the impact on headline price inflation. Consumer services price inflation had increased a little, largely due to rises in public transport prices and social housing rents earlier in the year, alongside the autumn increase in tuition fees. Some public transport prices were expected to rise again in the new year, but competition and weak demand were likely to continue to bear down on inflation in many other consumer services.

Agents' survey on investment and research and development intentions

The Agents asked businesses about capital expenditure, and research and development spending over the past year, and their intentions for the next twelve months. Firms were also asked to indicate how various factors were likely to affect their investment plans over the next twelve months. Four hundred and thirty nine companies participated in the survey, with a combined UK turnover of around £120 billion. The following results are weighted by turnover.

Overall, firms reported a modest increase in investment over the past twelve months, compared with the previous year. Investment intentions for the next year were stronger: on balance, more firms expected to increase investment over the next twelve months (**Chart A**).

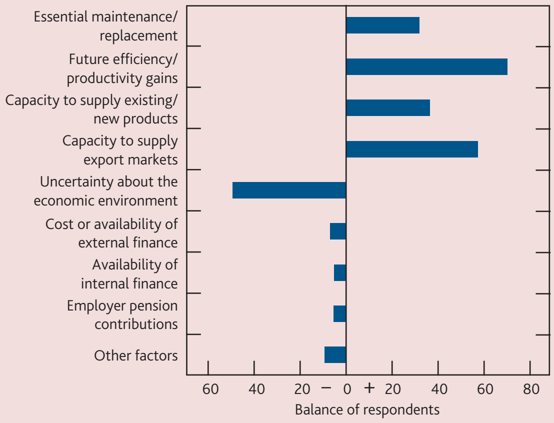
Chart A Investment over the past twelve months and intentions for the next twelve months



There was some variation across firm size, with the improvement in investment intentions most marked for the largest (UK turnover of over £400 million) and smallest firms (UK turnover of up to £50 million) in the sample. The proportion of medium-sized firms (UK turnover of £51 million to £400 million) reporting an improvement in intentions was lower. In terms of sectors, most showed a modest increase in investment over the past year. While intentions for the year ahead were positive for all sectors, they were stronger for respondents in manufacturing and consumer services than for those in business services and construction.

In terms of the factors affecting investment spending (**Chart B**), the majority of respondents expected the quest for future efficiency/productivity gains to boost investment over the next year. Investment in additional capacity to supply new and existing export markets, and to meet demand for new and existing products, was also expected to boost investment over the next twelve months. For the majority of respondents, essential maintenance and replacement was not expected to have a material impact on the level of investment for the year ahead, although it was cited as a driver of capital spending by some firms. The most significant factor weighing down on investment plans over the next year was uncertainty about the economic and financial environment. The cost or availability of external finance, the availability of internal finance, and other factors, were constraining investment plans for only a small minority of firms surveyed.

Chart B Factors affecting investment plans over the next twelve months



Research and development spending plans over the next twelve months were also more positive, compared with the past year (**Chart C**). The strongest intentions were reported among larger firms, and for those within manufacturing and consumer services. It should be noted, however, that a significant proportion of survey respondents answered 'not applicable' to the question, suggesting that they did not engage in such activity.

Chart C Research and development spending over the past twelve months and intentions for the next twelve months