BANK OF ENGLAND

Agents' summary of business conditions

July 2012

- There had been a slowing in the annual growth rate of consumer demand, with contacts reporting that confidence had dipped due to worries about the economic outlook.
- There had been further signs of weakening in the housing market.
- Investment intentions had softened a little, but remained positive, and there was a general sense of stepping back from expansion plans.
- Export growth remained strong but had slowed further on the month, in large part due to weaker demand in the euro area.
- In the business services sector, turnover continued to edge higher, but the annual rate of growth had slowed a little over the past few months.
- Manufacturing output growth had weakened somewhat, after having picked up during the spring. That was mainly down to the slowing in export growth.
- There had been a further decline in construction output compared with a year earlier, in large part due to weakness in public sector spending.
- Contacts continued to report that loan rates and fees were rising when facilities came to be renewed. And small firms were still often struggling to secure credit.
- Private sector employers did not expect much change in staff numbers over the next six months.
- There was a small margin of spare capacity in the manufacturing sector. There was a somewhat greater degree of underutilised labour and capital in the service sector.
- Labour costs continued to grow at a moderate pace, with settlements tending to be a little higher in the manufacturing sector than in services, due largely to its relatively stronger performance over the past year.
- Materials cost inflation eased further, with the prices of various commodities having levelled off, or even fallen in some cases.
- Manufacturing output price inflation continued to slow gradually, as the impetus from rising input costs began to wane. There was very little upward pressure on the price of business services.
- Consumer price inflation had slowed a little further on the month.

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 May 2012 and late June 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 had been a slowing in the growth rate of spending on retail goods and services, in part due to lower inflation. Contacts also thought that there had been a dip in consumer confidence due to worries about the economic outlook. The pattern of demand continued to be highly changeable, and influenced considerably by the weather and the timing of cultural and sporting events. For instance, a brief spell of fine weather in late May had temporarily boosted demand for seasonal goods, such as summer fashions, but had been offset by dreary conditions in June, and an overhang of stock had led some stores to begin mid-year sales early. Meanwhile, the Diamond Jubilee was reported to have provided a short-term boost to food sales. Households were becoming ever more focused on obtaining value for money, and as well as trading down to cheaper products, were increasingly switching away from fresh goods to dried and frozen products, to minimise waste.

Housing market

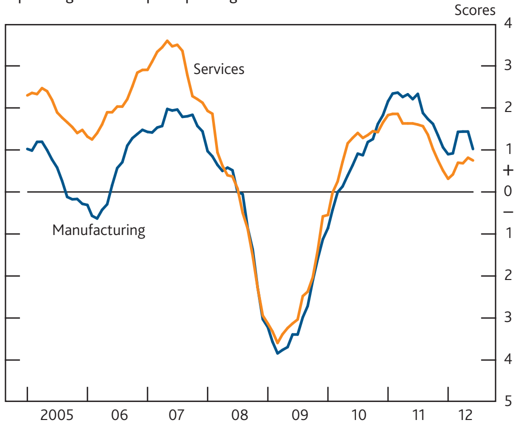
There had been further signs of weakening in the housing market. Some contacts thought that the drop-off in activity was, in part, the consequence of transactions having been brought forward ahead of the end of relief on stamp duty in March. More generally, buyers were reported to have become more cautious in light of uncertainty about events in the euro area. In addition, there had been the added distractions of the Diamond Jubilee and Euro 2012, which were likely to have caused some prospective buyers to postpone enquiries in the short term. But supporting the level of activity, buy-to-let investment continued to grow, and foreign investors had branched out of commercial property in the capital and begun also to invest in the London residential lettings market. There had also been further reports of downsizing by older homeowners in order to release equity. Vendors continued to show a more realistic attitude towards pricing, and there was a growing trend among homeowners to sell via auction.

Business investment

Investment intentions remained positive but had softened a little (**Chart 1**). And there was a general sense of stepping back from expansion plans, due to concerns about the prospects for demand going forward. That was particularly true of firms supplying the domestic market. For example, some of the large retailers had pared back their expansion plans, given revised expectations for household expenditure. But even among exporters, while some were still investing in capacity, for others, slowing growth abroad had lessened the urgency for further expansion. Nevertheless, firms were still keeping up with essential spending on replacement kit and repair and maintenance, and continued to invest in finding efficiencies and improving management information. The need to comply with regulatory change was also motivating capital spending in some sectors. For instance, lower emissions targets had led some hauliers to invest in their fleets.

Chart 1 Investment intentions

Expected growth in capital spending over the next twelve months



Exports

Export growth remained strong but had slowed further on the month (**Chart 2**), in large part due to weaker demand in the euro area. That was apparent both in those countries struggling with sovereign debt issues and increasingly in those that were not, such as Germany and France. There were also some reports of a softening in exports to China, although, for the most part, growth in emerging market economies remained strong. Demand growth in the United States had also fallen back. The aerospace and automotive sectors continued to represent some of the most robust sources of growth, but were now showing signs of a slackening in the pace of expansion. Reports of losses of competitiveness due to the appreciation of the pound remained rare, although some businesses had lowered their sterling prices to offset it and there were concerns about the prospect of any further rise in the exchange rate.

Chart 2 Manufacturing output growth

Three months on the same period a year earlier

Output

Business services

Activity across the service sector as a whole was broadly flat compared with a year earlier, although some firms were gaining market share as competitors exited the industry. And while some sectors were struggling, others were benefiting from weakness in the wider economy. For instance, the IT industry continued to grow as a result of the efforts of all types of business to reduce labour costs and go online. Accountants reported that advisory work on restructuring continued to support activity, as corporates sought alternatives to insolvency. And contacts in the legal profession had seen a switch from litigation to dispute resolution, as a cheaper means of settling corporate disagreements. In contrast, growth in business travel, conferencing and corporate hospitality had softened, as firms once again pared back non-essential spending. And many contacts in logistics had registered a slowing in both domestic and export related work.

Manufacturing

Manufacturing output growth had weakened somewhat (**Chart 2**), after having picked up during the spring. That was mainly down to the slowing in export growth, which was feeding its way through the domestic supply chain. It was also a result of both falling public sector spending, and a decline in demand for capital goods, consistent with weaker investment intentions in the wider economy. Output of consumer goods was reported to be fairly flat compared with a year earlier, although there was some hope that food and drink production would receive a fillip from the Olympics. For a few contacts, which had been operating at full capacity, the extra bank holiday due to the Diamond Jubilee had caused a significant reduction in output. But for most, the effect had been modest, and many of those affected expected to be able to recover the lost output in the near term.

Construction

There had been a further decline in output compared with a year earlier, in part due to very wet weather, which had halted work on some sites. But it was mainly due to underlying weakness in public sector spending, and there had been a noticeable pickup in project deferrals. Meanwhile, private sector activity continued to be supported by a small rise in house building and the construction of student accommodation. And there was some growth from work on energy and transport infrastructure. But commercial property development remained very weak, with significant overhangs of office and, increasingly, retail space, in much of the country. And some of the large retailers had cut back their plans for new store openings. Small regional construction companies noted a further step-up in competition from national players, as their remaining large projects came to completion.

Credit conditions

Contacts continued to report that fees and rates were rising when facilities came to be renewed, while some firms had been discouraged from applying for new borrowing in the first place. Lenders had been making progress at working through their portfolios of past commercial property lending and identifying breaches of covenants. And there had been a rise in instances of banks showing less forbearance on non-performing loans, sometimes encouraging borrowers to refinance elsewhere. Small firms were still often struggling to secure loans, although asset-backed forms of borrowing were reported to be fairly readily available. In contrast, larger businesses often had favourable access to credit, but frequently had little appetite to borrow, preferring instead to pay down existing debt, or use internal sources to fund investment. The general sense from contacts was that, so far, there had been little impact on lending from the National Loan Guarantee Scheme.

Employment

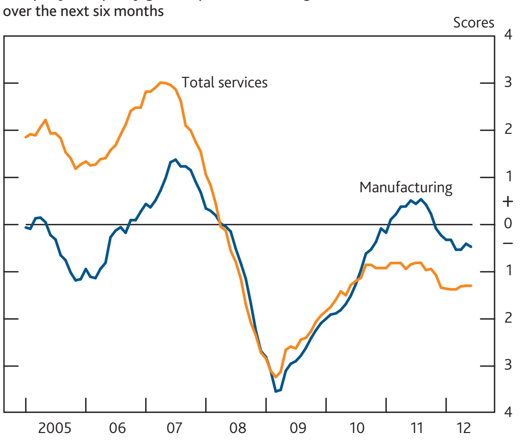
Private sector employers did not expect much change in staff numbers over the next six months, and there were frequent reports of low levels of churn in the labour market. In manufacturing, some exporters continued to take on additional employees, and concerns about future skills shortages were encouraging a growing number of businesses to create apprenticeships. But slowing demand had led some companies to scale back their recruitment plans. For many businesses, especially those facing the home market, any growth in output in the near term could be met using existing resources. In business services, in areas of growth, such as IT and engineering, contacts anticipated further job creation over the rest of the year. And some firms reported that it was difficult to recruit for certain specialist roles. In contrast, ongoing consolidation in those sectors where there was still considerable spare capacity, such as law and construction, was expected to lead to further job losses.

Capacity utilisation

There was a small margin of spare capacity in the manufacturing sector (**Chart 3**), in part due to past investment and hiring, but also due to slowing in the pace of output growth. Exporters tended to exhibit the least slack and were occasionally constrained by the lack of appropriately skilled staff. Firms facing the domestic market typically had rather more spare capacity. The weaker recovery in the service sector meant that there was still a degree of underutilised labour and capital (**Chart 3**), although consolidation through mergers and firm exits had eroded some of that slack. In growth areas, such as IT, businesses sometimes had little or no scope to take on new work. In retail, many businesses were already at minimum staffing levels, and were now considering closing stores, or reducing operating hours to try to raise productivity. Others were reducing staff numbers by introducing automated checkouts or better matching working hours to peak trading periods.

Chart 3 Capacity utilisation

Adequacy of capacity given expected demand growth over the next six months



Costs and prices

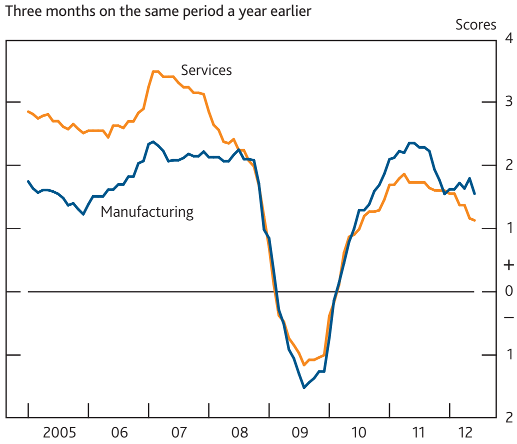
Labour costs continued to grow at a moderate pace (**Chart 4**), with slightly more upward pressure in manufacturing than services, due to the sector's relatively stronger performance over the past year. But across industries there had been reports of a slowing in pay growth in recent months, with concerns about the outlook leading some employers to defer making awards until later in the year. Moreover, firms were increasingly linking basic pay to the performance of the business, rather than inflation, and were making greater use of individual pay awards and bonuses over across-the-board settlements. Employees tended to remain broadly accepting of such measures. Although, where staff had been on extended pay freezes, increases in the National Minimum Wage had eroded pay differentials, and that was forcing a few employers to consider raising wages for all staff in order to preserve distinct pay scales.

Non-labour costs

Materials cost inflation continued to ease, with the prices of various commodities having levelled off, or even fallen — significantly in some cases. But past increases in energy prices were still pushing up on costs, sometimes markedly, for businesses renewing long-term contracts. Import price inflation had slowed somewhat, due to lessening upward pressure from input costs. And the rise in sterling had lowered the price of imports from the euro area for some companies. But offsetting that was a combination of rising wages in emerging market economies, along with a fairly sharp increase in shipping costs.

Chart 4 Growth in total labour costs per employee

Three months on the same period a year earlier



Output prices

Manufacturing output price inflation continued to slow gradually, as upward pressure from input costs began to wane. But some firms continued to try to pass on past increases in costs, or were hanging on to reductions in costs to rebuild lost margins. There was very little upward pressure on the price of business services, although there were differences between sectors. Some growth areas and specialist services had been able to raise prices, while fees for standardised services, and in sectors with significant spare capacity, continued to be squeezed.

Consumer prices

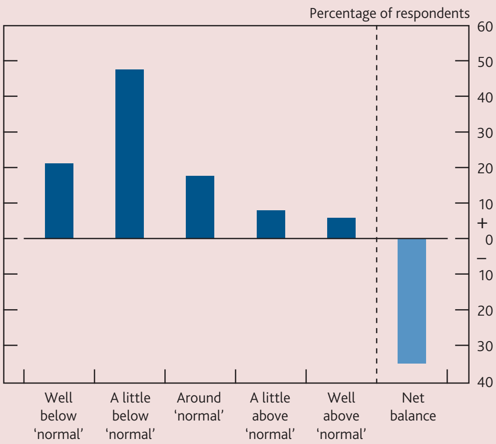
Consumer price inflation had slowed a little further on the month. The cost of petrol and the prices of various basic foodstuffs had fallen a little from recent highs, and the rise in sterling had lowered the price of some imported finished goods. A number of retailers had also started their summer sales earlier than usual, as poor weather had left them with a surplus of stock of seasonal products. In consumer services, links with official measures of inflation had pushed up the prices of transport and social housing, and postal charges had also risen. But the prices of a range of other services, such as hotel accommodation, visitor attractions, and car servicing, were rising only gradually due to the weakness of consumer demand.

Agents' survey on profit margins

To try to assess possible risks to inflation from firms' efforts to raise profitability, the agents conducted a survey to investigate corporate profit margins, where profit margin is defined as operating profit as a proportion of turnover. The agents asked firms how current margins compared with normal, how they had changed over the past year, and expectations for the coming year. 555 firms responded to the survey, with turnover of £53 billion.

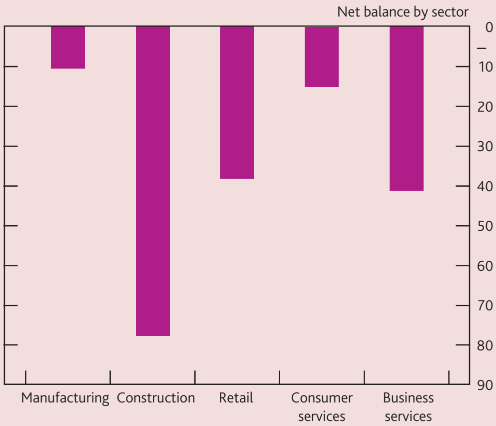
Weighting the results by turnover, around two thirds of firms reported that margins were currently below normal, where normal is defined as the pre-recession average (**Chart A**). That was the case across all sectors, with the biggest squeeze evident in construction (**Chart B**). Margins were also significantly below normal in retail and business services. In contrast with surveys in 2010 and 2011, however, which found that exporters' margins were above normal, the latest survey found that they were now somewhat below normal.

Chart A Current profit margin relative to normal(a)



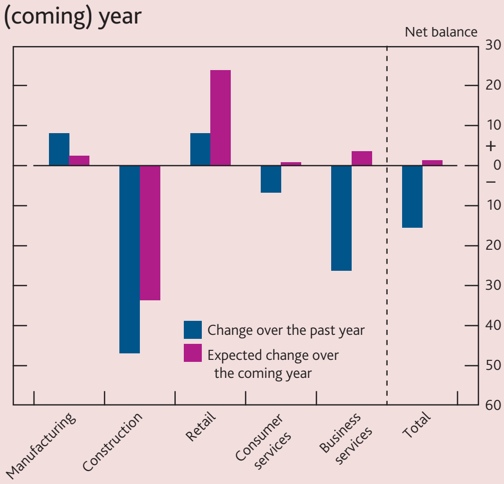
(a) The net balance is given by the percentage of respondents reporting that margins were above normal, less the percentage of those reporting that they were below normal. A weight of 0.5 is applied to responses of 'a little above/below', and a weight of 1.0 is applied to responses of 'well above/below'.

Chart B Current profit margin relative to normal



In terms of changes over the past year, the survey found that there had been a modest fall in margins overall (**Chart C**). On balance, contacts expected margins to be more or less unchanged over the coming year.

Chart C (Expected) change in margin over the past (coming) year



But behind the aggregate numbers there was considerable variation between sectors. For instance, in construction, margins had fallen markedly over the past year, and were expected to be squeezed further still in the year ahead. But in retail, businesses reported a small improvement in margins over the past year, with another increase expected in the coming year. Rather than coming through prices, however, that improvement was typically expected to come through factors such as gains in volumes arising from consolidation in the sector, changes in the mix of products, and growth in internet sales.

Among those respondents that reported that margins were currently below normal, the majority expected it to take between one to three years for them to return to normal (**Chart D**). However, a significant proportion of businesses felt that the outlook was too uncertain to say when margins might normalise, and some believed that profit margins would never return to pre-recession averages.

Chart D How long do you expect it to take for your profit margin to return to normal?