BANK OF ENGLAND

Agents' summary of business conditions

June 2012

- Consumer demand continued to grow at a gradual pace, although the Agents' scores for growth in retail goods and services edged down on the month.
- The fairly widespread improvement in housing market activity since the start of the year appeared to have dissipated somewhat.
- Contacts reported that investment was likely to rise at a modest pace over the coming twelve months.
- Goods exports continued to grow steadily, driven by increases in demand in a number of emerging market economies, but had slowed a touch on the month.
- Turnover in the business services sector had risen a little compared with a year earlier, but fortunes both across and within subsectors were very mixed.
- The manufacturing industry continued to expand at a modest pace. The strongest activity was typically among firms in export supply chains.
- Construction output had declined compared with a year earlier, as public sector contracts came to an end.
- Credit conditions had tightened somewhat, with a number of firms reporting that rates and fees had risen. And many firms remained focused on paying down existing debt.
- Private sector employment intentions suggested that job numbers would be broadly stable over the next six months.
- Capacity utilisation in the manufacturing sector was around normal, while there was rather more slack in the service sector.
- Private sector settlements tended to be between 2%–3%. Awards were, on balance, higher in manufacturing than services, while pay freezes remained common in construction and retail.
- Non-labour input costs had continued to stabilise, and the pace of inflation had slowed further.
- Manufacturing output price inflation remained around its historical average. Business services inflation was subdued.
- Consumer price inflation was falling slowly, 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 April 2012 and late May 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.

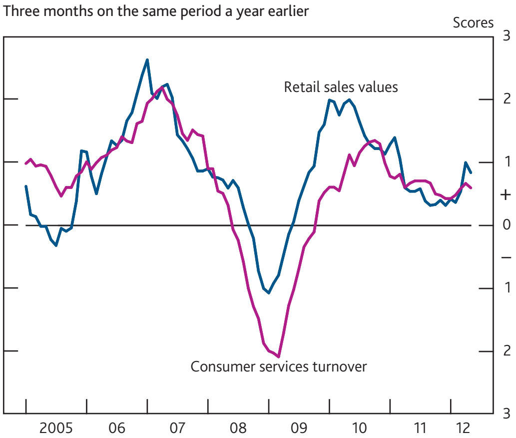
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx.**

Demand

Consumption

Consumer demand continued to grow at a gradual pace, although the Agents' scores for growth in retail goods and services edged down on the month (**Chart 1**). After fine weather had boosted demand early in the spring, poor weather during much of April and the middle of May had led to a material softening in activity, particularly for clothing stores and garden centres, and providers of outdoor leisure activities. More generally, spending patterns continued to be very changeable and driven by promotions, and the sector was characterised by ongoing shifts in market share. For instance, online sales were gaining ground at the expense of the high street, while discount stores and cheaper products were winning custom from mid-range competitors.

Chart 1 Spending on retail goods and services



Housing market

The fairly widespread improvement in activity since the start of the year appeared to have dissipated somewhat. Some contacts believed that activity had been deterred by worries about the economic outlook, perhaps related to developments in the euro area. And a few, in particularly buoyant parts of the country, attributed the softening in the market to a dip in demand following the end of stamp duty relief for first-time buyers, as some transactions had been brought forward ahead of the deadline. Buy-to-let investors continued to support demand, however, and there were further reports of first-time buyers returning to the market. Contacts thought that for some of those first-time buyers it had taken until now to save a deposit, while some others were getting help from family. But many remained constrained by tight credit conditions. There were signs of an emerging trend among the older age group to move to smaller properties.

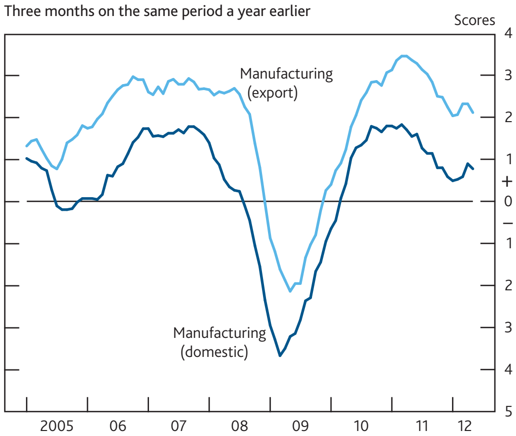
Business investment

Contacts reported that investment was likely to grow at a modest pace over the coming twelve months. Plans for spending were typically strongest among exporters, which were often still expanding capacity. And some production processes were being repatriated, due to concerns about quality and reliability of supply, and also because 'made in the United Kingdom' continued to carry a significant premium in many growth markets. Suppliers to the domestic market tended to be focused on finding efficiencies and replacing worn-out equipment. But some contacts were seeking to extend the life of existing assets, even though new equipment would be more productive. Plans for capital spending in the service sector tended to point to slightly weaker growth than in manufacturing, with firms generally focused on cutting costs and raising labour productivity through greater use of IT.

Exports

Goods exports continued to grow steadily, driven by rising demand in a number of emerging market economies (**Chart 2**). For instance, exports of capital goods had been supported by investment in energy and infrastructure in the Middle East and extraction industries in Africa, while there was growing demand for luxury consumer goods in China and Russia. Exports to the United States were also reported to be rising at a reasonable pace, but sales to Europe had weakened materially. That was particularly the case among the more vulnerable economies, although demand in some of the stronger countries had also softened. Increasing numbers of businesses were now looking abroad for the first time, and were focusing on rapid growth markets to offset the weakness of domestic demand. Tempering that somewhat, there were widespread concerns about the prospect of a further appreciation of sterling.

Chart 2 Manufacturing output



Output

Business services

Turnover in the business services sector had grown a little compared with a year earlier, but fortunes both across and within subsectors were very mixed, with sizable shifts in market share between firms. For instance, some outsourcing companies were benefiting from the efforts of corporates to cut costs by hiving off back-office tasks, while others had been squeezed as public sector bodies brought work in-house. And hauliers exposed to the export sector were often doing well, while those serving the domestic market faced more challenging conditions. The IT and energy sectors continued to grow rapidly.

Looking ahead to the Diamond Jubilee, most contacts found it difficult to predict the overall impact of the additional bank holiday on activity. A number of firms planned to close for the extra bank holiday and suggested that there might be a material effect on the level of output around that time. But for many businesses the celebrations were expected to cause relatively little disruption to activity.

Manufacturing

The manufacturing sector continued to expand at a modest pace (**Chart 2**). The strongest activity was typically among firms in export supply chains, particularly in car production, the aerospace industry and the energy sector. But there had been a slight slowing recently, as such firms felt the impact of softening demand growth abroad. Output for the domestic construction and household sectors was typically very weak, and suppliers to the public sector often reported that conditions had become more difficult. Some contacts expected to have to adjust the timing of production to accommodate the extra bank holiday for the Diamond Jubilee, but there was expected to be relatively little impact on output overall.

Construction

Construction output was reported to have continued to decline compared with a year earlier, as public sector contracts gradually came to an end. Where there was new work for the public sector, the jobs tended to be smaller than those they replaced. Outside of London, new starts on commercial buildings remained extremely rare. And supermarkets had rowed back on their expansion plans. But house building was showing some signs of improvement, and infrastructure development in transport, distribution and energy continued to provide a source of growth. The Jubilee was expected to result in relatively little lost output. But there was expected to be some disruption to activity due to an embargo on work along Olympic routes around the time of the Games.

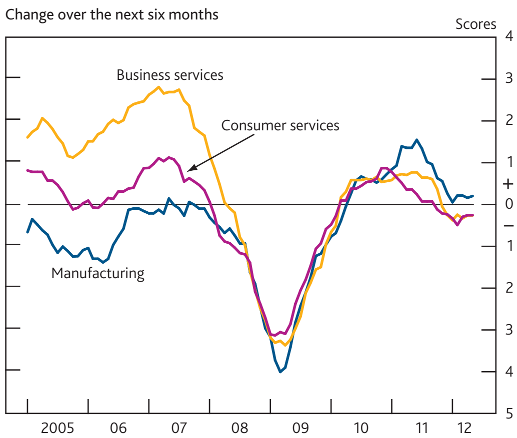
Credit conditions

Credit conditions had tightened somewhat, with a number of firms reporting that rates and fees had risen. And some businesses were being actively encouraged to pay off outstanding loans. But companies with strong balance sheets tended to be able to borrow at reasonable terms. A number of contacts reported that competition between lenders for the best credit risks had intensified. But their own appetite to borrow often remained very low, with many firms still focused on paying down existing debt. Small companies continued to prefer overdrafts to loans for the purposes of smoothing variable cash flows, but often complained about the fees charged for undrawn facilities. Some of them were now trying to work with lenders to find ways of minimising such charges. Even though debtor days generally remained under control, some contacts had become more cautious about providing credit to firms in their respective supply chains.

Employment

Private sector employment intentions suggested that job numbers would be broadly stable over the next six months (**Chart 3**). In manufacturing, past employment and investment meant that most firms were able to meet expected near-term demand growth through higher labour productivity. Some exporters continued to recruit, however, and skills shortages were prompting a growing number of businesses to take on apprentices. In the service sector, businesses in IT and distribution were hiring staff, along with some of the larger professional firms, but mergers among some small local practices were expected to result in job losses as back-office functions were integrated. Meanwhile, in the financial sector, contacts were often recruiting compliance personnel to ensure adherence to new regulations, while at the same time cutting staff numbers elsewhere. In retail, contacts were often shifting employees to part-time contracts, or shorter hours, to allow them to tailor staff numbers to demand. But store closures were expected to lower headcount in aggregate.

Chart 3 Employment intentions



Capacity utilisation

The level of capacity utilisation in the manufacturing sector was broadly normal, although exporters were sometimes at full capacity and a growing number of firms faced constraints due to difficulties obtaining staff with the right skills. In contrast, those supplying the domestic market often had significant amounts of slack. In the service sector, despite gradual consolidation through mergers and business exits, there remained significant spare capacity in a number of industries. In response, some firms had let staff go, but others continued to hold on to labour to retain key skills in the event of an upturn. Continued oversupply meant that there were frequent reports of 'too many firms chasing the work', with a large proportion of staff effort now dedicated to tenders and gold-plating the delivery of services. In one or two growth areas, such as IT and distribution, some businesses were near to capacity.

Costs and prices

Labour costs

The Agents' score for labour costs continued to point to a fairly restrained pace of growth, with settlements usually between 2%–3%. Awards tended to be higher in manufacturing than services, while pay freezes remained common in construction and retail, with any increases typically motivated by rises in the national minimum wage. There had been some more generous awards to retain key skills in areas of short supply — among IT professionals and engineers, for instance. But generally there was little upward pressure on pay from employees and there were signs that increased uncertainty might have held back settlements very recently. Many employers had also moved away from across-the-board settlements, towards individual merit-based awards, or had broken links between pay and inflation in favour of measures of profitability or labour productivity.

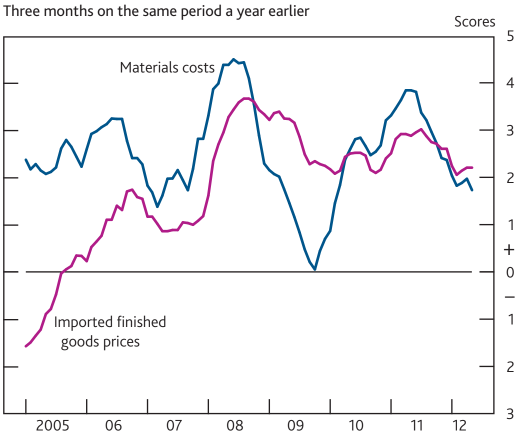
Non-labour costs

For many contacts, non-labour input costs continued to stabilise and the pace of inflation had slowed further (**Chart 4**). A range of commodities prices had levelled off, following significant increases over the past year, and some had fallen back a little. And a number of firms reported that they had successfully resisted suppliers' efforts to raise list prices. Importers of raw materials from the euro area had also seen a fall in sterling prices due to the appreciation of the pound. But there continued to be stories of rising costs due to past increases in oil and energy prices, and these continued to feed through the supply chain into the prices of oil-based and energy-intensive products. Inflation in the price of imported finished goods was coming down a little more slowly than for raw materials, as foreign production costs, particularly in China, continued to rise at a rapid pace (**Chart 4**). And shipping and air freight rates had also picked up quite sharply compared with a year earlier.

Output prices

Manufacturing output price inflation remained around its historical average, as past increases in costs continued to be passed on, even if only partially. To try to make it easier to pass on higher costs to customers, a small but growing

Chart 4 Materials costs and import prices



number of businesses were making use of escalator clauses and contracts in which the final purchaser was responsible for buying the raw materials needed for production. And a number of firms were seeking to secure higher margins by targeting foreign markets, or differentiating their products from others. Where demand remained weak, however, there tended to be rather less upward pressure on output prices.

In business services, output price inflation remained subdued. Some professional and financial service providers had managed to raise fees by targeting higher margin niche products, wealthy clients or international work. But many others, particularly suppliers of standardised professional and ancillary services, continued to report considerable downward pressure on prices. And many customers were seeking progressively more basic services, in order to secure a lower fee. In transport and distribution, meanwhile, some contacts had been able to pass on higher fuel costs. And in growth areas such as IT, fees had also been rising.

Consumer prices

Consumer price inflation continued to fall slowly, but remained elevated. Goods price inflation had been supported by last year's increases in fuel prices and utilities bills, along with more recent rises in duties. Discounting remained widespread, and supermarkets were increasingly making use of voucher schemes as well. Premium lines were often used to compensate for losses on cheaper products.

Consumer services prices were also still rising at a fairly steady pace, in part due to inflation-linking of the prices of a range of essential services such as transport and social rent. Some local authorities were also increasing charges for services to try to increase revenues. For providers of discretionary services, however, there was little scope for firms to raise prices, as demand was often very weak, and promotional activity was becoming increasingly common.