BANK OF ENGLAND

Agents' summary of business conditions

October 2012

- Spending on consumer goods and services continued to grow at a gradual pace. But the weather, together with sporting events over the summer, had affected the type and timing of purchases.
- Activity in the housing market picked up slightly. Contacts remained concerned though that this pickup would not be sustained, as continuing worries about the economic outlook restrained both potential buyers and sellers.
- Investment intentions continued to ease back, suggesting there would be little change in the level of capital spending by firms over the next six months.
- Export growth continued to slow, as euro-area demand weakened further.
- Turnover in the business services sector was still increasing at a gradual pace.
- Manufacturing output slowed further and was now broadly flat on a year ago. The slowdown appeared more widespread.
- Construction output continued to fall, as the slow recovery in private sector activity remained below the scale needed to replace public sector projects as they reached completion.
- For many companies the cost of borrowing appeared to be stabilising, albeit at levels well above a year ago. Typically larger firms had access to credit on good terms, but smaller firms still struggled to secure credit. Overall, demand for credit remained subdued.
- Employment intentions indicated there would be little job creation in the private sector over the next six months.
- In sectors where growth remained stronger, firms were operating close to capacity. Whereas in areas of persistent demand weakness, by contrast, there was typically a higher degree of slack. Manufacturers had seen capacity utilisation fall back recently, as activity slowed.
- Growth in labour costs per employee remained modest.
- Non-labour input cost inflation remained subdued. But contacts thought it less likely that inflation would fall further over the rest of the year, following the recent price increases of oil, cereals and some basic foodstuffs.
- Output price inflation had declined further, in response to past falls in input costs and weaker demand.
- The fall in consumer price inflation had slowed, in part as a result of renewed increases in energy and fresh food prices.

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 August 2012 and late September 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

Spending on consumer goods and services continued to grow at a gradual pace. But the weather, together with sporting events over the summer, had affected the type and timing of purchases. After a disappointing summer for many non-food retailers and consumer services firms, sales had picked up modestly in the early autumn. Shifts in market share, away from the high street and mid-market retailers and towards discount stores and destination shopping centres, remained the main feature of firms' growth, rather than any significant pick up in overall spending. Promotional activity was still seen as essential in order to stimulate demand, as households focused on finding value for money. Consumers continued to cut costs in various ways, for instance using public transport rather than their own cars, substituting cheaper brands or supermarket own label for more expensive ones, or shopping more frequently in order to minimise food waste. But despite the pressures on household disposable incomes, sales of more luxury goods such as technology and jewellery remained buoyant.

Housing market

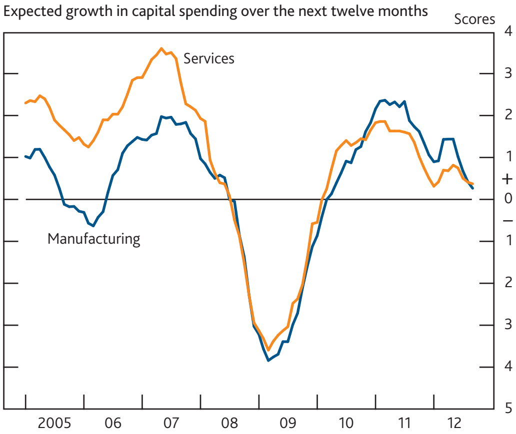
Activity in the housing market picked up slightly in the past month, following the usual seasonal lull associated with the school holidays, which had been exacerbated by the distraction of the Olympics for potential buyers. Contacts expressed concern though that this pickup would not be sustained, as continuing worries about the economic outlook restrained both potential buyers and sellers. Buy-to-let investors still made up a larger proportion of property sales in the lower stamp duty bracket, compared to before the recession. Would-be homeowners and those near the bottom of the housing ladder were still constrained by the lack of a sufficient deposit, credit and confidence. Mortgage availability had continued to improve slowly, but lending criteria remained tight. Sales of new houses continued to fare somewhat better in comparison to the secondary market, supported by government and developer initiatives, especially for first-time buyers.

Business investment

Investment intentions had continued to ease back, suggesting there would be little change in the level of capital spending by firms over the next six months (**Chart 1**). Uncertainty about future growth prospects remained the key constraint. The main factors driving investment were still cost savings, replacement cycles, new products and compliance with health and safety and environmental legislation. Reports of capital expenditure on new capacity fell further, even amongst exporters, who having previously anticipated stronger growth had now revised down their expectations. Where investment cycles were typically over much longer periods, in sectors such as energy, utilities and transport, spending plans had held up somewhat better. Spending on IT and online sales channels remained significant, especially for service sector firms.

Chart 1 Investment intentions

Expected growth in capital spending over the next twelve months



Exports

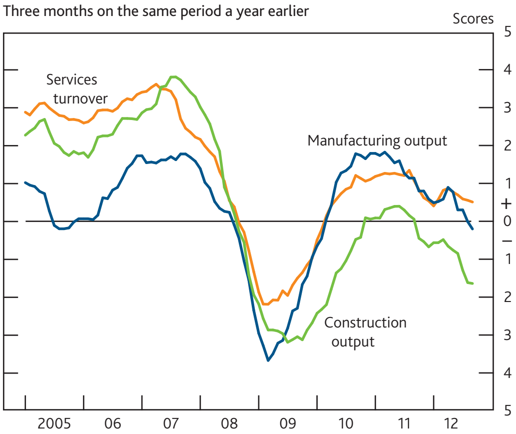
Export growth had continued to slow over the past month, as spending in the euro area weakened further. Despite the recent slowing in orders though, most contacts remained optimistic that exports would still increase over the next year. Firms were increasingly wary of the credit risks associated with selling in Europe. In response, an increasing number had either tightened payment terms or even refused orders where the risk of non-payment was considered to be too great. There were more examples in the past month of firms losing orders to European competitors. But this was thought to reflect extreme measures by some foreign firms to sustain output, at any price, in the face of weak demand rather than more widespread competitive pressures due to the appreciation of sterling against the euro this year. And some UK firms had won orders as a result of customer concerns about the viability of foreign suppliers. There were more signs of a slowdown in the rest of the world, notably in Asia. But market share gains for many firms were mitigating much of these effects. And smaller firms, especially, continued to increase their efforts to win orders in markets outside Europe.

Output

Business services

Turnover in the business services sector was still increasing at a gradual pace (**Chart 2**). The volume of activity continued to edge higher, compared to a year ago, while intense competition was keeping prices from rising. Reports remained mixed across sectors and tended to reflect trends in the wider economy. Unsurprisingly given the relative strength of capital spending on IT, firms advising on hardware systems, software and online sales were experiencing strong growth. And marketing firms, working with clients to expand into new markets, were also busy. Firms involved in preparatory work for longer-term projects in areas such as energy, utilities and transport infrastructure were also seeing growth. But for others, in corporate hospitality, transport, warehousing and recruitment services, growth had weakened as customers tightened spending further.

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



Manufacturing

Output slowed further over the past month and was now broadly flat on a year ago (**Chart 2**). The slowdown had become more widespread, reflecting lower spending by households, businesses and the public sector in the United Kingdom and overseas. Although firms in the aerospace, automotive and energy sectors were still experiencing modest growth there were some signs that shrinking order books were already having an impact on supply chains as inventories were reduced. For manufacturers of building materials and capital goods for the construction sector, output continued to fall. Greater uncertainty about future growth prospects had also increased volatility in order books and stock holdings, which had led to sizable changes in production volumes month on month.

Construction

The level of construction output remained down on a year ago, as the slow recovery in private sector activity was below the scale needed to replace public sector projects as they reached completion (**Chart 2**). There had though been some catch up of activity more recently following weather-related disruption on sites earlier in the year. The strongest boost to output continued to stem from infrastructure projects, especially in utilities, energy and transport. And private house building had picked up further. But there was little in the way of new commercial property development and, overall, the pace of retail expansion was now somewhat slower than before. Confidence and credit constraints remained significant drags on private sector activity.

Credit conditions

For many companies the cost of borrowing appeared to be stabilising, albeit at levels well above a year ago. Typically, larger firms, especially those with strong balance sheets, had access to credit on good terms. And those with sufficient scale to access capital markets reported healthy investor demand for corporate bonds. But some smaller firms still struggled to secure credit. Lenders were often demanding higher levels of security, exacerbating issues faced by some smaller businesses that were unable or unwilling to provide sufficient guarantees or collateral. Firms in sectors such as property, construction and retail continued to find borrowing more difficult than most. Demand for credit however, also remained subdued. And many firms were still building larger cash buffers and funding a greater proportion of their working capital and investment requirements internally than before the crisis. The funding for lending scheme had yet to have a significant effect on lending conditions, although reports of participation by lenders had increased further. For many contacts though, it was thought to be too early to expect a noticeable improvement in lending conditions, given the typical time periods associated with new loan applications. On residential mortgages, the lower cost of funding was expected to be passed through to mortgage rates, but intentions among those lending to companies were more varied. Some lenders intended to offer a price discount, while others were waiving associated fees.

Employment

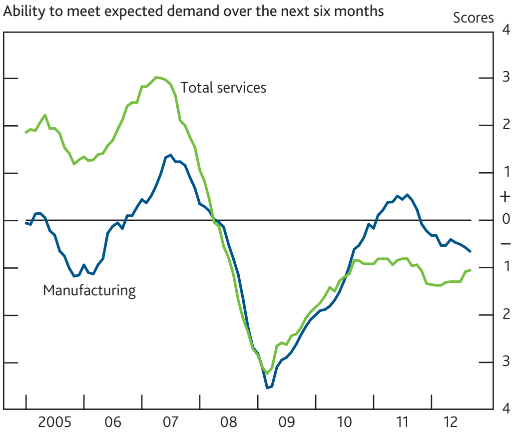
Employment intentions indicated there would be little overall job creation in the private sector over the next six months. While those in manufacturing still experiencing stronger growth were increasing headcount, firms more exposed to weaker spending by households and the public sector continued to shed jobs. There was no evidence though of a planned shakeout of employment, despite the recent slowdown in demand. The retention of key skills and the high costs associated with redundancies continued to act as a brake on future job losses. Indeed some firms had stepped up their recruitment of graduates and apprentices in anticipation of future skills shortages. While regulatory compliance and responding to issues such as the mis-selling of payment protection insurance were also supporting employment in the business services sector, continuing consolidation through mergers and firm exits was likely to result in job losses over the coming months, leaving employment broadly flat overall. Changes in consumer services employment reflected wider trends in spending, with some firms, especially discount retailers, increasing employment numbers as new stores opened, while closures on the high street served to drag down overall employment in the sector.

Capacity utilisation

In sectors where growth remained stronger, firms were often operating close to capacity. But manufacturers, especially those exporting to the euro area, had seen capacity utilisation fall back recently (**Chart 3**). There was further evidence of business closures and mergers in both the construction and professional services sectors, but to date this had only had a limited impact on the extent of excess capacity. Business development activity, especially in professional services, continued to absorb some of this slack, as did regulatory compliance in financial services. But competitive pressures remained intense, in particular in sectors such as accountancy, law and property, as firms competed for market share. The volume of empty commercial property space remained substantial, but had not risen sharply recently, perhaps reflecting a lack of appetite to break leases on the part of tenants, especially among retailers, coupled with the willingness of some landlords to offer rent reductions or temporary deals.

Chart 3 Capacity utilisation

Ability to meet expected demand over the next six months



Costs and prices

Labour costs

Growth in labour costs per employee remained modest. Pay settlements in manufacturing had eased in recent months and were now, on average, broadly the same as those in the service sector. Most pay awards were typically between 2% and 3%. But a significant minority of firms continued to freeze pay. Wage inflation remained especially low in consumer-facing firms, construction and property-related businesses. The weak economic outlook, together with falls in inflation in the past year was expected to restrain awards further over the next twelve months. But pension liabilities, arising from rising defined benefit scheme deficits, were expected to push up on labour costs over the coming year, as was the implementation of pension auto-enrolment rules. The trend toward performance-related pay awards rather than across-the-board increases had continued.

Non-labour costs

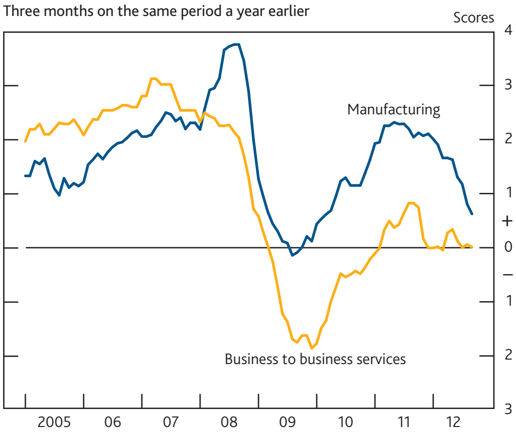
Non-labour input cost inflation remained modest, but contacts thought it less likely that inflation would fall further over the rest of the year, following the recent price increases of oil, cereals and some basic foodstuffs. While the price of steel and other metals had fallen back compared to a year ago, oil-related inputs, such as plastics and packaging, had started to rise again. Energy continued to be a significant driver of cost inflation for firms, albeit at a lower rate than in recent years. Imported goods prices remained higher than a year ago. But the rate of inflation continued to slow, helped by the appreciation of sterling against the euro and the slowing in global growth.

Output prices

Domestic manufacturing output price inflation continued to ease (**Chart 4**), in response to past falls in input costs and weaker demand. The resultant increase in spare capacity over the past year was thought to be having more of an effect in limiting firms' ability to raise prices in the near term. In construction, tender prices remained weak, but continuing firm failures, especially among sub-contractors, were expected to limit further falls. Business services prices were still largely unchanged on a year ago (**Chart 4**). Firms continued to find it hard to increase prices, given the sustained competitive pressures. And contacts often reported downward pressure on fees for more standardised services such as the auditing of company accounts, property management and hotel accommodation and conferencing.

Chart 4 Annual output price inflation

Three months on the same period a year earlier



Consumer prices

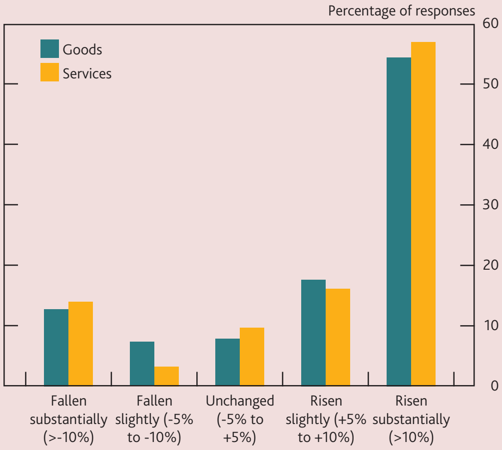
The recent fall in consumer goods price inflation had slowed, as a result of renewed increases in some fresh food and energy prices. Food price inflation was expected to edge up over the remainder of the year, as recent increases in the prices of cereals, vegetables and other fresh food fed through to meat and processed food prices. Some of this was expected to be offset by further slowing of inflation in the price of other imported goods. Consumer services price inflation remained slightly higher, reflecting previous increases in the prices of services such as public transport and social housing. Much of this was based on official measures of inflation in 2011 and would therefore ease in the next round of price-setting.

Agents' survey on exports

ONS data suggest that goods exports have grown more rapidly than services exports in the years since the start of the recession. The Agents conducted a survey of business contacts' export activities to see whether goods and services exporters had seen different trends in activity over the past few years and to help assess prospects for the next twelve months. In total 297 companies participated in the survey, of which 93 were services firms.(1) Service sector responses were skewed towards 'non-financial' firms.

The majority of firms reported substantial growth in exports since 2007 (**Chart A**). The results for goods exporters appeared consistent with those recorded in the official statistics. But service sector respondents' experiences seemed strong relative to the official data. That strength may in part reflect the under-representation of financial services in the sample, where exports have been significantly weaker during the recession.

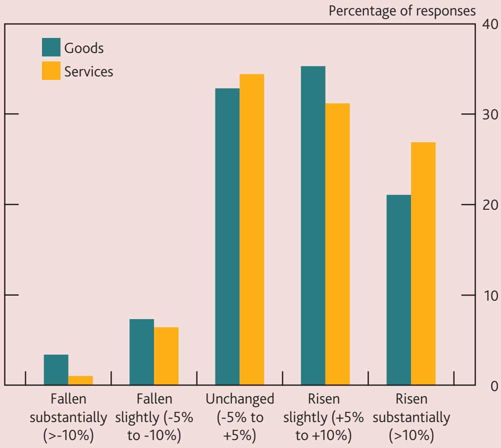
Chart A Changes in export volumes since 2007



Firms reported that growth in recent years had been driven mainly by increased market share in new and existing markets. Respondents had taken a range of actions to help penetrate new markets: including the development of overseas subsidiaries and partnerships and increasing their marketing spend and UK sales teams. These responses fit the flow of intelligence reports received by the Agents in recent years, in which many contacts have described efforts to break into new markets at a time when their core ones have been stagnant. Stronger overseas demand and the boost to competitiveness from the depreciation of sterling were also widely regarded as having boosted export activity, while tighter credit conditions were not thought to have restrained growth significantly over this period.

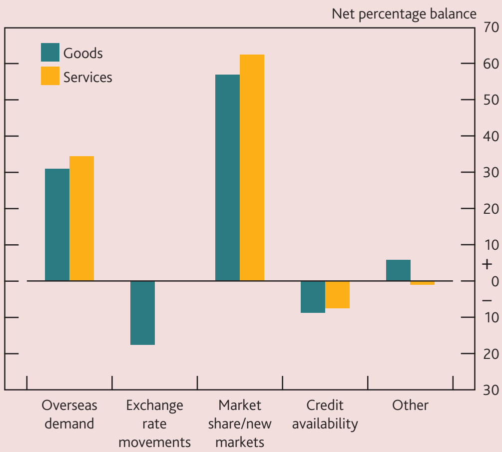
Looking forwards, most firms expected further growth in exports over the next twelve months (**Chart B**). These results were consistent with agency intelligence in recent months — in which contacts have reported that they continued to budget for growth despite a slowdown in recent sales. Survey respondents whose primary export market was the euro area reported both slower export growth since 2007 and weaker expectations of growth in comparison to those exporting to non euro area countries. And those with Asia as their main market in particular had typically seen stronger growth since 2007. But on balance these firms did not expect to see such strong growth going forwards.

Chart B Change in export volumes expected over the next twelve months



Increases in market share in new and existing markets were considered by the majority of respondents to be the main factor driving growth over the next year (**Chart C**). And growth in overseas demand was also expected to increase exports over the next year for a positive net balance of respondents. Recent currency movements however, were expected to act as a drag on goods exports — particularly to the euro area.

Chart C Factors expected to affect export growth over the next twelve months



(1) All results are present in unweighted form. There were few differences between the trends reported by large and small businesses.