BANK OF ENGLAND

Agents' summary of business conditions

September 2012

- Spending on consumer goods and services continued to grow at a gradual pace. Promotions remained essential to support demand, with households still focused on finding value for money.
- The housing market had been subdued. That was partly due to the usual summer lull, with some contacts suggesting that activity may have been postponed due to the Olympics.
- Investment intentions suggested that the level of investment would be broadly unchanged over the coming twelve months.
- Export growth continued to slow, reflecting weakening conditions throughout the euro area.
- Turnover in the business service sector was rising at a gradual pace, as the volume of activity edged higher compared with a year earlier.
- Manufacturing output growth had slowed further and was broadly flat on a year earlier.
- The level of construction output continued to fall, due in large part to reductions in work for the public sector, along with some weather-related disruption to sites.
- The cost of borrowing was creeping upward as lenders passed on higher funding costs, although many banks were preparing to make use of the Funding for Lending Scheme.
- Employment intentions indicated that there would be little job creation in the private sector over the coming six months.
- Businesses in growth industries were often at full capacity. This was particularly evident among exporters, although there had been some easing in constraints due to slowing foreign demand. In areas of persistent weakness, by contrast, there was typically a rather more significant degree of slack.
- Growth in labour costs per employee continued to moderate. Contacts reported that there was relatively little upward pressure on settlements from staff.
- Non-labour input cost inflation had slowed further. But energy prices had begun to rise again recently, and prices of various cereals and feedstock had also increased in anticipation of poor harvests in both the United States and Europe.
- Output price inflation had declined, as easing cost pressures fed through the supply chain and weak demand weighed on firms' pricing power.
- The annual rate of consumer price inflation remained fairly moderate, having fallen back in recent months.

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 July 2012 and late August 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.

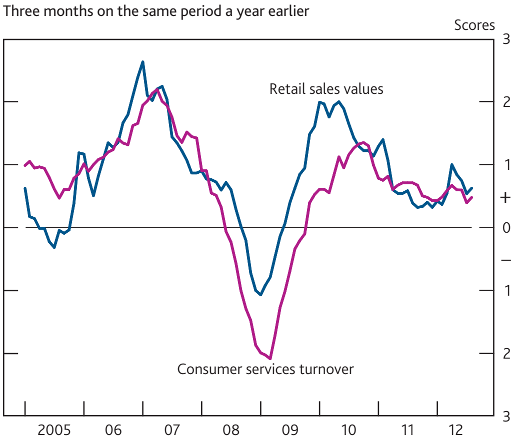
Demand

Consumption

Spending on consumer goods and services continued to grow at a gradual pace (**Chart 1**). Promotions remained essential to support demand as households were still very much focused on finding value for money, with discount retailers gaining market share from mid-range ones. There was also an ongoing shift away from the high street towards shopping online and destination retail centres. Consumers were trying to cut costs in various ways, such as reducing levels of insurance cover and having cars serviced less frequently, and there had been a rise in demand for financial advice, both to maximise returns on assets, and to minimise tax liabilities. According to some contacts, unseasonably dreary weather for much of the summer had led to higher numbers of people holidaying abroad compared with a year earlier, and it had weighed heavily on some leisure and tourist attractions at home. The Olympics had created some winners and losers, but the overall impact on demand had been fairly muted.

Chart 1 Annual growth in consumer spending

Three months on the same period a year earlier



Housing market

The housing market remained subdued. That was partly due to the usual summer lull, with some contacts suggesting that activity may have been postponed due to the Olympics. But there was a concern that there would be no pickup in the autumn, due to worries about the economy. Many banks were preparing to make use of the Funding for Lending Scheme, but it was too soon for it to have had any impact on demand. And credit conditions continued to frustrate the aspirations of some would-be homeowners. Numbers of first-time buyers had risen slightly, but buy-to-let continued to account for a larger share of transactions than prior to the recession. Further up the housing chain, activity was in large part driven by the usual factors of debt, death and divorce. Growing numbers of vendors were reported to be lowering their asking prices to stimulate interest.

Business investment

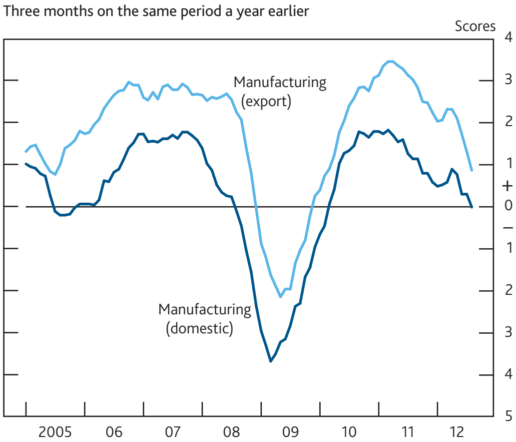
Investment intentions suggested that the level of capital spending would be broadly unchanged over the coming twelve months. There continued to be some plans for expansion in the manufacturing sector, notably among exporters, as well as some food producers. But many manufacturing firms had become more cautious about the outlook, revising down their expectations for activity in the euro area, and had scaled back their investment projects accordingly. In services, spending was often motivated by essential maintenance or the need to reduce costs. Regulatory change was also prompting investment in systems to ensure compliance with new rules. And spending on IT was needed simply to stay abreast of the competition, with an online presence increasingly important to maintain market share.

Exports

Export growth continued to slow, reflecting weakening conditions throughout the euro area (**Chart 2**). Some contacts had experienced problems securing payments from countries in the south of the euro area and had turned down subsequent orders as a result. And some suppliers to the public sector reported significant declines in demand. Rising awareness of the extent of economic problems in the euro area had caused many contacts to lower their expectations for growth there, adding momentum to the shift in focus towards emerging markets as a possible substitute for lost demand. But there were also signs of a moderation in the pace of expansion in these rapid growth markets, most notably in China. Generally, the recent rise in the value of sterling was not thought to have affected volumes of exports, as contacts had held their foreign prices constant. But inbound tourism had slowed compared with a year earlier, adding to the possible drag from net trade resulting from an increase in trips abroad by UK holidaymakers.

Chart 2 Annual growth in manufacturing for export and domestic markets

Three months on the same period a year earlier



Output

Business services

Turnover in the business service sector continued to rise at a gradual pace, with the volume of activity edging higher compared with a year earlier, while fierce competition kept prices from rising. Reports remained very mixed across subsectors, reflecting the pattern of spending in the wider economy. For instance, IT advisory companies were benefiting from corporates' efforts to find efficiencies, while businesses facing the consumer and those exposed to the government, often reported that conditions were difficult. And even within sectors, experiences varied considerably, as a result of shifts in market share. For instance, public relations companies reported increased demand from firms seeking to enter new markets, and corporate travel had risen as businesses sought to extend their reach. In contrast, in corporate hospitality, training and security, activity had fallen back as firms redoubled their efforts to cut anything but the most essential spending.

Manufacturing

The growth rate of manufacturing for the domestic market had slowed further and was broadly flat compared with a year earlier (**Chart 2**). That reflected a combination of softening demand from households and corporates, lower public sector spending, and the impact of weaker trade on export supply chains. As a result, many firms had revised their expectations for the outlook downwards. The aerospace industry remained among the most buoyant, in part because of the very long lead times involved in production in that sector. In contrast, activity in the automotive sector had slowed somewhat, although demand for premium brands remained robust. There continued to be a modest flow of reports from businesses that had decided to repatriate production processes, as customer demand for shorter production runs, at shorter notice than pre-recession, had eroded much of the cost advantages of foreign production. And there continued to be concerns about the quality of foreign supply.

Construction

The level of construction output had fallen compared with a year earlier, due in large part to reductions in work for the public sector, along with some weather-related disruption to sites. There was, however, some support to the level of activity from the energy sector, utilities, warehousing and distribution, and private house building. There was relatively little commercial property development in train, due to an overhang of office and retail space in much of the country, and larger retailers had trimmed plans for expansion through new store openings.

Credit conditions

The cost of borrowing for companies was creeping upward as banks passed on higher funding costs. Large businesses tended to have access to credit on acceptable terms. But smaller businesses, in particular, were often discouraged from borrowing by the need to provide guarantees, an increasingly prevalent condition for lending. As a result, small firms were often considering the use of non-bank sources of borrowing, or equity finance. While credit conditions were tighter than prior to the recession, lenders suggested that it was currently a lack of demand that was holding back borrowing. And firms themselves often reported that they were not prepared to increase their indebtedness for the purposes of investing, prefering to finance capital projects from internal sources. Awareness of the Funding for Lending Scheme among firms was rising. There was some concern, however, that fees and collateral requirements might not ease with any reduction in lending rates.

Employment

Employment intentions indicated that there would be little job creation in the private sector over the coming six months. In manufacturing, growth industries, particularly in export, continued to raise headcount, while those supplying weaker sectors, such as construction and retail, were typically seeking to reduce heads. But even firms that expected little demand growth were often reluctant to lose key staff, given structural shortages of certain skills. In business services, some large professional firms were taking on graduates as they gained market share, while firm exits and mergers among smaller competitors were expected to result in job losses. But, again, here too, there was a general unwillingness to let staff go. In retail, large national chains and discount stores planned further recruitment as they won custom from the high street and mid-range stores, respectively. These latter businesses, meanwhile, were often at minimum staffing levels, and could only lower the number of employees by closing underperforming outlets altogether.

Capacity utilisation

Businesses in expanding sectors were often at full capacity. This was particularly evident among exporters, although there had been some easing in constraints due to slowing foreign demand. In areas of persistent weakness, by contrast, there was typically a rather more significant degree of slack. Some of this had been eliminated through mergers and business closures — in legal and accountancy practices, for example. But consolidation to date had not been sufficient to have a noticeable impact on the extent of spare capacity overall. As a result, competitive pressures remained extremely fierce as firms sought to win market share. This was most evident in business services of a standardised nature, such as audit, and in manufacturing for the domestic construction sector. Companies in these industries were often busy competing for work, but winning relatively little.

Costs and prices

Labour costs

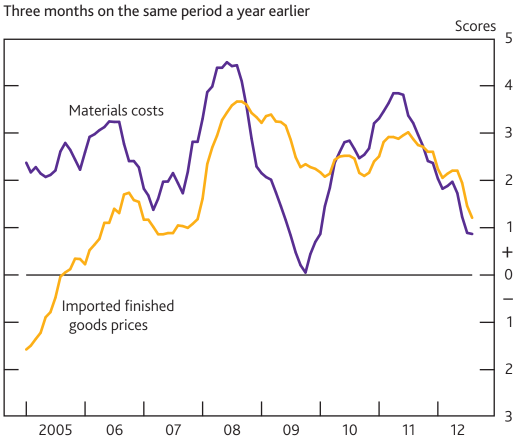
Growth in labour costs per employee continued to moderate. Contacts reported that there was relatively little upward pressure on settlements from staff, with awards typically around 2% or 3%. And pay freezes remained common, performance having disappointed relative to expectations for many businesses. Where there had been more generous awards, they were often justified on the grounds of catch-up for past restraint in pay, or were a reflection of rising profitability. Some of them were also attributed to the need to retain key personnel — typically those with skills that were in short supply, such as engineers and IT specialists. Across-the-board pay increases and inflation linking were increasingly giving way to individual performance-based settlements.

Non-labour costs

Non-labour input cost inflation continued to slow (**Chart 3**), with the prices of both raw materials and imports of finished goods having levelled off, or even fallen back a little, in the case of some commodities. Upward pressure from rising labour costs in some emerging market producers, most notably China, had begun to abate. And the recent rise in sterling had also lowered the cost of some imported goods. But energy prices had begun to increase again recently, and the prices of various cereals and feedstock had also begun to rise in anticipation of poor harvests in both the United States and Europe. That was expected to push up the price of basic foodstuffs going forward. And shipping costs had risen quite sharply as excess capacity had been mothballed.

Chart 3 Annual inflation in raw materials and imported finished goods prices

Three months on the same period a year earlier

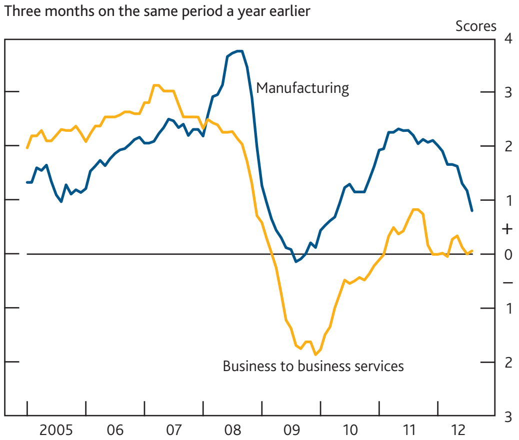


Output prices

Domestic manufacturing output price inflation had declined further, as easing cost pressures fed through the supply chain (**Chart 4**). A few firms continued to report that they were raising prices to recover lost margin, but most felt that softening demand conditions had limited the scope to raise prices in the near term. Suppliers of consumer goods faced particularly strong resistance from customers to any price increases, as did manufacturers producing inputs for the construction and public sectors. Business services prices were broadly unchanged compared with a year earlier (**Chart 4**). And contacts often reported that there was downward pressure on fees in those sectors with the greatest amounts of spare capacity, such as corporate hospitality and haulage, exacerbated by the still very low level of insolvencies during this recession compared with previous ones.

Chart 4 Annual output price inflation

Three months on the same period a year earlier



Consumer prices

The annual rate of consumer price inflation remained fairly moderate, having fallen back in recent months. That reflected a combination of slowing inflation in the price of imported goods, as well as softening domestic demand. But fuel prices had risen somewhat, and food prices were expected to increase over the coming months, as the impact of poor harvests began to be felt. Services inflation had slowed a little over the past few months, particularly for discretionary services in the leisure industry. But the annual rate of inflation continued to reflect fairly sizable increases in the prices of regulated services, such as transport and social housing, which were linked to official measures of inflation. The upward pressure from this source of inflation was expected to ease in the next round of price-setting.