BANK OF ENGLAND

Agents' summary of business conditions

April 2013

- Annual retail sales values growth had edged higher, resuming the gradual recovery reported since the middle of 2012.
- There were further reports of improving housing market activity, both for new home sales and secondary market transactions. An easing of mortgage conditions was said to be leading to some 'freeing up' of the housing market.
- Investment intentions for the coming twelve months remained subdued.
- Manufacturing exports had continued to pick up gently on a year earlier, as a result of gains in market share and some strengthening in global demand outside the euro area.
- Manufacturing output for the domestic market had remained broadly flat on a year earlier.
- Annual growth in business services turnover had edged higher since the turn of the year.
- The annual rate of decline in construction output had diminished. There were increased reports of a gradual recovery in private housebuilding.
- The availability of credit had improved for larger and some medium-sized corporates in recent months, but not for most small firms. Demand for bank lending had remained weak.
- Employment intentions had remained little changed and indicated a gradual rise in employment in business services, a flat manufacturing workforce, and gradual shrinkage in the number of staff employed in consumer services.
- Capacity utilisation had remained a little below normal in both manufacturing and services and was unchanged on the month. Reports of recruitment difficulties were largely confined to IT and engineering staff.
- The annual rate of growth in labour costs per employee had remained subdued, though it had edged up a little in manufacturing.
- The rate of inflation was reported to have edged higher for imported finished goods, and to a lesser extent for materials' costs, in part reflecting the effects of sterling's recent depreciation.
- Manufacturers' and business services' output price inflation had edged higher from a low base.
- The rate of inflation in retail goods prices had ticked up, but was unchanged for retail services.

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 February 2013 and late March 2013. 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.**

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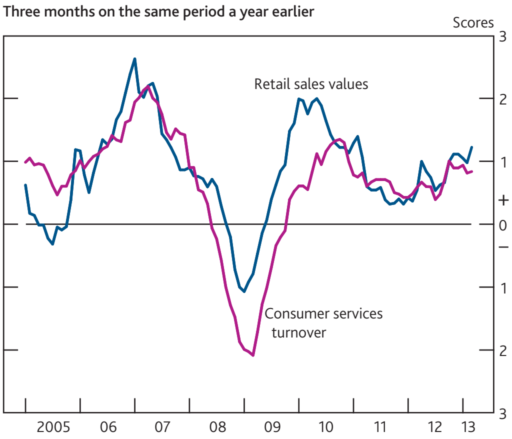
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the *Inflation Report*, obtained from: **www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx.**

Demand

Consumption

Annual retail sales values growth had edged higher (**Chart 1**). There had been a gentle recovery in retail sales values since the middle of 2012, though that had partly reflected a gradual rise in retail price inflation. Underlying consumer demand growth was reported to remain subdued, consistent with tight disposable incomes for many. The picture of strength in sales at the premium and discounted ends of the spectrum continued, with the middle squeezed. That was also reflected in the pattern of car demand, which was focused on luxury brands on the one hand, or on highly fuel efficient or 'discount' models on the other, and was generally said to have remained strong. Consumer services demand growth remained modest and was similarly polarised. For example, demand for foreign travel was reported to be strengthening, and self-catering demand at home was said to be strong; but a long tail of UK-based, mid-market hotels were said to be struggling. For the most part though, discretionary spending had remained weak and highly price sensitive. As might have been expected, the horsemeat furore was reported to have affected the composition rather than quantity of food demand — with stronger sales of unprocessed meat by independent butchers, offset by lower sales elsewhere.

Chart 1 Retail sales and consumer services turnover



Housing market

There were further reports of improving housing market activity, both for new home sales and secondary market transactions. That had continued to reflect falls in mortgage rates — including at high loan to value ratios — and an improvement in mortgage availability, as well as the effects of specific government-backed incentive schemes for home ownership. An Agents' survey of companies close to the housing market also found a marked improvement in mortgage conditions over the past year (see the box on pages 6–7). The easing in credit conditions — in part due to the effects of the Funding for Lending Scheme — was seen by many contacts as causing some 'freeing up' of the housing market, with some potential buyers — including first-time buyers — encouraged to return to the market. However, there were reports that sales were taking longer to complete than had historically been the case, reflecting tighter scrutiny of mortgage applications than in the past and buyer uncertainty in some cases.

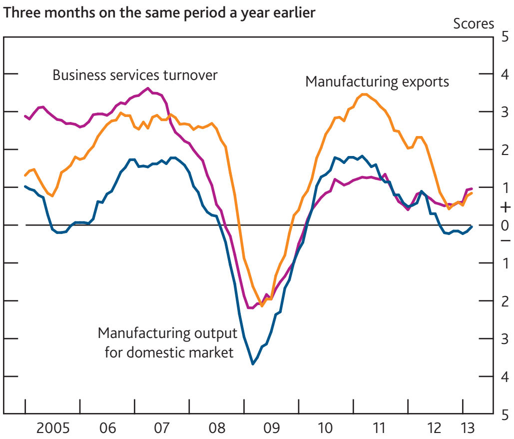
Business investment

Investment intentions for the coming twelve months remained muted. Although the recent slight improvement in confidence had been sustained, concerns about the wider macroeconomic environment remained high and investment was often aimed at improving efficiency or replacing existing assets. Increasing investment in IT was frequently reported, in part to expand and develop 'online' activities or model business plans. Among manufacturers, however, there were some increased reports of investment in research and development and product innovation in general, and in autos and aerospace supply chains in particular. There were also widespread reports of increased spending on new large commercial vehicles, to comply with new emissions regulations. But investment by many consumer-facing and heavy construction-related firms remained weak. There were a few reports that deficits in legacy defined benefit pension schemes had held back investment due to the effects on available funds, in most cases from firms for which access to finance was difficult or costly.

Exports

Manufacturing exports (**Chart 2**) had continued to pick up gently on a year earlier, as a result of gains in market share and some strengthening in global demand outside of the euro area. The recent depreciation of sterling was not as yet materially affecting export volumes. There were only isolated reports of exporters becoming more competitive overseas, as prices were often set for a long period in advance. There were also some reports of companies trying to export for the first time or to new markets, sometimes reflecting the weakness of UK or euro-area demand. Some contacts suggested that the

Chart 2 Manufacturing output and business services turnover



weakness of UK export performance relative to some euro-area competitors might have reflected weaker export networks in the Far East prior to the financial crisis: building up those networks took time. Among sectors, exports related to the oil and gas industry and by food processors were reported to be increasing. There were also some reports of rising exports from the professional services sector.

On the import side, increasing Chinese labour costs, higher freight costs and an appreciation of the renminbi continued to lead to a shift in sourcing towards other markets, both in Asia and closer to home. That included a continuing flow of reports of production moving back to the United Kingdom, centred on goods that were complex or expensive to transport, though at a slow pace that some contacts said reflected an absence of suitable existing productive capacity. In the opposite direction, reports continued of lower-value work moving overseas. Contacts continued to report rising imports of food, reflecting poor UK harvests.

Output

Business services

Annual growth in business services turnover had edged higher since the turn of the year (**Chart 2**). Within the professional services sector, a gradual increase in advisory work related to corporate mergers and acquisitions activity and asset disposals was said to have continued. There were also reports of growth in corporate litigation activity, in part as tight margins left little room for negotiation in contract disputes. But demand for audit and tax was reported to be flat, in line with the wider economy. Commercial property-related work was said to be rising slightly, in some cases because tighter regulatory requirements were leading banks to seek more valuations or reduce forbearance, leading to new transactions. And annual growth in other business services was reported to have edged up, alongside some more positive reports from transport and distribution and warehousing companies, ascribed to the effects of online retailing and thin inventories along some supply chains. Demand for IT services was on balance also reported to be rising. But for many other companies — such as in the corporate hospitality, conference and business travel subsectors — turnover had remained subdued.

Manufacturing

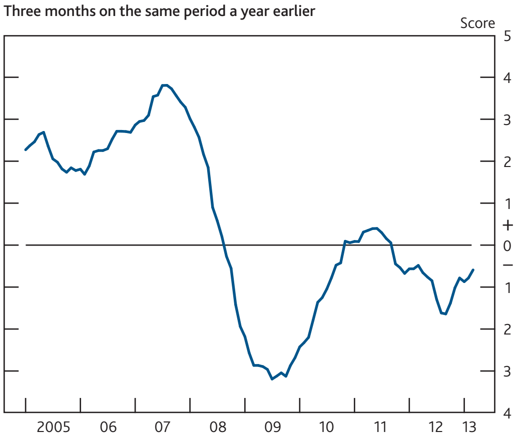
Manufacturing output for the domestic market was reported to have remained broadly flat on a year earlier (**Chart 2**), though there were further reports of some modest improvement of forward-looking sentiment in export supply chains. Areas of growth within the sector remained those related to utilities and oil and gas production, aerospace, luxury and fuel-efficient cars, high-tech electronics and food processing. Output remained weak among manufacturers of many consumer goods and construction materials, although there were reports of greater optimism among suppliers to private house builders.

Construction

The annual rate of decline in construction output had diminished (**Chart 3**). There were increased reports of signs of a gradual recovery in private housebuilding, with many contacts reporting increased starts, building plans, or new land transactions, including the release of land by local authorities whose planning processes, some contacts suggested, had eased. Access to secondary capital markets had improved financial conditions for larger housing associations, though overall activity in that sector remained weak. There were also some increased reports of town centre redevelopment projects and of building in the education and health sectors. But while those projects, and some large rail and energy infrastructure projects, provided support to the sector, elsewhere weak levels of publicly funded and private sector commercial construction were reported as continuing to act as a drag on activity.

Chart 3 Construction output

Three months on the same period a year earlier



Credit conditions

Contacts reported that the availability of credit had improved for larger and some medium-sized corporates in recent months, but not for most small firms — a pattern mirrored in an Agents' survey of changes in corporate credit conditions over the past year (see the box on pages 6–7). Most businesses were able to access credit for 'business as usual', but accessing credit to finance business change, or working capital to fund the extra costs associated with expansion, continued to be more difficult. Non-financial contacts generally reported that banks' risk appetite remained unchanged. The cost of available new lending had fallen for many over recent months, though for some the effect on interest rates paid had been offset by the refinancing of facilities arranged on narrow spreads before the financial crisis. Many contacts noted that the main effect of lower rates had been to reduce borrowing costs for existing 'low-risk' borrowers, with an increase in competition reported for lending to those firms. Demand for bank lending had remained weak, with many companies looking to reduce debts or build up cash reserves, in part reflecting a continuing lack of trust in banking relationships. Some growth in peer to peer lending and in financing from funding circles and private equity was reported, albeit from a low base. However, a number of small and medium-sized enterprise contacts reported that larger customers were extending the periods over which they settled invoices, adding to pressures on working capital. There were continued reports that forbearance on corporate loans was gradually diminishing, especially on commercial property exposures.

Employment

Employment intentions remained little changed. In business services, plans for increased employment often focused on firms that were winning or attempting to win market share, for example through looking to invest in staff for new specialisms or for marketing. Those companies that were losing market share were reported to have been slow to adjust employment levels downwards and lose skilled staff. In the professional services sector, the effect on employment of some consolidation was reported to be offset by plans to increase graduate or junior hiring to maintain a skills mix. Manufacturing employment intentions had remained stable and little changed, but consumer services employment was reported to be edging lower due in part to a gradual closing of unprofitable stores. Recruitment difficulties had continued to be largely limited to IT and engineering staff, though the number of reports of localised shortages in skills outside these sectors had edged higher.

Capacity utilisation

Capacity utilisation had remained a little below normal in both manufacturing and services and was unchanged on the month. There were reports across manufacturing and services sectors that investments made to increase efficiency had also raised effective capacity for some firms, offsetting the effects on capacity utilisation of gently rising output in some sectors, or consolidation within others. There were some reports of consolidation being restrained by uncertainty about the ultimate size of some companies' legacy defined benefit pension scheme liabilities and by the extent of asset encumbrance. Within sectors, some tightness of capacity was reported in high-tech engineering, luxury car supply chains and aerospace. And professional services reported only limited amounts of spare capacity, though the picture often remained one of staff working hard to maintain output in an environment of weak demand and of gradual consolidation. Spare capacity remained most obvious in the retail and heavy construction sectors.

Costs and prices

Labour costs

The annual rate of growth in labour costs per employee had remained subdued, though had edged up a little in manufacturing. Pay freezes were reported to be slightly less common, though where general pay rises were reported that was often said to reflect employers' efforts to address issues of 'fairness' — focusing on the living costs of less well-paid staff — rather than any rise in labour market pressures. However, there were some reports of skills shortages in IT and engineering putting upward pressure on pay in those specialisms. Pension costs were reported to be increasing, in part reflecting auto-enrolment, although the costs of that would vary across businesses depending on their existing pension scheme arrangements and employees' opt-out rates. Increased contributions to cover deficits on legacy defined benefit pension schemes were said to be raising pension costs for some, though that was rarely reported to be affecting companies' wage-setting.

Non-labour costs

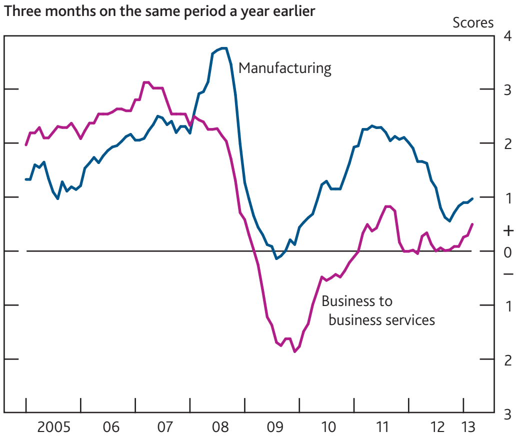
The rate of inflation was reported to have edged higher for imported finished goods, and to a lesser extent for materials costs, but remained modest. Costs continued to be driven up by the direct and indirect effects of energy and agricultural commodity price rises. In the latter case, concerns about food sourcing were said to be driving up red meat prices in particular. Some contacts reported that sterling's recent depreciation had started to put upward pressure on the costs of imported inputs and finished goods, and would feed through gradually with the usual lags, though the effect on food prices might be greater than normal given poor UK harvests had increased the reliance on food imports. However, these pressures were partly offset by falls in prices for timber and some metals.

Output prices and margins

Manufacturers' and business services' output price inflation had edged higher from a low base (**Chart 4**). Manufacturers

Chart 4 Manufacturing and services prices

Three months on the same period a year earlier



reported some pass-through of cost increases, albeit often only partial. Some professional services firms reported avoiding bidding for low margin work, encouraged in part by some recent increase in business volumes. And in other business services, there were some increased reports of rises in fuel costs being passed through. The profitability of manufacturing and services firms was reported to be unchanged on a year earlier. Contacts expected that any recovery in margins over the next year or two would be driven by cost reductions or the introduction of higher margin products, alongside a gradual pickup in activity, rather than increased pricing.

Consumer prices

The annual rate of consumer price inflation was reported to have edged up for goods, remaining unchanged for services. The slight increase for goods price inflation was said to reflect higher food prices, and some contacts expected a further increase in food price inflation during the year, in part reflecting the effects of sterling's recent depreciation. Alcohol prices were also reported to be increasing. And further increases in household energy prices were expected by some contacts as the year progressed. Manufactured goods price inflation remained modest but was expected to rise further out as the effect of sterling depreciation fed through. In services, inflation was seen as remaining largely concentrated in administered prices, including in public transport and social housing rents. More widely, the high price sensitivity of consumers was reported to be acting to restrain companies from seeking to pass through price rises for goods or services.

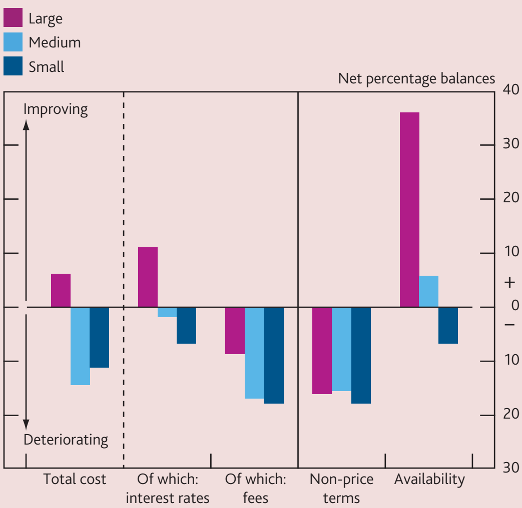
Agents' survey on credit conditions

During February and March, the Agents conducted two surveys, covering corporate credit and residential mortgage lending.

In the survey of corporate lending, firms were asked about changes in credit conditions in the past twelve months, and the impact of this on their use of credit and on their business more broadly. They were also asked about their likely use of bank borrowing over the next twelve months. Three hundred and seventy firms responded to this survey. In the following discussion, the reported results are weighted by firm turnover. It is important to note that, in interpreting the results, many firms have infrequent interaction with lenders on borrowing requirements and, as such, it can take time for changes in credit conditions to filter through. This may be particularly the case in this survey, given the relatively small sample size.

The survey showed that for large firms,[1] there had been an improvement in credit availability compared with a year earlier, and a small net balance reported a reduction in total borrowing costs due to lower interest rates (**Chart A**). For medium-sized firms, a net balance had seen an improvement in availability, but some increase in costs, while among the small firms surveyed, slight net balances reported a deterioration in the availability and cost of borrowing. The results were not markedly different between broad sectoral groups, although firms in construction and property development had seen a smaller improvement in credit availability and faced higher borrowing costs, compared with a year earlier, than those in manufacturing and services.

Chart A Corporate credit availability and cost[a]

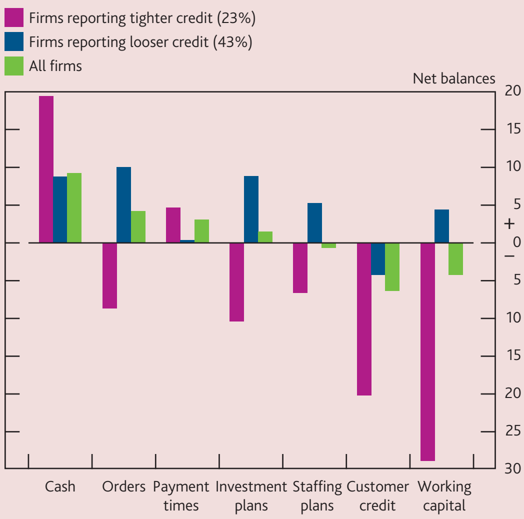


(a) Positive net balances show an improvement in credit conditions (eg an increase in credit availability or a decrease in cost). Negative net balances indicate a deterioration in credit conditions (eg a decrease in credit availability or increase in cost). Results are weighted by turnover.

Overall, the reported effect of changes in credit conditions on firms' use of credit over the period had been limited. Although a small net balance of respondents had increased their borrowing over the past twelve months, some 80% of the total sample reported that changes in credit conditions had not affected their use of credit.

Firms were also asked about the impact of changes in credit conditions on their holdings of cash, use of credit from suppliers, granting of credit to customers, use of working capital, and investment and employment plans. The net balance of firms reporting that changed credit conditions had influenced their decisions was relatively small — less than 10% of the overall sample for any of these factors. Within the sample, for firms reporting looser credit conditions over the past year, the effect on most factors — including orders, investment and staffing — was positive. For those firms reporting tighter credit conditions over the past year, however, the effects were more marked, with net balances of at least 10% reporting reduced working capital, credit terms offered to customers and investment plans, and with a marked increase in cash balances (**Chart B**).

Chart B Effects of changes in credit conditions on companies' behaviour[a][b]

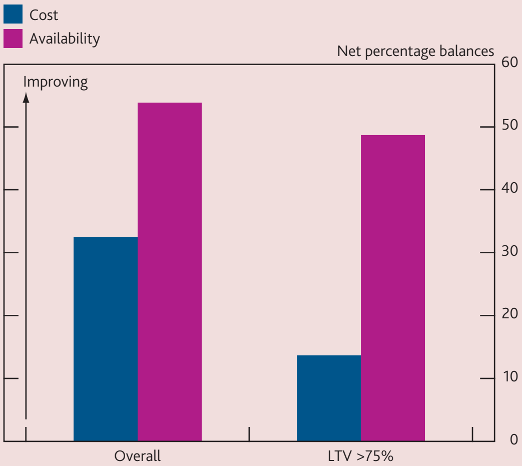


(a) Results are weighted by turnover.
(b) For the purposes of this survey, tighter credit conditions are defined as either increased cost or reduced availability, but excluding any firm that reported any aspect of looser credit conditions. Looser credit conditions are defined as either decreased cost or increased availability, but excluding any firm that reported any aspect of tighter credit conditions.

Firms were relatively positive overall about their likely use of bank borrowing over the next twelve months, with the survey results indicating that the growth in borrowing among firms surveyed might be slightly faster in the coming year, compared with the past twelve months.

The survey of mortgage lending was completed by about 120 mortgage brokers, estate agents and house builders. It suggested that overall mortgage availability and the cost of borrowing had improved significantly in the past year.(2) The improvement in availability was almost as marked for lending with loan to value ratios above 75%, although in this part of the market the reduction in cost was less pronounced (**Chart C**). Participants in this survey also expected lending to grow more rapidly over the next twelve months, compared with the past year.

Chart C Mortgage availability and cost(a)



(a) Positive net balances show an improvement in credit conditions (eg an increase in credit availability or a decrease in cost). Negative net balances indicate a deterioration in credit conditions (eg a decrease in credit availability or increase in cost). The sample is unweighted.

(1) For the purposes of the survey, a large firm was defined as one with a turnover of over £25 million; medium, a turnover between £1 million and £25 million; and small, a turnover below £1 million.
(2) The results of this survey shown in **Chart C** are unweighted.