BANK OF ENGLAND

Agents' summary of business conditions

February 2013

- Consumer goods sales during Christmas rose modestly on a year earlier, in line with retailers' expectations. Few anticipated a pickup in growth in the near term given the headwinds facing the economy. Growth in demand for consumer services remained subdued.
- There were tentative signs of a gradual increase in housing market activity, supported by reductions in mortgage costs. Some contacts thought that the Funding for Lending Scheme (FLS), along with some specific incentive schemes, was providing a stimulus to house sales.
- Corporate credit availability was gradually improving, though less so for smaller firms where conditions remained tight. There were some tentative signs of lender forbearance starting to wane in the commercial property market.
- Investment intentions continued to edge higher.
- Exports of goods were on average reported to be growing slowly on a year earlier, with weak euro area demand offset by growth in other markets.
- Modest growth in the output of business services had continued.
- Manufacturing output for the domestic market was reported to be broadly flat on a year earlier, with growth in some 'high-tech' areas offset by weakness in construction-related sectors.
- Construction output remained lower than a year ago.
- Employment intentions continued to edge higher in business services but declined for consumer services, partly reflecting recent high street failures.
- Capacity utilisation remained a little below normal.
- The rate of growth in labour costs per employee edged higher. Wage growth was expected to be little changed in 2013, though larger firms expected some upwards pressure on labour costs from pensions contributions.
- Non-labour costs and finished import prices had continued to drift upwards.
- Output price inflation remained subdued, with competitive pressures preventing the full pass-through of previous rises in input costs.
- The rate of consumer price inflation was reported to be unchanged.

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 December 2012 and late January 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.**

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.

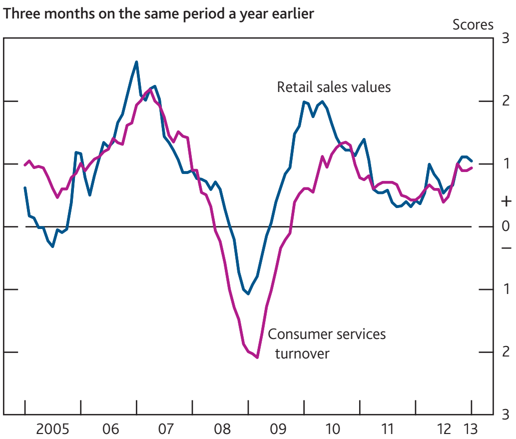
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the *Inflation Report*, obtained from: **www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx.**

Demand

Consumption

Subdued annual growth in the value of retail sales had continued (**Chart 1**). Contacts reported that sales over the festive period were in line with their modest expectations. Within retail sales, online retailing had clearly outperformed the rest of the market, showing robust growth. Post-Christmas sales were reported to have started strongly but to have fallen back more quickly than usual, in part reflecting lower levels of stock to clear due to tighter inventory control. Some retailers expected the adverse weather in late January to have hindered sales growth. More generally, few expected consumption growth to pick up in the near term given concerns about job prospects and a squeeze on disposable incomes. One area of continued strength had been new car sales, though some contacts questioned how long that could continue given a reliance on discounting.

Chart 1 Consumer services and retail sales



Growth in consumer services demand remained very modest (**Chart 1**). There were continued reports that demand for 'bigger ticket' leisure services — such as holiday and hotel bookings — was gently strengthening on a year earlier. But many consumers were said to be restricting their spending on lower-value 'discretionary' purchases, such as spending at restaurants and bars. A continued structural shift in demand towards public transport away from private car travel was widely reported.

Housing market

Housebuilders and estate agents reported tentative signs of a gradual increase in housing market activity, with some contacts seeing an increase in buyer interest and in transactions. That was said partly to have reflected falls in mortgage rates and an improvement in mortgage availability, albeit one that was patchier at higher loan to value ratios. There were also signs of a strengthening in new private housebuilding from a low base, concentrated in London and the South East, though that was partly offset by the continued weakness of social housing starts. Some contacts reported that the FLS had engendered increased optimism that housing sales would pick up during 2013.

Business investment

Investment intentions for the coming twelve months continued to edge higher for the manufacturing and service sectors. Investment plans were largely reported to be aimed at increasing efficiency or addressing regulatory issues, though one notable exception remained the energy sector, where North Sea investment was said to have been stimulated by a range of tax allowances as well as sustained high oil prices. In the manufacturing sector, plans to increase capacity were generally confined to exporters or to companies looking to introduce new product lines. In the services sector, investment plans were reported to be subdued, though IT investment was seen as an area of strength, as financial services companies responded to regulatory requirements, and as retailers aimed to expand and develop their online presence. Investment in commercial property remained weak, though a gentle increase in store and hotel refurbishment was reported.

Exports

Manufacturing exports were reported to be growing, but slowly. Weak demand in the euro area was being offset by strengthening demand elsewhere, including from emerging economies. Exports related to foreign oil and gas production were reported to be a source of strength, as were exports of luxury cars and aerospace products. More generally, export demand for niche 'high-tech' products remained stronger than for lower value-added outputs.

A sluggish rebalancing towards exports was attributed by some contacts to the length of time it took to build the necessary networks; for some there were signs that those efforts were starting to be repaid. Contacts in certain sectors — such as professional services — noted a tendency to service global demand through setting up local offices rather than from the UK office, dampening the effect on measured exports. However, there continued to be reports in the other direction of the re-sourcing of production to the United Kingdom following sterling's earlier depreciation, coming through with long lags. More immediately, some contacts reported greater import competition recently from euro-area companies due to overcapacity in their domestic markets. And poor UK harvests were expected to lead to an increase in food imports.

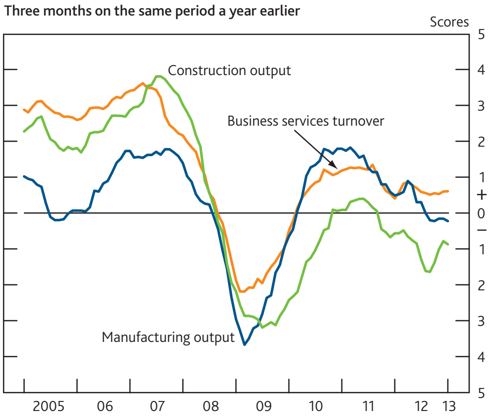
Output

Business services

Output was reported to be growing very modestly (**Chart 2**), with professional services firms reporting that gains in output were often at the expense of competitors' existing business or their own margins. Engineering and energy consultancy reported steady if slow growth as clients sought to use their services in an effort to control costs, and recruitment agencies were reporting an increase in activity, in line with wider employment trends. Output in IT services and parts of the distribution industry was being buoyed by the growth in e-commerce and some banks reported that the FLS had improved the outlook for their output. There were some reports of a slight increase in mergers and acquisitions activity and also litigation activity. But corporate use of other discretionary business services — such as conferencing and training — remained very subdued. A box on pages 5–6 summarises discussions held with business services firms on the reasons behind weak productivity in the sector since the financial crisis.

Chart 2 Manufacturing and construction output and business services turnover

Three months on the same period a year earlier



Manufacturing

Manufacturing output for the domestic market was reported to be broadly flat on a year earlier (**Chart 2**), reflecting subdued domestic demand. Some sectors were seeing growth where their product was directly for export or part of export supply chains. Growth was reported to be concentrated within aerospace, niche 'high-tech' manufacturing and the supply chain for luxury cars. Production related to the energy supply chain was also reported to remain resilient, but the output of construction-related sectors remained weak.

Construction

Output remained lower than a year earlier (**Chart 2**), though the outlook was reported to be less negative than during 2012. There were some tentative signs reported that private housing construction was starting to increase, as the effect of incentive schemes fed through. That was partly offset by continued weakness in social housing construction, which contacts attributed to uncertain financial support for the sector. Development of new commercial property was reported to be very subdued outside of London, and some major construction companies were said to be choosing to focus activities away from the United Kingdom, and towards higher-growth markets. Contacts noted that while there were signs that some infrastructure projects were taking shape, the effects of those would largely be felt in years to come rather than the near term.

Credit conditions

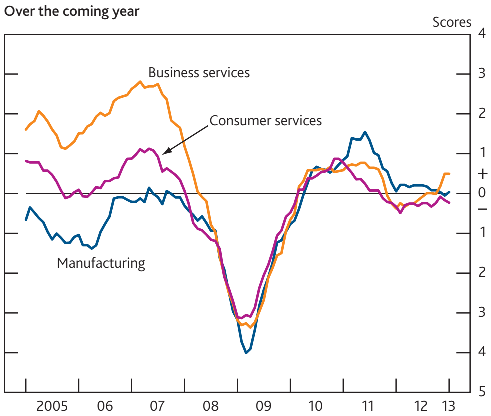
Banking and many non-financial contacts reported that the cost of bank lending had fallen in recent months, which was partly attributed to the FLS. A slight easing in credit availability was reported, particularly for the largest firms, but conditions were little changed for firms seen as riskier propositions such as small companies. Little sign of an increase in bank borrowing was reported, which was largely attributed to weak demand for credit. For some businesses that was reported to reflect a lack of trust in banking relationships. There were tentative signs that banks' appetite for forbearance on loans was starting to wane, with some contacts in the commercial property sector reporting a tougher stance being taken by lenders on covenant breaches and sales of assets by property owners whose lenders had signalled a lack of appetite to refinance debt.

Employment

Employment intentions in business services continued to rise slightly (**Chart 3**). That was said partly to reflect firms competing for market share, the hoarding of skills to meet future needs and in some cases a shift towards the use of more junior staff for routine work. In consumer services, employment intentions were slightly negative, in part reflecting a number of recent high street failures. Manufacturing employment prospects were flat. Recruitment difficulties continued to be limited, though some signs of skills shortages were reported in IT and engineering, consistent with the relative strength of demand in those sectors.

Chart 3 Employment intentions

Over the coming year

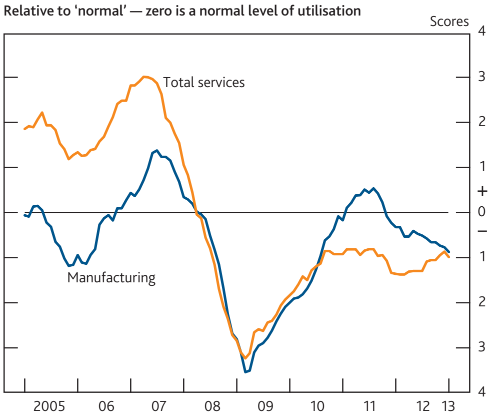


Capacity utilisation

Capacity utilisation remained a little below normal (**Chart 4**). In manufacturing, some firms reported increasing slack as previous investments in capacity had come on line and as export demand from the euro area had weakened. Within services, there were some reports of gradual consolidation within the professional services sector reducing spare capacity over time. Unused capacity was reported to be highest in the retail sector, partly reflecting a move to online models which were reported to be reducing labour intensity and to have increased spare physical capacity (such as retail property). More generally, there remained significant unoccupied secondary commercial property, though the use of prime property was said to be intensifying.

Chart 4 Capacity utilisation

Relative to 'normal' — zero is a normal level of utilisation



Costs and prices

Labour costs

The rate of growth in labour costs per employee had edged higher. Pay growth was expected to be little changed in 2013, with settlements said to be centred on the 2%–3% range, as for the previous year. Economic uncertainty and continued slack in the labour market were said to be restraining wage demands, though slightly fewer pay freezes and some increased pressure on pay was reported in some areas, such as the energy sector and IT. Auto-enrolment was expected by larger firms to add to labour costs in the coming year, though there was uncertainty about the size of the effect which would be dependent on the eventual opt-out rate. A box on page 7 summarises the results of the Agents' annual survey on pay and labour costs.

Non-labour costs

Materials costs and the prices of imported finished goods continued to drift up on a year earlier. Increases in agricultural prices as a result of poor harvests were reported, though the effect on consumer food price inflation had been diluted by the relative stability of some other non-ingredient costs. Increasing sea freight costs — reflecting restricted capacity — were reported to be putting upwards pressure on import prices generally, though prices of some imports from the euro area were said to be falling in part due to weaker domestic demand on the continent. Upward pressures from Chinese wage costs were reported to be contained by re-sourcing towards lower-cost production.

Output prices and margins

Output price inflation remained subdued, with companies often unable to pass fully through increases in input costs. A squeeze in margins was reported by food producers in particular, as supermarkets resisted the pass-through of higher ingredient prices.

Retail margins were reported to have been supported by improved stock management over the Christmas period, which had reduced the need to discount goods to clear stock relative to a year earlier, though many firms reported a generalised downward pressure on margins from the rise in e-commerce. In business services, output prices were reported to be little changed, with professional services margins said to be under pressure from excess capacity and tight procurement.

Consumer prices

The annual rate of increase of consumer prices was reported to be stable. Higher energy and fresh food prices were pushing up consumer prices, though the latter were said to be partly offset by promotional activity in supermarkets and competition between retailers. New car prices were generally reported to be flat after promotional activity, but some contacts indicated that used car prices were increasing a little due to low stocks. Consumer services prices were rising more quickly than goods prices, reflecting increases in administered prices such as tuition fees, domestic energy prices and transport costs.

Agents' survey on business services productivity

A key feature of the UK economy in recent years has been the weakness of productivity growth relative to its pre-crisis trend. One area where that weakness has been particularly marked is in business services. In an effort to understand better the drivers of weak productivity in this sector, the Agents undertook over 100 bilateral discussions with professional services contacts during November and December 2012. This box summarises the finding of those discussions.

Contacts confirmed that productivity growth — as measured by real output per hour worked — had been weak relative to pre-crisis trends. Over the period since 2010 in particular, subdued output had been accompanied by a gentle rise in employment in the sector, rather than a decline. Most contacts were aware of some spare capacity in their firms and subsectors, and expected consolidation over time. However, the prevalence of partnership and owner-managed structures had allowed many contacts to take a longer-term view, for example through reductions in partner drawings, and in some cases this approach had been supported by creditor forbearance.

Contacts laid most emphasis on current and future expected demand conditions as the key drivers of upward employment drift and thus weak productivity growth. The actions taken by contacts to help them to survive in the weaker demand environment, and the need to be prepared for the eventual upturn, were reported to have reduced their productivity, at least in the short term.

In particular, weak demand growth had made winning and delivering work harder, requiring more staff input. Firms had sought to expand their geographical and sectoral reach, at home and abroad, potentially depressing productivity due to the associated set-up costs and overheads. Up-front business development and marketing, together with increased frequency and complexity of bidding and tendering for business, were reported to have accounted for increased employee time, without always leading to higher output. And some contacts reported 'overservicing' clients to retain and win work, providing more reassurance and added extras.

Persistent expectations of a return to trend demand growth were also said to have supported employment. Contacts had been repeatedly surprised by the weakness of the recovery and the consequent, persistent lack of staff churn, but enduring optimism had led them to continue to retain and recruit staff for the upturn. In particular, the vast majority of contacts had resolved not to stop graduate recruitment, having suffered from a severe skills gap in the late 1990s following weak graduate hiring during the preceding recession. More generally, many cited maintaining longstanding personal relationships with clients as a key driver of retention. In some cases firms were hiring experienced teams and individuals to gain market share.

Less emphasis was laid by contacts on more structural drivers of weak productivity, though some were identified. Although IT investment had generated some productivity gains early in the downturn, often replacing administrative staff, further gains were felt to be harder to achieve given the differentiated services being delivered, especially in customer-facing roles. Meeting compliance requirements was reported by most surveyed companies (which excluded financial services firms) to have led to a continued small increase in non-chargeable hours worked, rather than any material increased hiring. Credit conditions were rarely mentioned in the context of productivity, although tighter debt availability had placed some constraint on consolidation among small and medium-sized enterprises, partly reflecting that many firms' main source of collateral — their property — had fallen in value. Property leases were also said to be deterring consolidation as it would take time to realise the potential synergies from a merger. And working capital constraints were mentioned as a factor by some contacts, partly reflecting increasing client demand for fee arrangements where payment is conditional on delivering a final desired outcome. That had the effect of increasing work in progress, tying up cash which might otherwise have been put to more productive use, and meant that some hours worked did not result in 'paid' outputs.

Looking forward, contacts expected some gradual recovery of productivity growth over time, even if demand growth remained subdued. Contacts expected new markets to become more productive and fixed overheads to reduce over time. Expected growth rates had gradually been downgraded and there were signs that this was reducing labour hoarding and hiring, especially where companies' reserves had been eroded. But contacts did not on average expect significant job losses in their own businesses in 2013 and they expected consolidation to proceed only gradually, reflecting the nature of management structures in the sector and creditor forbearance.

Most contacts expected that productivity growth would increase should domestic demand return to trend rates of growth. Organic growth in demand from existing clients would be expected to drive productivity growth, with less time devoted to new business development. Contacts also saw potential for the recent commoditisation of business services — such as web-based recruitment — to generate more productivity growth. Many legal and accountancy firms reported spare capacity that could be utilised if corporate finance and commercial property transactions picked up alongside a wider recovery in domestic demand, boosting productivity.

Contacts did not expect, however, that all of the productivity shortfall would be recouped. Some firms had responded to weak conditions by shifting their recruitment mix towards more junior staff (paralegals not solicitors; graduates not mid-career hires), whose productivity might be less than that of more experienced staff. Bidding and tendering costs were expected to remain high and time consuming, with clients having got used to choosing between competing business services providers. And in some cases clients' expectations of higher service levels would also be difficult to erode. These factors were expected to affect the level of productivity in the business services sector over the longer term.

Agents' survey on pay and labour costs

The Agents have conducted an annual pay survey since 1998, asking contacts in the private sector about their expected pay settlements for the year ahead, and the key drivers of any changes to growth in total labour costs per employee. This year 391 firms responded with a combined UK employment of 890,000.

The average pay settlement for 2012 reported in this year's survey was 2.2% (the green diamond in **Chart A**). That was close to the expectation for 2012 in the previous year's survey (the blue diamond for 2012). Looking forward, the average expected pay settlement for 2013 from this year's survey was 2.3% (the red diamond). That remains well below pre-crisis growth rates and suggests that pay growth is unlikely to pick up significantly this year.

Chart A Agents' surveys and private sector settlements

(a) Bank of England wage settlement database, December average over the past twelve months based on monthly data.

Responses to the survey suggested that average settlements were expected to be slightly weaker for small firms (employing fewer than 50 staff) and medium-sized firms (employing 50 to 249 staff) than for larger ones (**Chart B**). Most large firms expected to make a pay award of between 2% and 3% this year. Expected pay settlements for small and medium-sized firms included a higher proportion between 1% and 2% than for large firms. A significant minority of small and medium-sized firms expected to freeze pay during the coming year, though that share was smaller than in the previous year's survey.

A modest net balance of respondents expected total labour costs per employee to increase more rapidly in 2013 than in 2012. A significant proportion of the sample expected changes in employer pension contributions to exert upward pressure on total labour cost growth (**Chart C**), in part reflecting the impact of auto-enrolment requirements on the largest firms in the sample. More modest upward effects were expected from changes in productivity and recruitment or retention of staff. As in last year's survey, inflation was not expected to put significant upward pressure on total labour cost growth.

Chart B Expected pay settlements for 2013 by firm size

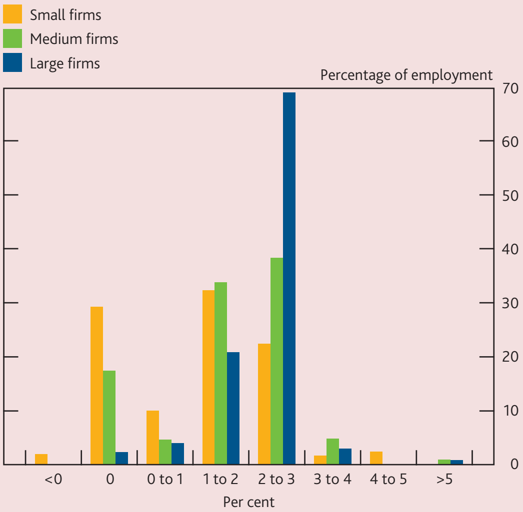
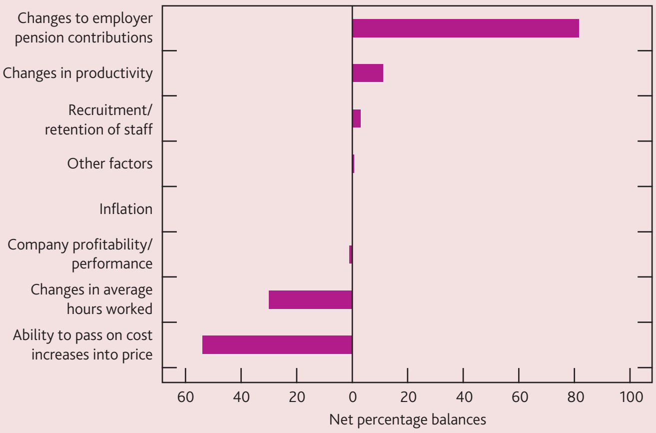


Chart C Influences on expected growth in total labour costs per employee in 2013 relative to 2012



Turning to the downward influences, as in the previous survey, both changes in average hours worked and an inability to pass on cost increases into prices were cited as reducing growth in total labour costs per employee compared with 2012. In contrast to last year, when company performance and profitability was expected to have a negative impact on labour costs, in this year's survey no significant effect on labour costs was expected from this source.