BANK OF ENGLAND

Agents' summary of business conditions

January 2013

- Growth in consumer goods sales had continued at a slow rate, with contacts anticipating a late pre-Christmas surge in demand. Growth in demand for consumer services had also remained very modest.
- The Funding for Lending Scheme was expected to take a few more months to have a meaningful impact on housing market activity. But competition was improving both in the mortgage and commercial lending markets.
- Investment intentions had remained broadly stable, at a low, though positive, rate of growth.
- Export sales growth had recently steadied, in part due to demand from emerging economies.
- Growth in the output of business services had continued at a slow pace.
- The gentle easing in manufacturing output for the domestic market had not altered, but growth in output for export had steadied.
- Construction output was still lower than a year ago.
- Employment intentions had picked up a little in business services but were otherwise unchanged.
- Capacity pressures remained a little below normal.
- The rate of inflation in labour costs remained low.
- Non labour cost inflation had edged up slightly but remained below the rate of six months ago.
- Output price inflation had picked up a little, but firms' margins were tightening.
- The rate of consumer goods price inflation had softened slightly.
- Consumer services price inflation had continued to drift up.

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 November 2012 and late December 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

Growth in retail sales had continued at a slow rate. A number of contacts had expected a late surge in spending over the long weekend that led up to Christmas day (the box on page 5 summarises an Agents' survey of consumer spending over the Christmas period). Growth in food sales had been supported by rising price inflation, but underlying volume growth had appeared weak. Colder weather had contributed to a pickup in winter clothing sales, and there had been further signs of a slightly firmer market for some durables; demand for mobile devices, for instance tablet computers, had been growing rapidly. Continued double-digit growth in internet retail had been widely reported.

Growth in demand for consumer services also remained very modest. As with sales of consumer goods, there were signs that demand had continued to be stronger at low and high price points than in the mid-market. Sales of tickets for major sporting and leisure events had remained strong and demand for hotel accommodation had firmed up a little. Some travel agents had reported a pickup in demand for luxury foreign holidays. Domestic demand for rented accommodation had continued to strengthen, but with more signs of resistance to high prices. As households reduced private car travel, public transport usage had grown further. Consumers had been economising on catering services such as restaurants and pubs.

Housing market

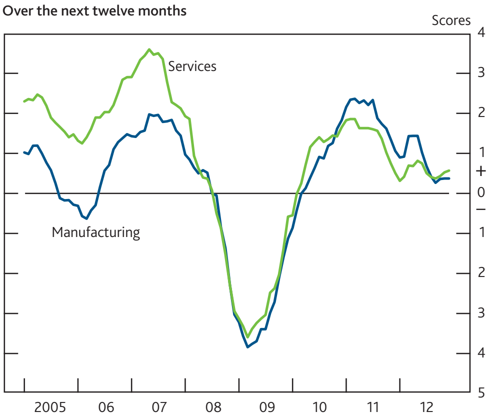
Growth in secondary market sales had been weaker than in new housing during the autumn. Demand had been strongest for property priced below the £250,000 stamp duty threshold and, outside London, relatively subdued above that level. Some estate agents felt vendors' expectations remained too high, notably those of households looking to downsize; this would continue to hold back the supply of homes for sale. Additionally, some prospective second-time buyers had seen the value of their existing property ease back, and this would restrain demand. There had been a number of recent reports of mortgage supply improving and interest rates falling, with competition increasing between banks and building societies. But increasing competitiveness had been focused on the lower loan to value (LTV) part of the market and those buyers without a significant deposit still struggled to purchase. Contacts expected the Funding for Lending Scheme (FLS) to support greater activity in the new year and gradually to improve the availability of mortgages at higher LTV ratios.

Business investment

Investment intentions over the next twelve months remained slightly positive in both the manufacturing and services sectors (**Chart 1**). Contacts' plans had become less finance constrained during the past year but projects affording quick returns or increasing competitiveness were still being prioritised, particularly investment in information and communications technology (ICT). For some contacts, recently announced increases to investment allowances would engender a higher level of spend in 2013 than previously planned. However, some manufacturers were now cutting back, either after a period of strong investment growth or in anticipation of weak demand. A major positive exception was firms in the energy sector. In services, some spend followed deferral and therefore would not persist, or had been prompted by regulation rather than expansion. But there had been widespread reports of property refurbishment increasing and some business services firms were investing ahead of anticipated growth in exports.

Chart 1 Investment intentions

Over the next twelve months

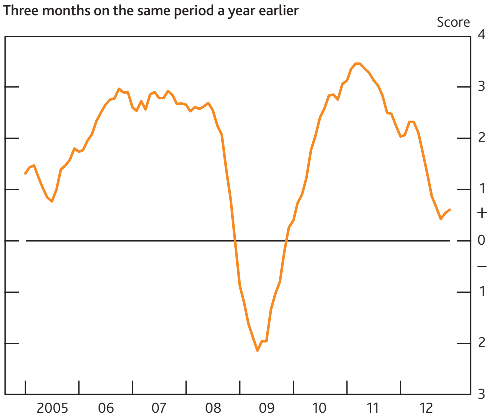


Exports

Manufacturing exports (**Chart 2**) had steadied. Sales to the euro area were still declining; demand for capital goods and from the automotive industry had fallen. And the US 'fiscal cliff' had delayed orders for defence and healthcare goods. But demand from the US oil, gas and energy sectors had remained strong. Bright prospects had been evident in some emerging market economies. Sales of luxury goods, cars, medical equipment and education services were rising; and demand for infrastructure-related goods and services had also grown, though projects were slow to start. Growth in the number of small firms either expanding export activity or exporting for

Chart 2 Manufacturing exports

Three months on the same period a year earlier



the first time had showed no sign of abating. But contacts had highlighted a rising level of international competition from European firms and from some Asian factories. Car imports from the euro area during 2012 H2 had been relatively buoyant, and food imports had picked up.

Output

Business services

Professional, financial and other business services firms' turnover had continued to grow slowly. Some professional firms' volumes of M&A activity had increased slightly, as had land use planning services, litigation and exports. But turnover growth had continued to be held back by downward pressure on fees. Tight margins had increased pressure to consolidate and encouraged further relocation of some work to lower-cost locations. In financial services, there had been a sharp pickup in the volume of pension and annuity-related activity. Some employment agencies had reported better prospects, notably those specialising in sales and business development positions. ICT services firms were also growing. The logistics industry had seen rising demand for parcel delivery services, reflecting the rapid growth in e-commerce. But though corporate usage of hotel and conference facilities had firmed up, firms' discretionary spend was not rising. Advertising showed signs of having been trimmed back since the Olympics.

Manufacturing

The gentle easing of domestic market sales had not altered in recent months. But growth in output for export (**Chart 1**) had steadied, though at well below the pace of six months ago. Business prospects were strongly polarised. Further new orders for civil aircraft had added to the strong forward visibility in the aerospace sector. Demand for equipment from the oil and gas sector was strengthening. And 2013 would see additional models launched by UK car producers, for some of whom production was now ramping up. Output of some consumer durables had also risen in recent months. But output of construction goods had continued to weaken and the outlook for many defence contractors remained subdued. Brewing volumes had fallen and a number of food processors had seen lower order levels than expected.

Construction

Output was still less than a year ago, though the decline had shown further signs of flattening off. Output of new homes was broadly stable, skewed towards homes for sale and away from new social housing, thanks to incentive schemes for the former and uncertain financial support for the latter. Home builders generally remained cautious, though some were budgeting for a slightly higher output in 2013. Poor prospective returns had restrained commercial new build. In London and in some other regions, a higher proportion of work was now in refurbishment. There were only patchy reports of any pickup in public spending, albeit in the medium term the sector would benefit from infrastructure schemes that had been announced.

Credit conditions

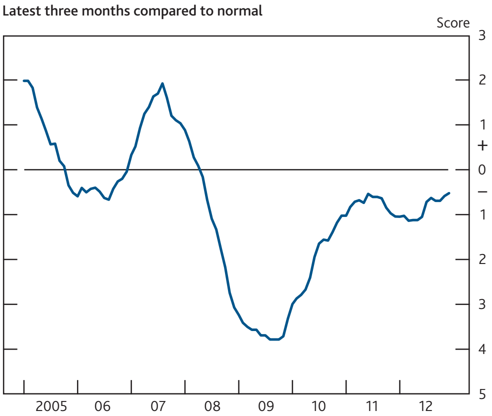
Several major banks had begun to market the FLS energetically to firms in recent weeks. The supply of term lending had become more price competitive. But non-price conditions were proving slower to improve and available loans had remained generally limited to shorter maturities. Demand for new business lending from banks had remained muted, except among the smallest firms, for whom a lack of security still restrained supply. Business advisers had commented that banks' risk appetite appeared little changed. Banks themselves had continued to speak of a lack of demand from firms with solid business plans, but lower interest rates under the FLS could begin to make it easier for loan applicants to pass affordability tests. Some contacts had noted a growing preference among businesses for finance from private equity firms, venture capital funds and business angels.

Many firms preferred to use cash, not borrowings, for expansion. Some contacts had continued to pay down debt as quickly as possible. A number had described the build-up in their cash balances as being in large part as a bulwark against risks to working capital. Settlement of invoices was said to be slowing, and several manufacturers had seen customers unilaterally extend payment terms. Working capital had tightened significantly in the farming sector. Some contacts had noted that trade credit insurance availability had tightened in recent months, both for exporters and more generally.

Employment

Employment intentions were rising in business services. In part this reflected a stronger demand for school leavers and graduates, to meet future needs. And though some professional firms were shedding posts in the higher salary bands, others were hiring selectively at this level, to broaden their range of services ahead of a revival in demand. In consumer services, numbers employed continued to drift down, in part because of business failures; many employers had sought greater staff flexibility and some guaranteed fewer working hours than before. Manufacturing employment prospects remained broadly flat. Contacts generally expected a revival in manufacturing output to be met from current slack labour before any further recruitment. Prospects in the construction industry remained poor, with further labour shedding possible. Recruitment difficulties (**Chart 3**) remained a little below normal but were gradually creeping up. Engineering skill shortages had been reported from the power generation industry. And ICT skills for a range of activities, including both publishing and programming, had tightened. A number of contacts in these areas, including professionals, were looking abroad for skills. For many low-skilled positions there was an oversupply of suitable applicants.

Chart 3 Recruitment difficulties



Capacity utilisation

Capacity constraints had remained a little below normal. A number of producers were protecting spare capacity, some of it relatively new, until business conditions improved. Falls in domestic demand had triggered several firm closures. Some export-facing manufacturers were now under a little less pressure than earlier in the year; but others expected to phase in any further capacity required or to handle volatile order patterns through short-term overtime working. Some of the slack in the service sector was being addressed by mergers. In a few locations, the supply of grade-A office space had become tight following several years of very low investment. But there had continued to be a hangover of secondary and tertiary office space, and the retail vacancy rate had continued to climb.

Costs and prices

Labour costs

Pay growth had remained slightly faster in manufacturing than in the service sector. However there had been suggestions of a decline in the overall amount of overtime being worked. And some contacts expected lower bonus payments in 2013 than the previous year, reflecting falling profitability. Many firms were now considering what impact auto-enrolment might have on their wage bill. The advent of the new requirement was not expected to affect the majority of pay decisions in the short term, but a few firms were bringing new pension schemes forward.

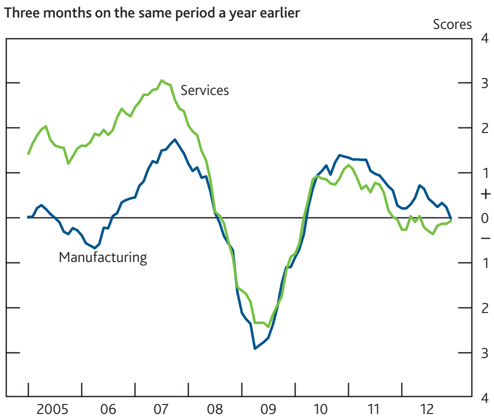
Non-labour costs

Having softened over the summer, growth in non-labour costs had edged up very slightly. Hard commodity and oil derivative inflation had been subdued, reflecting weaker demand from Asia and the stable price of oil. Cereal prices had fallen back, but higher grain costs were now affecting early-stage food production — bakeries, animal feed and egg production, for example. Weakening export demand had contributed to softening prices for some foods, and the cost of some others had benefited from the appreciation of sterling. Fast-rising Asian labour rates, and higher shipping costs, were adding to the upward pressure on finished goods such as cottons. An increasing number of firms were facing higher energy bills, though many continued to seek some offset from efficiency measures.

Output prices and margins

Producers' domestic prices had drifted up a little, but they had not fully recouped rising costs. Some manufacturers felt that pressure on margins had intensified during the second half of the year (**Chart 4**). A margin squeeze had become apparent in the food supply chain. And advanced engineers' customers still expected suppliers to achieve price reductions year on year. In sectors such as energy extraction and generation there had been greater scope for cautious margin improvement. And in the service sector business-to-business services prices had continued their glacial rate of increase, though margins still reflected the lack of higher value-added work. Prices for waste management and utilities were steadily rising, but for a wide range of other business services, absent a correction to labour costs, margins were still tightening as downward pressure on prices persisted.

Chart 4 Pre-tax profits



Consumer prices

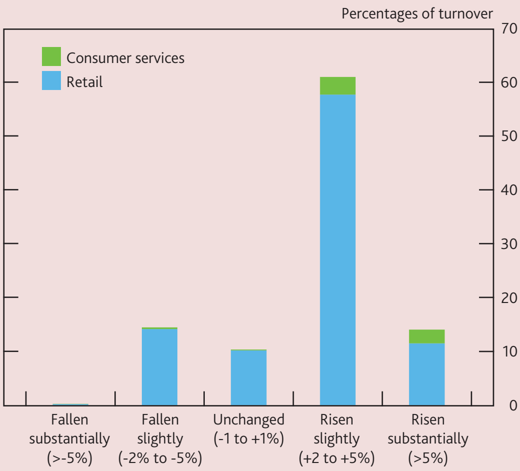
Non-food discounting in the run-up to Christmas had been more tightly managed than a year ago, retailers having committed ahead to less stock. Some food prices had risen but fixed-price contracts and downward price pressure on food processors were thought likely to continue to restrain further price growth. Falls in the price of petrol and lat-autumn clearance sales had helped overall goods price inflation to soften slightly. Consumer services price inflation remained higher than for goods and was drifting up. Hotels and some travel agents had felt less need to discount than a year ago. Air fares continued to rise slowly. The turn of the year would see further pass-through of higher utility bills and rises in some public transport prices, though at a slower rate than twelve months before.

Agents' survey of consumer spending over the Christmas period

As in previous years, the Agents conducted a survey of retailers, shopping centres and consumer services firms in late December and early January to get a view of sales over the Christmas and New Year period. Two hundred and thirty six businesses responded.

Contacts were asked about trading relative to the same period a year earlier. Weighted by turnover, around 75% reported growth in sales values (**Chart A**), with 14% seeing growth in excess of 5%. Additional selling space had accounted for some of this growth. So, too, had price inflation (eg on food products), with retail contacts reporting weaker growth in volumes than values. Most consumer services respondents, including many hotels, pubs and restaurants, had also experienced sales growth.

Chart A 2012 seasonal turnover versus 2011

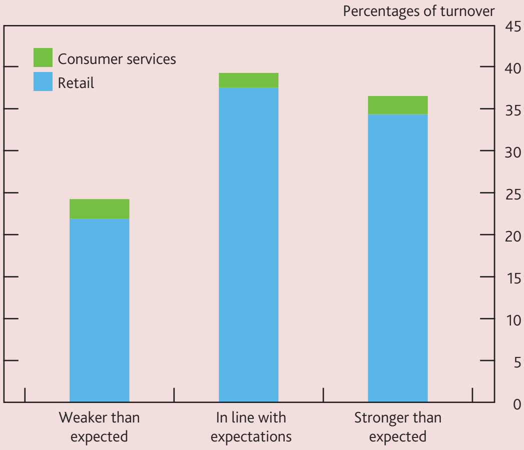


The majority of contacts (also 75% when weighted by turnover) reported their sales performance as either in line with, or exceeding, expectations (**Chart B**). Expectations had been modest and trading conditions were broadly as anticipated.

Most businesses reported a pickup in trading in the final few days before Christmas and at the start of their main discounting period. Those with a strong online presence had done well, though partly at the expense of sales in-store. Those with weaker online offerings had seen less online sales growth this year. Also, some smaller stores were finding online trading activity tougher. Electrical items had sold extremely well.

About half of contacts reported the timing of discounting as broadly similar to a year ago. The remainder were split evenly between those who had waited until after Christmas, and

Chart B Sales versus expectations



others that had discounted earlier this year in a bid for market share. The level of discounting had been slightly deeper than a year ago, but more targeted on specific items or ranges. Non-price promotional techniques had been used more aggressively, for instance vouchers and loyalty schemes. A strong theme this year was one of better stock management. There were few reports of excess stocks from retailers as they entered the post-Christmas discount period; this was likely to boost margins when compared to a year ago.

Finally, contacts were asked about expected sales over the next three months (**Chart C**). Expectations were, on balance, for very low nominal sales growth relative to the year before, although price inflation could contribute to food sales growth. Pressure on disposable incomes was expected to continue to act as a drag on growth. Consumer services firms hoped to see recent modest growth continue, but remained cautious. Among those with a more positive outlook were contacts selling household durables, who expected recent steady growth, described as primarily replacement spending, to continue.

Chart C Sales expectations for 2013 Q1 versus 2012 Q1