BANK OF ENGLAND

Agents' summary of business conditions

February 2012

- Nominal consumer demand continued to grow slowly, with many consumers directing their spending towards essential goods and services.
- The level of activity in the housing market remained subdued, but enquiry numbers had picked up in January.
- Investment intentions had softened further, although more recently a few contacts reported having resumed projects that had been on hold, despite ongoing uncertainty about the outlook.
- The pace of goods export growth continued to moderate. That reflected slowing world demand growth, particularly in the euro area, while demand in Asia remained robust.
- The growth rate of turnover in business services had slowed further, reflecting weaker demand and downward pressure on some fees, although some contacts recently noted a pickup in activity, as customers had become a little less cautious.
- Manufacturing output for the domestic market continued to rise gradually.
- The level of activity in the construction sector was slightly lower than a year earlier. But the pace of contraction had slowed a little.
- Contacts reported that credit conditions had tightened in recent months, with both small and large businesses noticing the change in the stance of lenders.
- Employment intentions in the private sector continued to soften, and suggested that employment was likely to be broadly flat over the next six months.
- Capacity utilisation in the manufacturing sector had fallen back recently, reflecting both slowing growth in demand and past investment and recruitment. In the service sector too, weakening activity had caused spare capacity to widen.
- Labour costs continued to grow at a moderate pace, with the outlook for pay settlements in 2012 broadly the same as in 2011.
- Inflation in the price of imports of finished goods fell back further this month, suggesting that the recent slowing in the pace of increase in raw material prices was starting to feed through.
- Manufacturing output price inflation continued to moderate. Manufacturers' pricing power had weakened following a reduction in domestic demand.
- Annual retail goods inflation slowed further, but consumer services inflation remained elevated.

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 2011 and late January 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/agentssummary/index.htm.

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/inflationreport/index.htm.

Demand

Consumption

The annual rate of nominal spending remained weak (**Chart 1**). Early reports suggested that the value of retail sales in January was broadly flat on a year earlier. Although, spending the year before had been boosted by a bounceback in demand after extreme weather conditions had disrupted shopping patterns. Nevertheless, retailers tended to report little sign of any underlying improvement in consumer confidence. Consumers continued to direct their spending towards essential items such as food and fuel and away from discretionary products, particularly durable goods. And while retailers went into the post-Christmas trading period having managed to sell much of their excess inventory, discounts were still considered to be essential to drive sales. And some contacts felt that consumers had come to expect goods to be on promotion.

Chart 1 Nominal spending on retail goods and consumer services

The rate of growth of demand for consumer services also continued to slow. Christmas spending had temporarily supported some non-essential leisure services, such as pubs, bars and restaurants. But trading conditions in January had so far proved more difficult than usual, as households opted to stay at home. In response, many contacts in the leisure industry had begun to make greater use of promotions, such as voucher-based deals on meals out. Meanwhile, growth in spending on non-discretionary services such as transport, insurance and rents continued to be boosted by price increases.

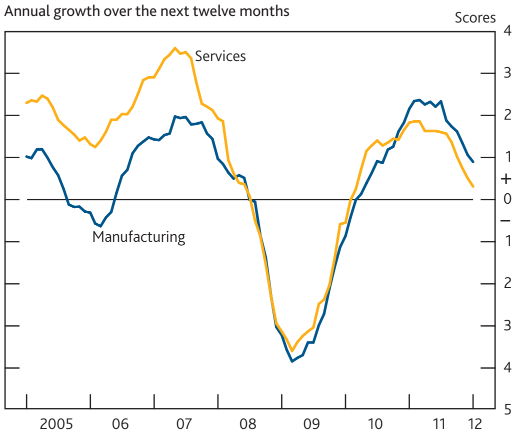
Housing market

Contacts reported that there had been a modest increase in activity in the housing market since the start of the year, beyond what was expected. According to estate agents, enquiry levels in the secondary market had risen a little in January. Contacts suggested a number of reasons for this. Part of it represented catch-up from a particularly subdued end to last year, as well as awareness among buyers of the approaching end to stamp duty relief. Demand from buy-to-let investors had also been growing, due to rising rental yields. Rents had been pushed up by growing demand, particularly from frustrated would-be first-time buyers, many of whom remained unable to secure a mortgage. For existing homeowners, some had been unable to move because they had insufficient equity in their current property, while others had become more cautious about trading up as a result of concerns about the outlook for the economy.

Business investment

Investment intentions continued to weaken, suggesting little growth in spending on capital over the next twelve months (**Chart 2**). But the softening in intentions remained gradual, with little sign of an abrupt reappraisal of spending plans. And while heightened uncertainty about future demand had been a prime driver of the reduction in investment expectations, very recently, a few firms reported having restarted postponed investment, even though they remained uncertain about the outlook.

Chart 2 Investment intentions



In manufacturing there continued to be a divergence in intentions between domestic and export-facing businesses. Those supplying the domestic market tended to be more inclined to lower their investment plans, often reflecting weaker expectations for demand, particularly among those producing goods for the construction and consumer sectors. In contrast, exporters were often planning to increase capacity, particularly in the aerospace, energy and agricultural sectors. In the service sector there was more widespread evidence of a lowering in investment intentions, reflecting weak demand growth and a rising margin of slack. And some of the larger retailers were scaling back their store expansion programmes.

Exports

Goods exports growth continued to slow, reflecting softening world demand, particularly in the euro area. But some of this was thought to have been due to de-stocking in end markets, which some contacts believed was now coming to an end.

And demand in emerging markets continued to grow steadily. A number of contacts reported strong growth in areas such as aerospace, equipment for the energy industry and luxury consumer goods. In the service sector, professional and financial services firms reported robust demand from emerging markets, especially for services related to oil and gas extraction, for instance in engineering consultancy.

Output

Business services

Business services turnover growth continued to slow, reflecting weaker demand and downward pressure on fees, particularly among accountancy and legal firms. That had been driven in part by the high degree of uncertainty about the outlook for the economy. And contacts in the financial sector had seen a decline in work on corporate transactions as companies put plans on hold. But very recently, some contacts had reported a pickup in activity, as clients adjusted to the high degree of uncertainty and decided to go ahead with projects in spite of it. Contacts in corporate hospitality also reported a softening in demand, and distribution companies had been relatively quiet as retailers ran down stocks.

Manufacturing

The annual growth rate of manufacturing output for the domestic market had fallen further this month, with reports becoming increasingly polarised. Firms which were increasing output tended to be those supplying essential goods, or in supply chains for the export sector, for instance in food production and high-tech industries. But there was particular weakness from suppliers of goods destined for the domestic household and construction sectors. Producers of goods destined for the public sector also reported falling orders, in part a reflection of tighter procurement processes following cuts in public sector spending.

Construction

Activity in the construction sector continued to contract but the pace of decline appeared to have moderated. Underpinning this was a modest pickup in private demand, for instance from the construction of new homes, projects in the utilities sector and commercial property in London. In addition, a number of contacts had reported a spike in the number of solar panel installations in the run-up to the reduction in the feed-in tariff. In the public sector, previously commissioned capital projects were expected to support activity for some months. But as these came to an end, they tended not to be replaced by projects of a similar size, or sometimes not at all. There was further evidence this month that the pace of floor space expansion of some of the big national retailers had slowed.

Credit conditions

Contacts reported that credit conditions had tightened recently. And that had been felt by both large and small companies. Larger firms and those with strong balance sheets still typically had reasonable access to credit. But some large contacts expected to make greater use of capital markets if credit conditions tightened further. Smaller firms continued to report that credit conditions were tight, with persistent pressure from banks to commit to asset backed forms of lending, rather than overdrafts, which contacts often preferred. Many firms remained focused on paying down existing debt.

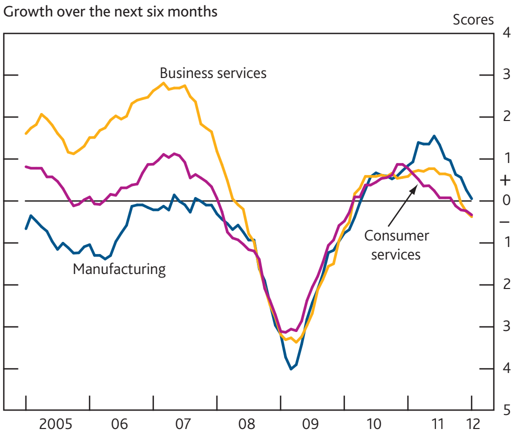
Some contacts reported that the maturity of their borrowing had shortened over the course of the recession, and as a result refinancing was required more often, taking up more management time than in the past. And recently, some firms had experienced difficulties with syndicated loans, as European lenders sought to withdraw from commitments, complicating the task of refinancing further.

Contacts reported a continued unwillingness by banks to lend into sectors such as construction, consumer services and property, with some lenders acknowledging that these sectors were essentially closed to new lending. Where funds were available for these sectors, banks had usually reduced loan to value ratios, or increased charges to reflect better their perception of risk.

Employment

Employment intentions in the private sector continued to weaken, and suggested that employment was likely to be broadly flat over the next six months (**Chart 3**). The weakening outlook for activity had led many firms to sharpen their focus on costs, with recruitment freezes becoming more commonplace, and further steps taken to achieve productivity gains before adding to headcount. But instances of involuntary redundancies remained infrequent.

Chart 3 Employment intentions



In the manufacturing sector, a weaker domestic outlook and concerns for certain export markets had encouraged employers to scale back recruitment plans, while in business services, spare capacity was opening up in many professional services firms, with an increase in the number of reports of underemployment among newly qualified staff. Many firms in this sector were attempting to rearrange resources to target growth areas, and introducing non-replacement policies in others. There were expected to be further payroll reductions in the banking industry. In retailing, some additional jobs would come from the expansion of the larger businesses, albeit at a slower pace of growth. But many consumer-facing firms were often already at minimum staffing levels, and store closures were expected to cause retail employment to fall overall.

Capacity utilisation

In the manufacturing sector capacity utilisation was, on average, around normal, but had fallen back somewhat in recent months, reflecting both softer demand conditions and past investment and recruitment. Contacts reported that capacity utilisation was highest among exporters, especially those facing areas of robust growth, for instance, in the aerospace and automotive industries. By contrast, those supplying domestic households and the construction sector tended to exhibit a much larger degree of slack. In services, slowing activity had caused spare capacity to widen further. But contacts were responding more quickly than in the past, actively adjusting working arrangements to meet changes in demand. For instance, some businesses in the retail sector were shortening their opening hours, while professional services firms often reported a reduction in the use of overtime and temporary staff.

Costs and prices

Labour costs

Labour costs continued to grow at a moderate pace, with the majority of settlements between 2% and 3%. Higher awards tended to be associated with formal wage agreements, or where pay was indexed to inflation through multi-year deals, although instances of these appeared to be more than offset by pay freezes. Looking forward, the outlook for pay settlements in 2012 was thought to be broadly the same as in 2011. There had been some upward pressure on settlements due to rising labour productivity and the need to retain key staff. But this had been broadly balanced by other factors, including lower inflation expectations and reduced corporate profitability. Slower growth in profits was expected to lower bonus payments in the manufacturing sector over the coming year.

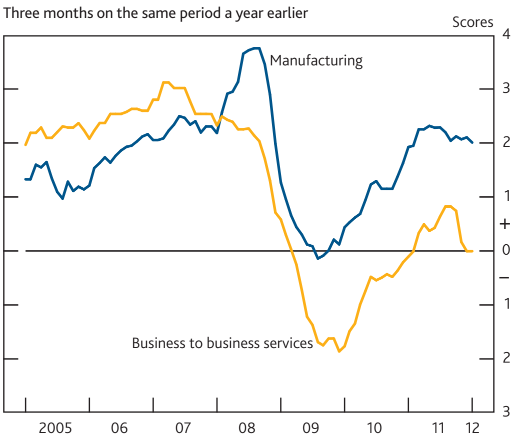
Non-labour costs

Inflation in raw materials prices continued to slow, with a wide range of commodity prices either levelling off or declining. Although, for firms with forward contracts it would take some time for these to feed through. And contacts continued to report significant increases in energy costs, and in the prices of agricultural commodities. Inflation in the price of imports of finished goods fell back further this month, reflecting softer world demand growth and slowing inflation in raw material prices, which suppliers were beginning to pass on. Offsetting that to some extent was the rising cost of production in emerging market economies, where wage growth was sometimes in double digits. The Agents continued to hear reports of elevated inflation in the price of certain electrical components as a result of flooding in Thailand, and some contacts thought that supply chains might not fully recover until the autumn.

Output prices

Manufacturing output price inflation had edged down on the month (**Chart 4**). That was partly due to a fall in pricing power, as demand growth had weakened. It was also a reflection of the slowing in the pace of increase in input costs, although some firms were reluctant to pass on price reductions. In business services, output price inflation had fallen significantly in recent months, with contacts in professional services reporting further downward pressure on fees. In the corporate hospitality and events industry falling demand had led to a rise in spare capacity, leading to some sizable last-minute discounts.

Chart 4 Manufacturing and services output prices



Consumer prices

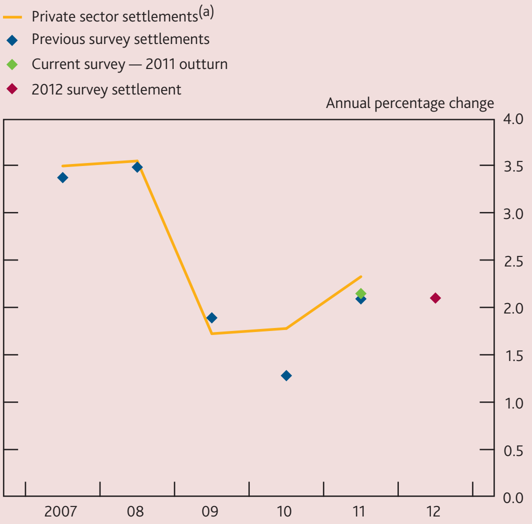
The rate of retail goods inflation continued to fall back, with most contacts expecting this to continue, helped in part by recent announcements of future price reductions by some of the large energy providers. Contacts maintained that discounting was essential to induce consumers to spend, and this was expected to continue for some time. In services, the rate of inflation remained elevated. Despite evidence of widespread discounting, especially by suppliers of non-essential services, the prices of essential services and those linked to inflation, such as rail fares, continued to rise fairly quickly.

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 384 firms responded with a combined UK employment of 538,000.

The average pay settlement for 2011 reported in this year's survey was 2.2% (the green diamond in **Chart A**). That was more or less in line with the expectation for 2011 in the previous year's survey (the blue diamond for 2011). Looking forward, the average expected pay settlement for 2012 from this year's survey was 2.1% (the red diamond). That remains well below pre-recession growth rates and suggests that the rate of increase in pay will not pick up during 2012.

Chart A Agents' survey and official settlements



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

Responses to the survey suggest that average settlements are expected to be slightly weaker for small firms (employing fewer than 250 staff) than larger ones (**Chart B**). Most large firms expected to make a pay award of between 2% and 3% in 2012, whereas small and medium-sized firms tended to expect settlements to lie between 1% and 3%, with a significant minority expecting pay freezes in 2012.

Only a very small net balance of respondents expected total labour costs per employee to increase more rapidly in 2012 than in 2011. But there were some sizable opposing forces at play. Changes in productivity and increases in employer pension contributions were both expected to exert upward pressure on growth in labour costs (**Chart C**). Expectations of upward pressure from changes in productivity were evident in

Chart B Expected pay settlements in 2012 by size of firm

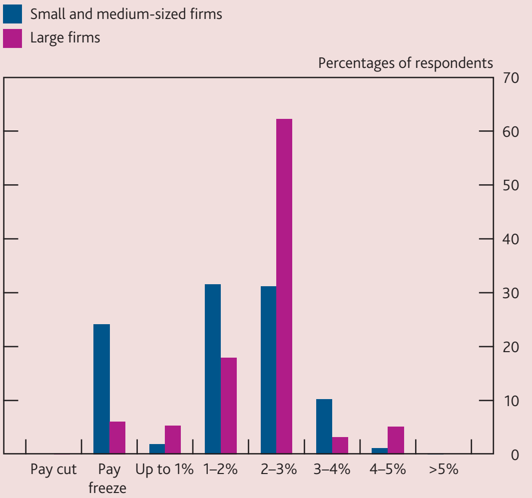
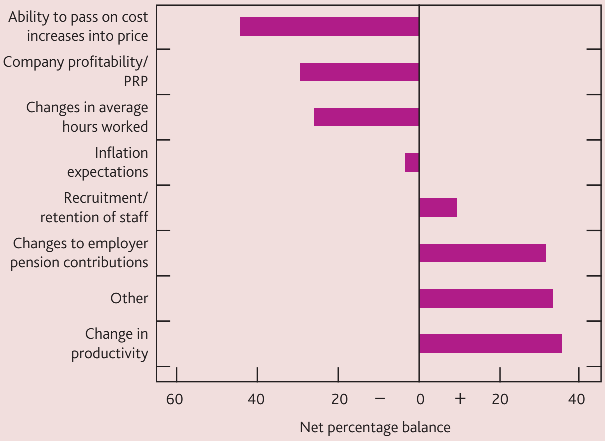


Chart C Influences on total labour costs per employee



responses from all sectors, but were strongest in the manufacturing sector. Meanwhile, in a notable change from the previous year's survey, inflation expectations were no longer expected to put significant upward pressure on total labour costs. And weakening company profitability, lower performance-related pay and reductions in average hours were all expected to slow growth in labour costs over the coming year. Firms also reported that they had little pricing power and expected that to restrain growth in labour costs during 2012.