BANK OF ENGLAND

Agents' summary of business conditions

January 2012

- Consumer spending growth remained weak, leading to aggressive discounting in the run-up to Christmas.
- The level of activity in the housing market was still generally very subdued.
- Investment intentions continued to weaken, due in large part to heightened uncertainty about the outlook.
- Goods exports were still growing at a fairly strong rate, but the pace of expansion had slowed compared with earlier in the year.
- Manufacturing output for the domestic market continued to grow gradually, but the growth rate had edged down again, with reports becoming more mixed.
- The growth rate of turnover in business services eased further, reflecting both weaker activity and downward pressure on prices.
- Contacts in construction reported a slight weakening in the level of activity compared with a year earlier.
- Firms with relatively strong balance sheets usually had access to credit if required, but small businesses often remained nervous about approaching banks. Many contacts remained focused on the preservation of cash.
- Employment intentions in the private sector continued to weaken, and suggested that employment was unlikely to grow over the next six months.
- In the manufacturing sector, capacity utilisation had fallen back a little recently. The margin of spare capacity in the service sector had begun to widen.
- The pace of growth of total labour costs had declined a little.
- There had been a further slowing in the annual rate of inflation in raw materials costs.
- Annual inflation in the price of imports remained elevated. But contacts expected it to fall over the course of the next year.
- Manufacturing output price inflation was expected to begin to decline, due to slowing in the pace of inflation in input costs. Inflation in business services prices had softened in recent months, reflecting more intense competitive pressures.
- Annual consumer price inflation remained elevated, but had fallen slightly, due to heavy discounting in both goods and 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 November 2011 and late December 2011. 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 rate of growth of consumer spending remained weak (**Chart 1**). And discounting in the run-up to Christmas had started earlier, and been deeper, than last year. Despite some fillip from bargain hunters, however, the squeeze on households' real disposable income continued to depress the overall volume of consumption and cause shifts in the pattern of spending. Value goods and services continued to outperform mid-range ones, for instance. And rising prices for essential services, such as transport and housing, had reduced the amount left over for spending on leisure activities. Many contacts expressed concerns about the possibility of a sharp fall in the volume of consumption in the first quarter, compared with a year earlier.

Chart 1 Nominal spending on retail goods and consumer services

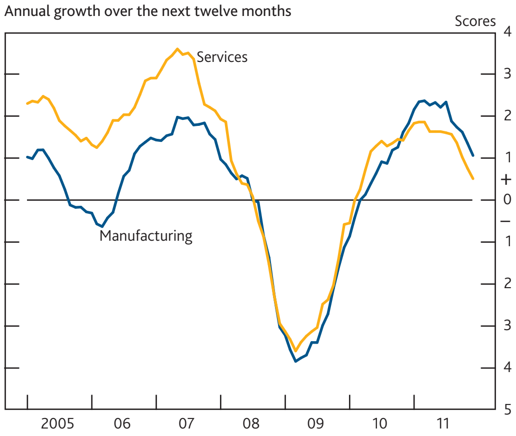
Housing market

Activity in the housing market remained subdued. And there had also been an increase in the frequency of breaks in housing market chains, as buyers withdrew offers, which contacts attributed to concerns about the economic outlook. First-time buyers typically still struggled to raise the deposit required to secure a mortgage, pushing up the demand for rental properties and rents. The London market continued to be supported by inflows of money from abroad, in part because it was perceived to be a safe haven for international investors. The higher end of the housing market also continued to show some resilience, with the supply of new homes increasingly targeted at this segment. A reduction in government grants to housing associations had lowered the supply of social housing.

Business investment

Investment intentions continued to weaken, but still pointed to an increase in capital spending over the coming year (**Chart 2**), with plans usually strongest among exporters. Heightened uncertainty had caused some investment to be put on hold, or scaled back, with a greater focus on the preservation of cash flow, particularly among smaller firms.

Chart 2 Investment intentions



And there had been fewer reports of plans to increase capacity, as past projects came to fruition. But many contacts continued to invest in raising efficiency, lowering energy use, waste reduction and regulatory compliance. Spending was also still being supported by some large infrastructure projects in transportation and the energy and utilities sectors, although some major schemes would go into abeyance for several months around the time of the Olympics.

Exports

Goods exports continued to grow at a fairly steady pace, but had slowed somewhat. The increase in exports reflected rising demand in emerging economies and a shift in the orientation of both established exporters and newly exporting firms towards these growth markets. Businesses supplying the aerospace, automotive and energy sectors were among those seeing the most resilient demand, while high commodity prices had encouraged an increase in mineral extraction in large areas of the developing world, increasing the demand for exports of construction plant. A number of exporters remained optimistic about their ability to continue to expand their share of the market in emerging economies, despite slowing growth in some of these countries. Meanwhile, activity in the euro area had softened, particularly among those countries most affected by concerns over sovereign debt.

Output

Business services

The growth rate of turnover in business services continued to ease, due to slowing demand growth and downward pressure on price inflation, particularly among professional and financial services. Some contacts attributed the weakening in activity to the impact on confidence of problems in the euro area. And slower growth in manufacturing was having knock-on effects for the suppliers of a range of ancillary services, such as haulage and industrial cleaning. Regulatory and compliance work continued to support demand, however, and providers of IT services and telecoms continued to grow on the back of clients' efforts to find efficiencies and cut costs. There had also been some increase in outsourcing by the public sector. Large legal and accountancy firms were increasingly chasing market share, leading to consolidation in the sector and forcing some smaller businesses to exit.

Manufacturing

The annual growth rate of manufacturing output destined for the domestic market had edged down, but remained positive. Reports were increasingly mixed, however, and some contacts thought that orders were becoming more volatile and smaller in size. Firms in supply chains for goods that were ultimately destined for export were still growing at a solid pace, for instance in the aerospace and energy sectors. But weak domestic demand continued to weigh on a range of manufacturers, including suppliers of durable consumer goods and construction materials and on the defence industry. There had been relatively few reports of disruption to output due to flooding in Thailand.

Construction

Contacts in construction reported a slight weakening in the level of activity compared with the same period a year earlier. Public sector work had contracted as some large-scale projects were completed. And more generally, contacts reported that what work there was tended to be small-scale, was fiercely fought over on price, and was often subject to delays in procurement. There was some support to activity from the private sector, particularly from energy and transport infrastructure. And there had been an increase in the construction of warehousing space and distribution facilities, in part due to the growth of on-line sales. But the pace of expansion of some of the big national retailers had slowed, and there was little speculative office development underway outside London. Difficulties in securing planning permission continued to be a source of frustration for many contacts.

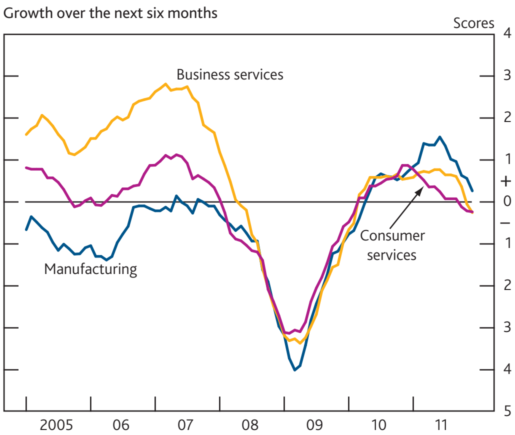
Credit conditions

Businesses with strong balance sheets generally had access to credit. But small companies frequently reported that conditions remained tight, and were often wary of approaching banks for loans, fearing re-pricing of existing facilities or requests for increased security against lending, such as personal guarantees. Among those contacts that had recently been in touch with their lenders, there were a few instances of a tightening in credit conditions in recent months, particularly for longer-term lending. But for most firms, higher funding costs for banks did not appear to have been passed on yet. Anticipating such a change, however, there was a rising note of caution among contacts, with many businesses focused on building up cash holdings, in case of a change in the position of their banks. This had been given added impetus by a squeeze on working capital as payment times began to lengthen. And some firms were building up cash buffers in case declines in bond yields caused upward revisions to the size of pension fund deficits.

Employment

Employment intentions in the private sector continued to weaken, and suggested that employment was unlikely to grow over the next six months (**Chart 3**). Manufacturers often reported that they were taking a pause from further recruitment, in light of heightened uncertainty about the outlook and a slowing in orders. The weakest plans were among those supplying the domestic economy, particularly households and the construction sector. In business services, many firms had seen margins come under renewed pressure. That was most acute in sectors where there remained significant overcapacity, for instance, in legal and accountancy work and haulage. Having already pared back non-labour costs as much as possible during the recession, many business services contacts now felt that they would be forced to reduce staff numbers. And there was likely to be a further shakeout in the financial services industry. Consumer-facing firms were often already at minimum staffing levels. But store closures were expected to cause employment to fall, despite some job creation by the larger retailers.

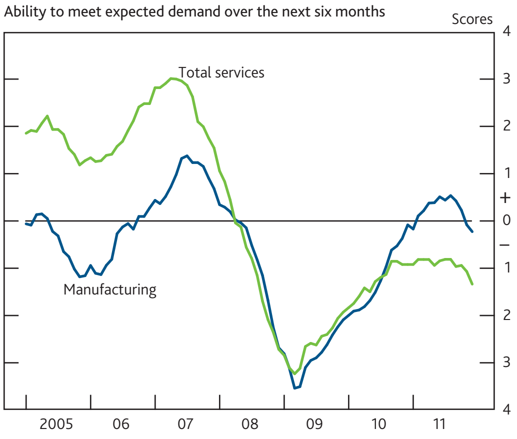
Chart 3 Employment intentions



Capacity utilisation

In the manufacturing sector, capacity utilisation had fallen back a little in recent months, due to past investment and recruitment, along with a slowing in the pace of growth of new orders (**Chart 4**). Capacity utilisation was generally highest among exporters, with those supplying households and the construction sector tending to exhibit much higher levels of slack. Some firms expressed concerns about supply bottlenecks, for example, due to shortages of hard disk drives following the flooding in Thailand, although the impact of this on output so far had been fairly muted.

Chart 4 Capacity utilisation



In services, slowing activity had caused spare capacity to begin to open up again, and flexible working arrangements were increasingly being used to adjust staffing levels quickly, to meet changes in demand. But further consolidation was thought to be required in a number of sectors. That was especially apparent in the intensity of competition in some legal and accountancy services, and among those supplying the construction sector. Consumer-facing businesses typically had ample scope to accommodate more customers, with staffing often already at minimum levels. Some firms were opening shorter hours, in response to softening demand, with store closures the last resort.

Costs and prices

Labour costs

The pace of growth of total labour costs had slowed a little over the past few months, reflecting weakening profitability, and a deterioration in the outlook, particularly among services firms. Settlements remained fairly modest, with the biggest increases tending to be concentrated among manufacturers, particularly exporters, or where there were shortages of particular skills, as in IT, for instance. Elsewhere, pay freezes had become more common. And there continued to be a general move away from across-the-board settlements to performance-based awards and bonuses. Looking ahead, many contacts expected settlements in the upcoming pay round to be at or below the percentage increases seen last year. Wage drift had eased, due to weaker growth in profits than expected this year and a fall in the use of overtime as the pace of growth had moderated. So far, the Agency Workers Regulations had not had much impact on the wage bill for most contacts, although it had caused a small increase in administrative costs for a few.

Non-labour costs

There had been a further slowing in the annual rate of inflation in raw materials costs. Recently the price of some inputs had even fallen, due to weaker world demand growth. For instance, cotton prices had fallen significantly from recent peaks, along with some metals and basic foods. More downward pressure was expected to come, given the deterioration in the outlook for global growth. But higher energy costs continued to feed through to businesses as contracts came up for renewal. Inflation in the price of imports remained elevated, in large part due to past increases in the cost of raw materials, as well as higher labour costs in a number of emerging market economies. Import price inflation was expected to fall back over the course of 2012, however, due to the slowing in the pace of increase in raw materials prices. A few contacts reported that the price of hard disk drives had risen sharply, due to supply shortages.

Output prices

Manufacturing output price inflation had yet to decline, despite some slowing in cost growth, as contacts continued to pass on some of the past increase in raw materials prices. But this was usually only partial. And a number of contacts, particularly producers of consumer goods, expected to come under pressure from the large retailers to pass on any recent reductions in input costs. Business services price inflation had softened in recent months, reflecting slowing activity, and more intense competitive pressures. And the effect of fuel escalator clauses was also beginning to drop out of the annual comparison, reducing inflation in charges for haulage, for example. That masked some differences between sectors, however, with niche service providers sometimes able to achieve increases in fees, while suppliers of staple legal and accountancy services often had to reduce their prices, or offer fixed charges for multi-year contracts.

Consumer prices

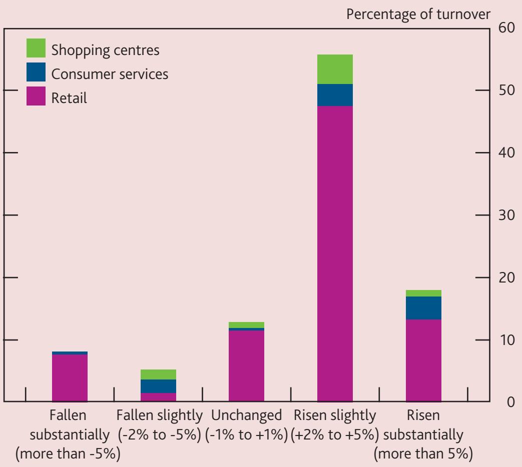
The rate of inflation remained elevated. Goods prices had been pushed up in large part by increases in VAT at the beginning of 2011, and higher energy prices. There had also been fairly sharp price rises for a range of essential services, including for transportation and rented accommodation, often linked to official measures of inflation. But there had been some moderation in the pace of increase in food prices, and there had been more aggressive discounting among retailers in the run-up to Christmas compared with last year, particularly for winter clothing lines, due to stock overhangs following unseasonably mild weather. Suppliers of non-essential services were also making more extensive use of promotions than in the past, with discounts increasingly used to get customers through the door.

Agents' survey on consumer spending over the Christmas period

The Agents contacted a broad range of retailers and leisure service providers in late December and early January to get a view of sales over the Christmas period. 225 businesses participated in the survey.

Weighting the responses by turnover, around 75% of those surveyed reported positive growth in nominal sales compared with a year earlier (**Chart A**). This was in part due to rising prices, as well as the relatively weak performance the previous year, when shoppers' plans were disrupted by extreme weather conditions during much of the Christmas trading period.

Chart A Value of spending during the Christmas trading period compared with a year earlier

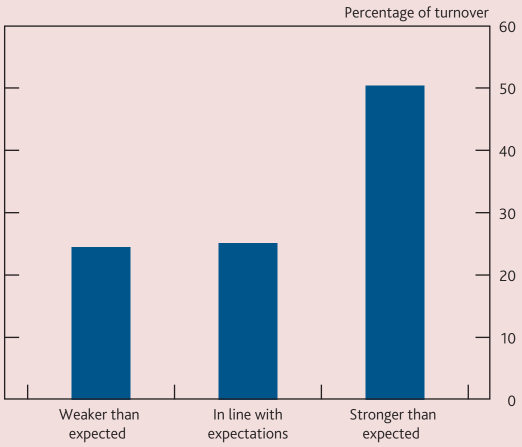


Contacts also thought that there had been a boost to spending this year because the timing of the holidays allowed for a full week of trading ahead of Christmas. And many reported a stronger online performance in 2011, perhaps because there was less concern among shoppers this Christmas that deliveries would be disrupted by the weather. Some of this was at the expense of in-store sales.

Three quarters of those surveyed, when weighted by turnover, also reported that their sales performance had been in line with, or above, expectations (**Chart B**). But expectations were often modest to begin with; a number of retailers reported that they had revised down their targets for Christmas, reflecting weaker than expected performance earlier in the year.

Respondents were also asked about the timing and magnitude of promotional activity. Contacts reported that discounting had begun earlier and had been deeper in 2011 compared with the previous year. In part, that was because the level of inventories had been relatively high going into the festive period. There was reported to have been excess stock of winter clothing and footwear, due to the mild weather, as well as an overhang of electrical and some other big ticket items. Once on promotion, surplus inventory fell quickly, with some retailers reporting record sales for the period either side of Christmas. But the extent of discounting meant that margins had been squeezed.

Chart B Value of spending versus expectations



Looking ahead, contacts were asked how they expected sales to go during the first quarter of 2012, compared with the same period a year earlier (**Chart C**). When weighted by turnover, responses to this question were broadly balanced. That suggested that turnover was expected to be broadly unchanged on a year earlier. Given increases in prices over the past year, that pointed to something rather weaker for the volume of consumption.

The mix of responses suggested that some firms expected to win market share at the expense of others. For instance, food retailers tended to be more optimistic than non-food retailers, while contacts within the consumer services industry were on balance slightly more positive than sellers of goods.

Chart C Expected change in spending in 2012 Q1 compared with a year earlier