BANK OF ENGLAND

Agents' summary of business conditions

March 2012

- Consumer demand continued to grow at only a gradual pace, although spending so far this year had been a little stronger than retailers had expected.
- There had been further signs of some improvement in housing market conditions.
- Investment intentions had risen a touch, but still pointed to only modest growth in capital spending over the coming year.
- Goods exports continued to grow steadily, but there had been some slowing in the pace of expansion in recent months.
- The rate of growth in business services turnover remained sluggish, with considerable variation across sectors.
- Manufacturing output continued to grow at a modest pace.
- The level of activity in the construction sector was slightly lower than a year earlier, in part due to a slowing in work for the public sector.
- There had been an increase in the number of contacts reporting that credit conditions had tightened, although for many firms the demand for loans remained fairly weak.
- Employment intentions pointed to broadly stable employment in the private sector over the next six months.
- Capacity utilisation in manufacturing was a little below normal, due to a slowing in demand growth in recent months and ongoing improvements in labour productivity. There remained rather more slack in services.
- The rate of growth of total labour costs had been fairly modest, with settlements in manufacturing typically higher than in services.
- Materials cost inflation continued to slow steadily. That was beginning to feed through to the prices of imports of finished goods, but had been offset, in part, by rising production costs in emerging markets.
- Inflation in manufacturing output prices remained elevated, but had slowed a touch, while there was renewed downward pressure on fees for many business services.
- Annual retail goods inflation continued to slow, and consumer services inflation had also fallen back slightly.

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 January 2012 and late February 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

Consumer demand continued to grow at only a gradual pace, although for many contacts spending since the start of the year had been a little more resilient than expected. Growth in goods volumes tended to be strongest in food, supported by widespread promotional activity, although households were increasingly trying to cut down on waste, buying smaller pack sizes and more frozen food, for instance. Sales of clothing had picked up, due partly to deep discounting to clear stock. And a period of particularly cold weather had helped to bolster sales of winter fashions.

Annual growth of spending on consumer services had also edged a little higher this month. That was in part due to rises in prices for certain essential services, such as transportation and rented accommodation. But the volume of spending on services had also risen a little, supported by promotional activity and discounting, which was becoming increasingly widespread. Households were also making greater use of public transport, reflecting the rising costs of private travel. Spending on leisure activities continued to be weak.

Housing market

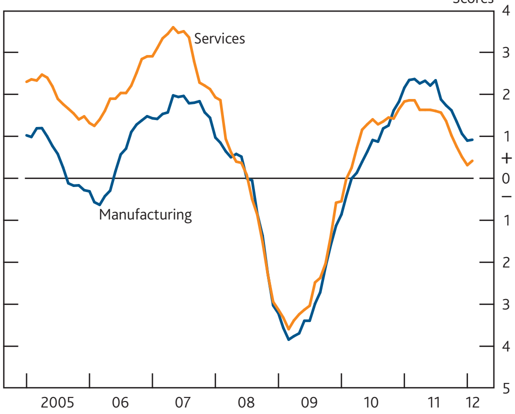
There had been some further improvement in the housing market, with fairly frequent reports of an increase in viewings, offers and transactions, although the level of activity remained low, and many areas had not seen a pickup. Part of the rise in demand was thought to be due to the approaching end of stamp duty relief for first-time buyers. And there had been some increase in the range of mortgages on offer, although many first-time buyers continued to find it difficult to save a deposit, having to rent instead. Buy-to-let investment had risen further, attracted by high rental yields, although some contacts reported that the pace of increase in rents had slowed as more supply had become available.

Business investment

Investment intentions appeared to have risen a touch, but still pointed to only modest growth in capital spending over the coming year (**Chart 1**). Most firms continued to undertake essential repair and replacement investment. And many were prepared to spend on projects that would generate fairly quick returns: efficiency gains through increased use of IT, or expansion through online marketing, for instance. Some investment which had been postponed due to worries relating to the euro area was also now back under way. Many exporters continued to invest in capacity to meet growing foreign demand, and a few businesses had been investing to bring parts of the production process back to the United Kingdom. In the service sector, intentions were strongest in growth industries, such as IT and energy-related consultancy. Investment plans elsewhere tended to be more modest, and were typically motivated by the need to generate

Chart 1 Investment intentions

Expected growth over the next twelve months



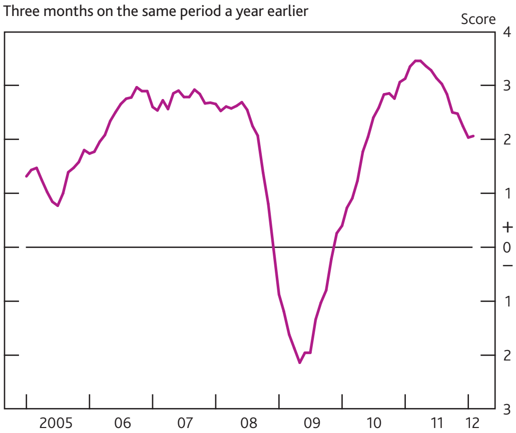
productivity improvements or to meet changing regulatory requirements.

Exports and imports

Goods exports continued to grow steadily (**Chart 2**), although the pace of expansion had been slowing in recent months. Some contacts suggested that destocking abroad, due to concerns about the euro area, had caused much of that slowing, and might now have run its course. Activity was typically most robust in emerging market economies. But the United States had shown some signs of improvement, and demand from Europe had not slowed as much as had been feared. A rising number of firms reported that they were expanding into new markets, or were exporting for the first time. This was the case in the service sector as well as manufacturing. Online fashion retail had been a particular source of growth, along with engineering, management and energy consultancy services.

Chart 2 Export volumes

Three months on the same period a year earlier



Firms were increasingly reassessing the costs associated with offshored production, reflecting a number of factors: concerns about quality; delays in deliveries; a rising preference for shorter production runs — which reduced the competitive advantage of high volume foreign suppliers; rising production costs abroad; and a greater awareness of the risk to supply chains following natural disasters last year in both Japan and Thailand. In some instances, firms were re-sourcing imports away from distant, low-cost, countries, towards countries closer to home, for example in the EU. Domestic suppliers were winning some of this business as well. And in some cases where there was no local supplier, firms were bringing production in-house altogether.

Output

Business services

The rate of growth in business services turnover remained sluggish, with considerable variation across sectors. Some sectors had benefited from the continued expansion of the manufacturing industry, for instance in haulage, while IT firms also continued to provide the expertise needed by a range of different businesses either to lower costs, or target the online market. By contrast, in areas of oversupply, such as standardised legal and accountancy services, growth in turnover was often reported to be slowing, with fees under renewed downward pressure. Uncertainty about the outlook had also led many businesses to look again for any scope to cut non-essential expenditure, with contacts in corporate hospitality and suppliers of business travel noting a slowing in activity. And a fall in work for the public sector was also being felt by some service providers.

Manufacturing

Manufacturing output continued to grow at a modest pace. For those in export supply chains, activity was often growing quickly, for instance in the medical and pharmaceutical and automotive industries. And some of those firms that had experienced a slowing in activity towards the end of last year, as customers ran down stocks, were now seeing that process unwind. A few firms also reported that output had been growing as a result of winning domestic market share at the expense of foreign competitors. But for businesses facing the domestic consumer, activity was typically weak. And those supplying the domestic construction and public sectors also reported that business conditions remained difficult.

Construction

The level of activity in the construction sector was slightly lower than a year earlier, in part due to a slowing in work for the public sector. Private sector activity had been fairly mixed. There was very little speculative office development outside London. And some of the large retailers had reduced their plans for expansion, due to both weakness in demand and the expectation that failures of other high street names would free-up space in the secondary market. But investment in rail and utilities, ports, the energy sector, and warehousing and distribution facilities continued to support activity. There had also been an increase in private house building, although reduced grants had lowered the amount of social housing under construction.

Credit conditions

There had been a rise in the number of contacts reporting an increase in spreads or fees when refinancing existing loans. And banks continued to encourage small businesses to use asset-backed forms of borrowing, rather than overdrafts. Business advisors suggested that some banks were averse to lending to smaller firms altogether, because of the high administrative costs associated with small loans. Some small companies were now seeking alternative sources of funding, such as 'angel finance', from wealthy individuals, or peer-to-peer arrangements. There had been a tightening in supply chain finance, and a few contacts had noted a rise in debtor days. Large firms and businesses with strong balance sheets typically had access to credit on reasonable terms, although many remained focused on paying down debt or stockpiling cash.

Employment

Employment intentions in the private sector pointed to stable employment over the next six months. In the manufacturing sector, some continued to plan to take on more staff to meet rising foreign demand, while others were holding off from further recruitment due to uncertainty about the outlook, or hoped to meet future demand growth through increased labour productivity. In business services, headcount was expected to continue to rise in growth areas, such as IT and energy-related consultancy. But past labour hoarding in some sectors, such as law and accountancy, and property, along with a further softening in expectations for activity in recent months, had led some contacts to revise their staffing needs downward. For businesses facing the consumer, firms with scope to lower headcount typically planned to do so, while others were making more use of flexible working practices, reducing opening hours or closing under performing stores.

Capacity utilisation

Capacity utilisation in manufacturing was a little below normal, having fallen back from slightly above normal over recent months (**Chart 3**). That was partly due to a slowing in the rate of growth of demand, and also due to past recruitment and investment — and consequent increases in the total capacity available. Some firms, exporters in particular, were operating at full capacity however, and even with additional investment in capital would probably find themselves constrained by staff shortages. In contrast, firms supplying the domestic household and construction sectors often exhibited significant amounts of slack. Businesses in the service sector typically had more spare capacity than manufacturing firms, but there were signs of staffing constraints developing in IT, reflecting continued rapid growth in the industry. In the consumer sector, firms were increasingly

Chart 3 Capacity utilisation

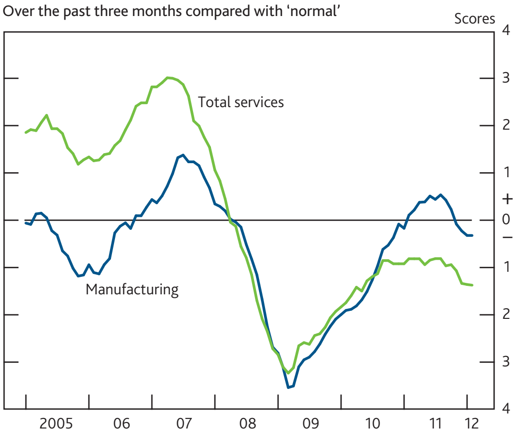
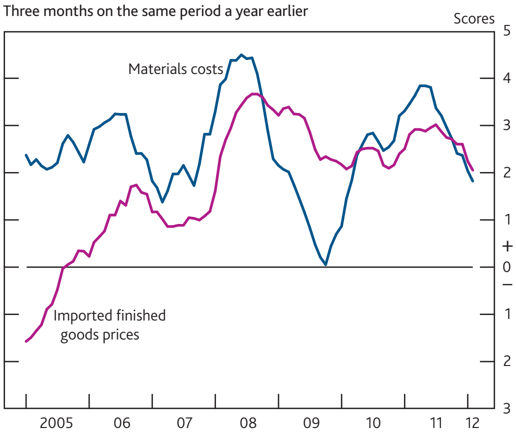


Chart 4 Input cost inflation



using flexible working practices to try to tailor labour input to match changes in demand.

Costs and prices

Labour costs

The rate of growth of total labour costs remained fairly modest, with an increased sense of caution holding back pay increases in some sectors. Settlements in manufacturing were typically stronger than in services, particularly for engineers, reflecting rises in both profitability and labour productivity. In the service sector, upward pressures on pay were generally quite muted, reflecting weaker activity, and pay freezes had once again become common, especially in areas where staff tended to be underemployed, such as standardised legal and accountancy services, and in property related businesses. There were still some areas where pay was growing rapidly, however, for instance in IT. Across sectors there had been an increase in the use of performance-related pay and bonuses, in order to better match labour costs to activity, although the size of bonus payments had tended to be lower than a year earlier.

Non-labour costs

Materials cost inflation had edged down a little further, with a slowing in the pace of increase in the prices of a range of basic materials — food, cotton, and steel for instance (**Chart 4**). But the use of forward contracts meant that this would take some time to feed through fully to the prices paid by firms, and higher energy costs were still being felt as long-term contracts came up for renewal. Rising fuel costs were also a significant source of cost increases for contacts in transport sectors, such as haulage and travel. And some contacts expressed concern about the impact of renewed upward pressure on oil prices on various oil-based materials. Inflation in the price of imports of finished goods had begun to slow over the past few months (**Chart 4**), reflecting the moderation in the pace of increase in materials costs, as well as a marked decline in the cost of shipping and a stronger sterling exchange rate. But production costs continued to rise rapidly in some emerging market economies, leading some firms to try to resource supplies from elsewhere, or even bring production in-house.

Output prices

Manufacturing output price inflation remained elevated, but had slowed a touch recently. Many contacts continued to pass on past increases in input costs, or were trying to hold on to cost reductions, in order to claw back lost margin from earlier rises in costs which had not been passed on. These efforts were met with varying degrees of success, however, with those firms supplying sectors where final demand remained weak tending to struggle to achieve any increase in price. But suppliers of some niche products were often able to pass on much of any increase in costs. In the service sector, specialist service providers, in IT, for instance, were typically able to raise prices, reflecting strong demand. But the weakness of demand for many business services had put downward pressure on fees, particularly in areas of oversupply such as corporate hospitality and standardised professional and financial services.

Consumer prices

Annual inflation in consumer goods prices had slowed further on the month, reflecting the past increase in VAT falling out of the annual comparison, as well as recent reductions in the cost of some utilities. There had also been some downward pressure on food price inflation, in part due to increased competition among some of the large supermarkets. Inflation in the price of clothing was expected to moderate going forward, reflecting the decline in the cost of cotton compared with a year earlier. Consumer services price inflation remained elevated, although it had fallen back slightly. For essential services, many businesses continued to raise prices, for instance for telephony and insurance. Rents and fares for public transport had also risen due to indexing to official measures of inflation. Household demand remained very sensitive to changes in the price of many discretionary services, however, tending to prevent firms from achieving significant increases.