BANK OF ENGLAND

Agents' summary of business conditions

March 2013

- Annual growth in the value of retail goods and services was reported to have remained modest.
- There had been further signs of an increase in housing market activity, supported by reductions in mortgage costs. Some contacts thought that the effects of the Funding for Lending Scheme (FLS) had become more evident on the pricing and availability of higher loan to value ratio mortgages.
- The cost of credit was reported to be falling for some firms, though not for many smaller companies. Improvements in credit availability remained mostly confined to larger businesses and credit demand remained weak.
- Investment intentions had edged higher, which was said partly to reflect improved confidence amid diminished uncertainty about the near-term global outlook.
- Growth in exports of goods had edged up and perceptions of the outlook for export demand had improved.
- Manufacturing output for the domestic market remained slightly lower than a year earlier, though forward-looking sentiment had improved.
- Output of business services had ticked up, with some increase in mergers and acquisitions and financial market activity.
- Construction output remained subdued, though there were reports of a slight strengthening in private homebuilding activity by larger firms.
- Employment intentions had edged higher in business services but were broadly flat for manufacturing, consistent with the pattern of output in those sectors over the past year.
- Capacity utilisation remained a little below normal. There were few reports of recruitment difficulties outside of information technology and engineering.
- The rate of growth in labour costs per employee remained subdued, though some firms reported increasing pension costs.
- Inflation in material costs and finished import prices was unchanged.
- Output price inflation remained muted.
- The rate of inflation in retail goods and services prices had edged 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 January 2013 and late February 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

Retail sales values were reported to have risen only modestly in the past three months, relative to a year earlier, with growth often reported to reflect price increases rather than volumes. Some contacts reported that adverse weather in late January had a slightly negative impact on sales overall. More generally, the picture of mid-market retailers being squeezed by discount and higher-end outlets continued, while out-of-town and online sales were benefiting at the expense of local stores. One area of continued strength had been new car sales, though some contacts noted that some of those gains had partly come at the expense of second-hand sales. Growth in consumer services demand also remained modest, and had also been affected by poor weather, though there were continued reports of 'bigger-ticket' services — such as foreign travel — outperforming the wider market. There were also a number of reports of some housing market services — including estate agency and mortgage brokerage — starting to experience a pickup.

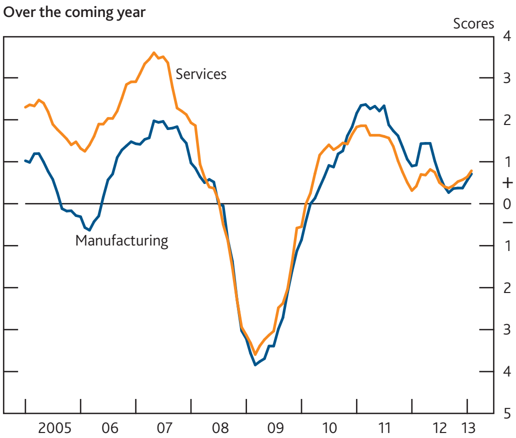
Housing market

There were further reports from housebuilders and estate agents of signs of a gradual increase in housing market activity, both for new home sales and secondary market transactions. That was reported to have reflected falls in mortgage rates and an improvement in mortgage availability, as well the effects of specific incentive schemes for home ownership. The easing in credit conditions was feeding through to higher loan to value mortgages more widely than before, though conditions for first-time buyers remained difficult. Some contacts saw that demand and supply in the housing market had become more balanced in recent months. Demand in the private rental market had remained strong.

Business investment

Investment intentions for the coming twelve months had edged higher for manufacturing and services (**Chart 1**).

Chart 1 Investment intentions

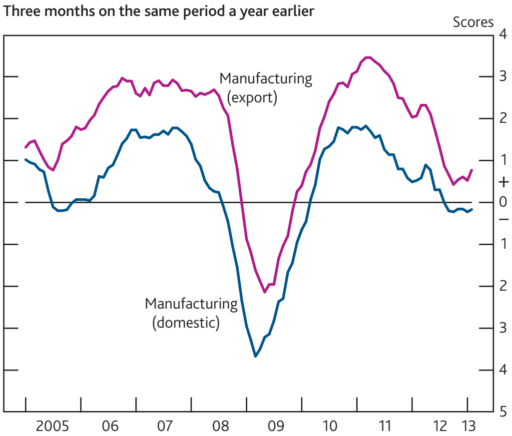


Uncertainty about near-term demand had fallen back as concerns about the global outlook had lessened, providing a more stable platform for investment. Nonetheless, concerns about the wider macroeconomic environment remained high and investment was often 'incremental' — seeking to improve efficiency rather than to expand capacity. Increasing investment was often reported in IT, in part to expand and develop 'online' activities. Investment had remained relatively strong in those companies in or closely linked to the energy and utilities sectors, and weak in consumer-facing products and heavy construction sectors.

Exports

Manufacturing exports (**Chart 2**) were reported to have gently picked up, as a result of gains in market share and some strengthening in global demand outside of the euro area, and contacts' perceptions of the outlook for export demand had improved. Some services exporters had seen a similar pattern with, for example, reports of increased exports in architectural and engineering consultancy due to growth in the emerging economies. More generally, growth was reported for those companies manufacturing for, or servicing the production of, energy overseas. As yet, effects from the recent depreciation of sterling were limited to removing concerns that were beginning to emerge last autumn that some multinationals might switch production back to continental Europe.

Chart 2 Manufacturing output



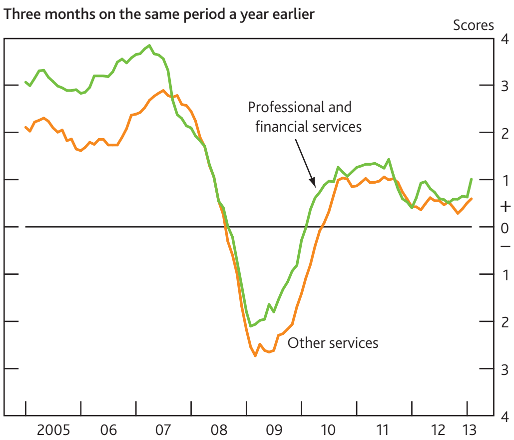
On the imports side, increasing Chinese labour costs, higher freight costs and an appreciation of the renminbi were leading to a continued shift in sourcing towards other markets, both in Asia and closer to home — including, in some cases, back to domestic markets. More generally, a slow stream of production switching back to the United Kingdom continued to be reported following sterling's 2007/08 depreciation, but against the backdrop of an ongoing structural shift of domestic lower-value work to cheaper markets overseas. There were continued reports of greater import competition from euro-area companies due to overcapacity in their domestic markets. Poor UK harvests were said to be leading to an increase in food imports.

Output

Business services

Turnover was reported to have strengthened a little for professional and financial services (**Chart 3**), partly related to an improvement of global sentiment in the absence of adverse shocks. According to some contacts, a period of stability had encouraged a slight pickup in corporate mergers and acquisitions activity, raising demand for advisory work for larger accountancy and legal services firms. Inflows to asset management had picked up, as had trading activity. Separately, some growth in consultancy work was also reported, reflecting companies' efforts to reposition themselves strategically, review product ranges, or cut costs; IT consultancy was a particular area of strength as companies updated systems, moved online or adopted mobile platforms. Commercial property related work had also picked up, albeit in some cases because tighter regulatory requirements were leading banks to seek more valuations or reduce forbearance, leading to new transactions. But many smaller professional services firms had not experienced a pickup in activity. And other business services turnover was reported to have remained subdued, with companies continuing to exert tight control over discretionary expenditures such as corporate hospitality, conferences and business travel.

Chart 3 Business services turnover



Manufacturing

Manufacturing output for the domestic market was reported to have remained slightly lower than a year earlier (**Chart 2**), though some reduction in global uncertainty had improved sentiment among companies in export supply chains. Areas of growth within the sector included those related to utilities and oil and gas production, aerospace, luxury and fuel-efficient cars and high-tech electronics. But output among manufacturers of many consumer goods, heavy construction goods and paper and newsprint was weak. As yet, little impact was reported on food production from the horsemeat furore, though it was too early for contacts to draw firm conclusions about the longer-term effects.

Construction

Output remained lower than a year earlier. Some large infrastructure projects were reported to be providing support to the sector, notably in the rail and energy sectors, but elsewhere weak publicly funded and private sector commercial construction continued to act as a drag on activity. There were reports of a slight strengthening in private homebuilding activity by larger firms, though many smaller firms reported their activity remained credit constrained. Some contacts also noted that changes in permitted development rights might encourage the conversion of commercial space for residential use. Social housing activity was reported to have remained weak, though some mitigation of funding difficulties for social housing might allow for an increase in activity in that sector over the short to medium term. Plans for some major regeneration and infrastructure projects had progressed further, though the effects of those would largely be felt in years to come.

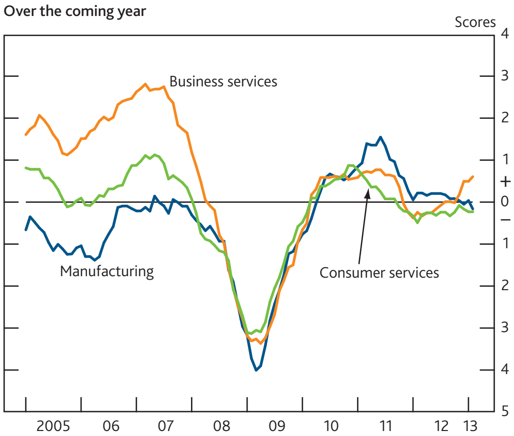
Credit conditions

The cost of credit had fallen for many companies, though this was yet to generate any material increase in lending. Falls in loan pricing would take time to feed through to actual borrowing costs as existing lending was reviewed and repriced gradually over time. And banking contacts reported that some smaller companies might not see lower costs because lenders were seeking to increase the differentiation of loan pricing across the small and medium-sized enterprise sector. Smaller companies and firms in those sectors perceived to be of higher credit risk were yet to report any material increase in credit availability or in banks' risk appetite. More generally, bank lending for new activities or expansion was reported to be much harder to find than funding for 'business as usual'. The availability of non-bank finance also appeared to be easing further, as reflected by very recent evidence of an improved functioning of the initial public offering (IPO) market. Demand for bank lending was still reported to be weak, with many companies looking to reduce debts or build up cash reserves. While that often reflected precautionary motives, in a gradually increasing number of cases contacts reported accumulating cash for potential future investment or acquisitions activity. There were continued reports of a decrease in forbearance by banks on commercial property lending.

Employment

Employment intentions in business services had continued to rise slightly (**Chart 4**). That primarily reflected developments in professional and financial services, where there had been some increase in business turnover. Plans for increased employment often focused on firms that were winning or attempting to win market share, for example through looking to invest in staff to cover new specialisms, while those companies that were losing market share were slow to adjust employment levels downwards and lose specialist staff. In slight contrast, consumer services employment plans were stable. Manufacturing employment intentions had also remained broadly flat, with current workforces seen to be consistent with expectations of gently rising output to come. Recruitment difficulties had continued to be limited, though skills shortages were said to be increasing in IT, with some companies said to be actively recruiting abroad for specialists. The availability of engineering skills remained tight, though there were some reports of an increasing use of apprenticeship schemes starting to mitigate constraints in some areas.

Chart 4 Employment intentions



Capacity utilisation

Capacity utilisation had remained a little below normal in both manufacturing and services. Within manufacturing, some tightness was reported in high-tech engineering, luxury car supply chains and aerospace, with the degree of slack reported to be greatest for consumer and heavy construction products and printing, mirroring the pattern of demand. Within business services, professional services reported only limited amounts of spare capacity, though the picture often remained one of staff working hard to maintain output in an environment of weak demand, and there were continued reports of gradual consolidation in the sector. Spare capacity remained most obvious in the retail and heavy construction sectors, reflected in a gradual closing of unprofitable stores in the former, and some increased reports of mothballing of capacity in the latter.

Costs and prices

Labour costs

The annual rate of growth in labour costs per employee had remained subdued. Wage inflation had remained low, with increases in pay typically related to company performance and individual merit, rather than general labour market pressures. Pension costs were reported to be increasing, in part reflecting auto-enrolment, which involved some set-up costs and ongoing contributions that were expected to rise over time. In addition, legacy liabilities for some firms with defined benefit schemes were said to have increased following triennial revaluations. There were mixed reports about the size of companies' expected bonus payments, but in the financial sector these were expected to be significantly down on last year.

Non-labour costs

The rate of inflation in materials costs and imported finished goods prices was reported to be unchanged. Costs continued to be driven up by energy price rises and the effects of earlier agricultural commodity price rises, both directly and indirectly through the effect on other goods. Some contacts reported that sterling's recent depreciation had started to put upward pressure on costs and would feed through with the usual lags due to hedging and forward purchases. Those factors had been offset in part by a weakening in some other input prices, including steel, newsprint, timber and some packaging. Contacts also noted continued upwards pressure from Chinese wage inflation and shipping costs, partly offset by re-sourcing to countries that had a lower cost base or were closer to home, with some contacts seeking UK suppliers.

Output prices and margins

Manufacturers' and business services output price inflation was little changed, remaining muted. Some manufacturers were passing through input price rises by less than their full extent. Excess capacity and increasingly open procurement were bearing down on business services prices, though there had been a slight increase in reports of professional services firms being able to pass on wage rises to fees. Some commercial property rents were reported to be flattening after a period of decline. Margins were reported to remain tight for manufacturing and services companies, though downward pressure had abated for some professional services firms as demand for more complex advisory services had started to climb.

Consumer prices

The annual rate of consumer price inflation was reported to have edged up for goods and, to a slightly greater extent, for services. The slight increase for **goods** price inflation was said to reflect higher fuel, food and alcohol prices. Some contacts expected food prices to rise further, as limits to discounting led to a fuller pass-through of price increases in the supply chain. However, inflation in household goods was subdued, with some contacts reporting that prices for clothing, footwear and furniture were little changed on a year earlier. In services, some contacts reported an increase in administered prices in public transport, though those prices determined by a mark-up on retail price inflation were increasing at a slower rate than a year earlier. There were also reports that food and alcohol price increases were being passed through — at least in part — in restaurant and bar prices, and that higher fuel costs were coming though indirectly. Against that, insurance premia were said to be falling due to pressure from online comparison sites.