BANK OF ENGLAND

Agents' summary of business conditions

April 2011

- The growth rate of nominal spending on retail goods slowed, while goods price inflation continued to rise.
- Growth in spending on consumer services remained weak.
- Activity in the housing market appeared to have softened slightly, although there had been a slight increase in demand for newly built homes.
- Investment intentions suggested that growth in capital spending was likely to strengthen a little further over the next twelve months.
- Emerging market demand continued to support growth of exports of goods, and demand from Europe and the United States was beginning to pick up.
- Domestic demand had provided only a modest spur to manufacturing output growth.
- The underlying level of activity in the construction sector remained weak.
- There had been a further rise in employment intentions in manufacturing and business services, but intentions had dipped for consumer-facing firms.
- The level of capacity utilisation was broadly normal in the manufacturing sector, but there was still significant slack in the service sector.
- Total labour costs had been growing at a moderate pace, and the Agents' scores had drifted a little higher on the month.
- Inflation in the prices of raw materials had picked up further, adding to the upward pressures from rising foreign wages on the cost of imported finished goods.
- Output prices in manufacturing had risen somewhat in response to rising costs, but for business services they were broadly flat compared to a year earlier.
- The rate of inflation in both consumer goods and services was above its historical average, reflecting the recent increase in VAT, and the rising costs of imports, raw materials and fuel.

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 February 2011 and late March 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.**

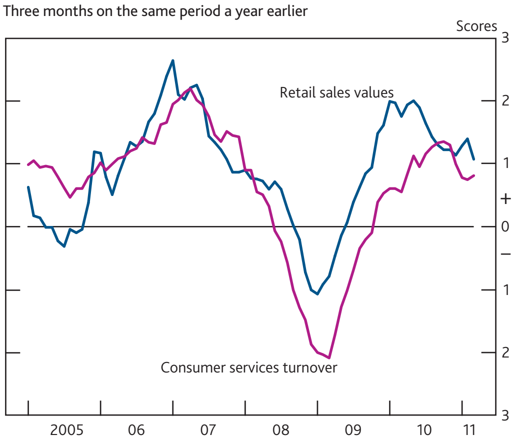
Demand

Consumption

The Agents' score for nominal spending on retail goods fell in March (**Chart 1**). Against a backdrop of rising inflation, that suggested slowing growth, or even declines, in volumes compared to a year earlier. Within that, there had been a fall in the growth rate of spending on durables and the shift towards consumption of lower-quality products had continued. Contacts attributed these trends to falling confidence among households, and the effect of high inflation on real spending power. And the outlook for consumption was thought to have weakened. There were, however, some reports of rising spending on premium brands of food, retail goods and cars.

Chart 1 Retail sales values and consumer services turnover

Three months on the same period a year earlier



As with consumer goods, there had been an ongoing trend towards spending on cheaper consumer services. Dining out in restaurants had declined but demand for fast food continued to strengthen. And there was some evidence of a switch away from the use of private cars toward public transport. More generally, spending on non-essential services was thought to have fallen. For instance, hotel bookings were down compared to last year, and were being made much later. But, as with goods, there were some signs that spending on services at the expensive end of the spectrum had strengthened.

Housing market

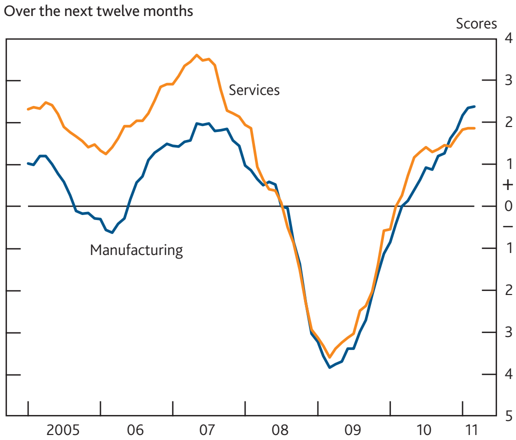
Having received mixed signals about the strength of activity around the beginning of the year, contacts now reported that there had been a softening in the housing market. Concerns about future incomes and the prospects for house prices were weighing on demand, while first-time buyers remained constrained by a lack of credit. The re-emergence of buy-to-let investment was helping to support demand, however. There were signs of a fall in supply of existing homes onto the market, as vendors had become more cautious. In the market for newly built homes, there was reported to have been a slight improvement in activity, with enquiries and sales having picked up a little. That was thought to reflect a change in the mix of the supply of properties toward the type of larger homes sought by households with access to finance.

Business investment

In the service sector, contacts expected investment to continue to grow at a moderate pace (**Chart 2**). That was in large part due to spending on IT to reduce costs, or improve on-line presence. In the financial sector, firms were also investing to meet coming changes to regulatory requirements. There had been a slight slowing in the pace of expansion of some of the large retailers and budget hotel chains. But retailers were investing more in warehousing and distribution facilities.

Chart 2 Investment intentions

Over the next twelve months



In the manufacturing sector, intentions suggested that growth in investment would be a little more robust than in services. That was particularly true of the export sector, where there were further reports from firms that planned to expand capacity to meet rising foreign demand. There were also continued reports of new product development to target rapid growth markets. Investment among firms facing the domestic market was more likely to be motivated by efforts to find efficiencies, perhaps by reducing energy costs, or resuming routine replacement and maintenance projects that had been on hold.

Exports

Exports of goods continued to grow quickly, with the Agents' score rising further on the month. This was driven by rapid growth of demand in emerging markets, along with strengthening activity in parts of Europe and in the United States. Exports of capital goods had been growing particularly strongly reflecting the mix of world activity, with the aerospace, automotive, energy and construction sectors providing much of the impetus. Some contacts among smaller firms reported that they were unable to target growth markets, however, because of the high initial cost of entry, and significant attendant risks. Civil unrest in the Middle East and North Africa had, in some instances, led to a hiatus on spending for certain professional services. But for most exporters, it remained too early to say with confidence what the overall impact on demand would be. See the box on page 5 for the findings of a survey by the Agents on imports.

Output

Business services

There had been a gradual improvement in the growth rate of turnover in professional and financial services. Reports of a modest rise in accountancy and legal work reflected, in part, an increase in mergers and acquisitions activity. Property leasing had picked up a little, as firms felt better placed to make longer-term decisions on office space. And the IT sector continued to benefit from the efforts of firms in the wider economy to achieve efficiencies. But a fall in public sector work had offset much of the improvement from the private sector.

Similarly, in other business services there had been some improvement in activity in corporate travel and among hoteliers and providers of corporate conferencing facilities. But there were widespread reports of a fall in supply to the public sector. Contacts at ports reported a rise in shipments of goods, which might have been a function of the strength of the export sector. And hauliers continued to benefit from the growth in manufacturing output.

Manufacturing

Foreign demand was helping to support domestic suppliers of intermediate and capital goods to the export sector, particularly in the aerospace and automotive industries. Businesses that ultimately served the domestic market were growing at a more modest pace. And there were some reports from suppliers of consumer goods of a slowing in the rate of growth of output, with some unplanned build up of stocks as a result. Across the manufacturing sector, despite rising output and fairly strong order books, contacts remained uncertain about the outlook for growth. Some considered their own positive experience unrepresentative, or were downbeat because of the pressure on household spending power.

Manufacturing output was expected to exhibit a little more volatility than usual over the coming months. Following the Japanese earthquake, some manufacturers that depended heavily on components from Japan had slowed production to conserve inventories. The full effect on output would likely take some time to be felt, as it worked its way through the supply chain. But, so far, the impact on output for most contacts had not been significant. The royal wedding in April was also expected to generate some unevenness in monthly growth rates, as firms rescheduled production to make up for lower output during the week of the event. The impact on output over the second quarter as a whole was expected to be limited.

Construction

The level of construction activity remained relatively subdued. There had been a small increase in commercial projects in the capital, but outside of London there was little speculative commercial development underway. There had been some increase in activity from exporters seeking to refurbish premises, or move into larger ones, as well as some projects related to renewable energy and infrastructure. And there had been a small rise in house building, albeit from a very low level. A slowing in the pace of expansion of retailers was expected to exert a drag on the rate of growth in construction, but there was increased work on warehousing and distribution facilities. The very negative outlook for public sector work continued to weigh heavily on sentiment in the industry.

Credit conditions

Large firms continued to report that they had access to credit if required. And competition had lowered the cost of borrowing further, although credit spreads were still high compared to prior to the recession. Contacts among some small and medium-sized companies with significant holdings of assets and strong cash flow had also seen an improvement in credit conditions. But many small and medium-sized firms remained frustrated with their current banking relationships, and some were planning under the assumption that they would not make use of bank finance in the medium term.

Employment

According to contacts in business services, hiring was expected to continue, albeit at a rather slower pace than prior to the recession. Firms in the IT and engineering advisory sectors planned to raise headcount further. And accountancy and legal firms intended to take on more graduates over the coming year. Services firms related to the construction sector were more pessimistic about employment, however. Among consumer-facing firms, there was expected to be only a small increase in jobs over the next twelve months, despite the continued expansion of some of the larger retailers, and the Agents' score had edged down further.

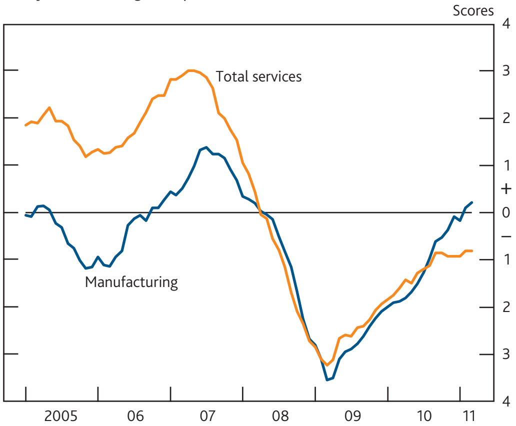
Contacts in the manufacturing sector also expected to continue to recruit more staff over the next six months. Much of that would be under temporary contracts in the first instance. But there were a number of reports of existing temporary and part-time staff having been converted to permanent and full-time contracts, as firms had become more confident in their own prospects. Concerns about skills shortages in the sector had re-emerged, and the pace of expansion was such that there was thought to be a greater risk than usual that this constraint would become binding. As a result, a number of firms had started to make more use of apprenticeship schemes.

Capacity utilisation

For most manufacturers, the level of capacity utilisation was thought to be broadly normal (**Chart 3**). But there were further reports from exporters who were now approaching uncomfortable levels of capacity utilisation, and were investing in additional capacity in response. There were also reports of shortages of raw materials and components in some sectors, due to global supply problems. It remained unclear to what extent the earthquake in Japan might add to these. There continued to be a substantial amount of slack in services, leading to strong competition in some sectors.

Chart 3 Capacity utilisation

Ability to meet change in expected demand over the next six months



Costs and prices

Labour costs

Labour costs in the manufacturing sector had picked up a little, to around the pre-recession growth rate. Average settlements had risen due to improved profitability, and recognition of past wage restraint. There had been fewer instances of pay freezes, and more reports of above-average settlements among some of the more rapidly growing exporters. Overtime and bonuses had also risen compared to last year. The rate of growth of total labour costs in services remained rather slower than in manufacturing. Contacts attributed that to the still-significant amount of slack in the sector, as well as continued job insecurity. Across manufacturing and services there had been a degree of compensation for increases in the cost of living.

Non-labour costs

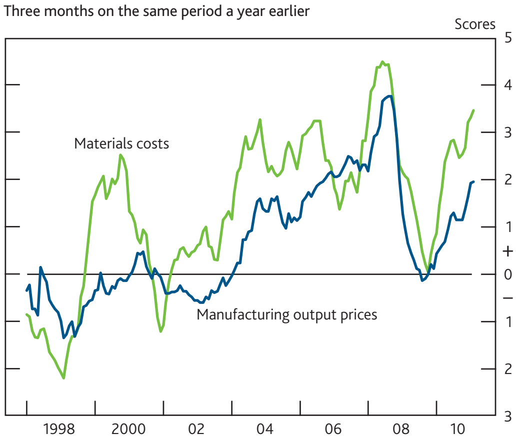
Contacts reported that inflation in the cost of raw materials had edged higher (**Chart 4**). Suppliers of a range of materials were now only offering indicative prices for forward delivery, or were only entering into very short-term contracts. And civil unrest in the Middle East and North Africa had pushed up the cost of oil. There were few reports of additional pressures on prices arising directly from the Japanese earthquake, though the full implications of the disaster remained unclear. Inflation in the cost of materials and transportation, and higher wage costs for suppliers in some emerging markets had added to the cost of imports of finished goods.

Output prices

Contacts reported that manufacturing output prices were rising at a moderate pace (**Chart 4**). Manufacturers had managed to pass on some of the increase in the cost of inputs, and had begun to reprice outputs more frequently to reflect changes in costs. But food manufacturers continued to find it difficult to negotiate price increases with supermarkets. The competitive environment in professional and business services continued to exert downward pressure on fees, especially for standardised legal and accountancy work, and for firms related to the construction sector. Some specialist professional services had managed to raise their prices, however. And firms in haulage, distribution and transportation had also had some success in passing on the higher cost of fuel, often through automatic surcharges.

Chart 4 Material costs and manufacturing output prices

Three months on the same period a year earlier



Consumer prices

Contacts reported that consumer goods price inflation remained elevated, and had risen slightly on the month. The Agents' score for the past three months compared to the same period a year earlier had been pushed up by the recent increase in VAT, as well as the higher cost of materials, imported finished goods and fuel.

In consumer services, the rate of inflation remained around its historical average. Higher fuel costs had pushed up private and public transport costs. And the price of car insurance had also risen very sharply compared with a year earlier. But charges for non-essential services had been rising less quickly. There had been considerable discounting in the leisure sector and for hotel rooms, to try to boost demand. And some restaurateurs reported that there was little scope left to adjust menus to avoid passing on cost increases.

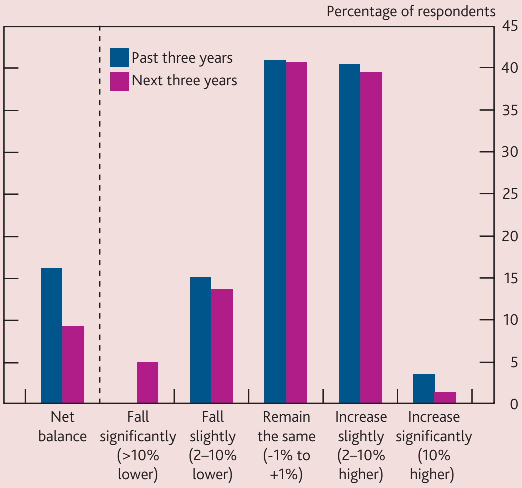
Agents' survey on Imports

The value of sterling declined significantly from around the middle of 2007, raising the price of foreign goods and services compared with domestically produced ones. An important influence on the strength of the recovery has been the extent to which the lower level of the exchange rate has led to switching of expenditure away from relatively more expensive imports, toward domestic alternatives.

To investigate the factors influencing imports, the Agents asked contacts about changes in the share of imported inputs over the past three years, and the drivers of those changes. The Agents also asked about expected changes over the next three years. The results of the survey are weighted by turnover and import intensity of production.

Imports of intermediate goods and services, which firms use in the production process, or to support operational activities, comprise around 60% of imports. A substantial majority of firms reported that since the depreciation, the share of imported intermediates in total non-labour inputs had remained broadly the same, or increased slightly (**Chart A**).

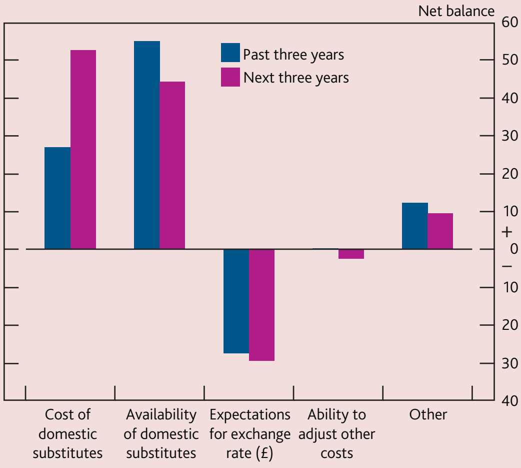
Chart A Past and expected changes in input share of imports of intermediate goods and services



In many cases domestic substitutes were still considered uncompetitive (**Chart B**). Or there simply were no domestic substitutes to switch to. Among the other factors affecting import intensity of production were the use of global procurement practices by international firms, and the cost of switching towards domestic producers.

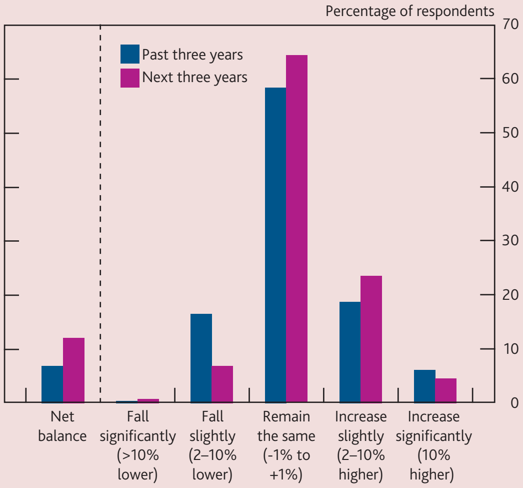
The net balance of firms expecting the input share of imports to rise over the next three years remained positive, although there was a slight shift in the distribution of responses toward firms that expected it to fall.

Chart B Factors exerting upward pressure on input share of imports of intermediate goods and services



Turning to finished goods and services, which account for around 30% of imports, a majority of respondents reported that there had been no change in import penetration over the past three years (**Chart C**). The relative cost of domestic alternatives and outright lack of supply were the dominant drivers.

Chart C Past and expected changes in input share of imports of finished goods and services



Imports of finished goods were expected to become less competitively priced over the next three years, due to rising labour costs in some emerging economies, and higher transport costs. Nevertheless, over that time horizon, there was a small rise in the net balance of firms expecting an increase in the intensity of use of imported finished goods, as firms planned to re-source inputs from other low-cost overseas producers, instead of repatriating production.

Basic materials, which include energy, make up the remainder of imports. Import intensity had risen since the depreciation, but there was only a small positive net balance expecting further increases going forward. Lack of availability of domestic substitutes was the overriding influence.