BANK OF ENGLAND

Agents' summary of business conditions

April 2010

- Consumer spending growth had softened slightly relative to the rates recorded at the end of 2009.
- The imbalance between demand and supply in the housing market had corrected further. House prices, which had been rising for a number of months, appeared to have stabilised.
- Investment intentions had picked up a little, but remained subdued.
- Export growth had continued to recover gradually.
- Business services output was reported to have picked up, mainly reflecting stronger demand for professional and financial services. Manufacturing output had continued to recover gradually, mainly reflecting stronger exports.
- By contrast, output in the construction sector remained depressed.
- The availability of bank lending had improved a touch. Competition in the banking sector was reported to have increased, as some foreign banks had entered, or re-entered the market.
- There remained a significant margin of spare capacity in the economy, which could be mobilised relatively quickly were demand conditions to warrant it.
- Employment intentions had remained stable. Few businesses were planning to increase headcount, but most major redundancy programmes appear to have been completed.
- Pay pressures remained muted, but reports of pay freezes had become less widespread than in 2009.
- Non-labour costs had continued to rise, reflecting increases in metals prices and transport costs. Imported finished goods prices had also picked up a little.
- Consumer price inflation had stabilised. Contacts reported that the rise in VAT had now been passed through by the majority of those planning to do so.

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 2010 and late March 2010. 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.

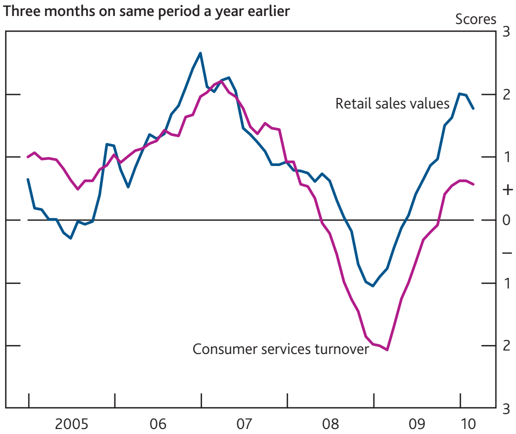
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the Inflation Report, obtained from: **www.bankofengland.co.uk/publications/inflationreport/index.htm.**

Demand

Consumption

The Agents' sense was that annual retail sales values growth had softened slightly and that spending on consumer services had also flattened off (**Chart 1**). But contacts had continued to find it hard to ascertain the underlying trend in consumer spending. The rise in VAT may have boosted spending in 2009 Q4 at the expense of 2010 Q1. And both changes in the pattern of discounting and the inclement weather (in early 2010 and in February 2009) had made interpreting annual comparisons difficult. Looking ahead, retailers thought that both announced and expected tax increases, coupled with the possibility of a further reduction in employment (particularly in the public sector) would weigh on consumer spending.

Chart 1 Retail sales and consumer services



Sales of new cars had been strong over the past year, reflecting the substantial boost provided by the car scrappage scheme. Although the scheme's expiry at the end of March had given rise to some concerns of a sharp fall in car sales, a number of contacts were less pessimistic. Some dealers had introduced promotional schemes of their own to smooth the adjustment. Others thought that the scheme had not simply brought forward planned expenditure, and so were more sanguine about the outlook for sales over the remainder of 2010.

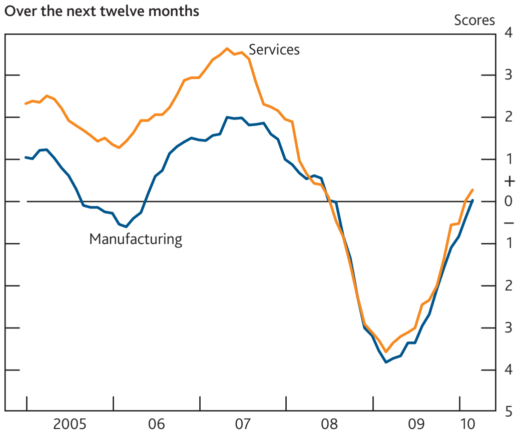
Housing market

The lack of mortgage finance, particularly at higher loan to value ratios, had continued to deter potential homebuyers. A slight increase in new instructions had, however, reduced the imbalance between demand and supply. As a result, the Agents' sense was that house prices, which had been rising in recent months, had stabilised.

Business investment

Investment intentions remained subdued — the Agents' scores (**Chart 2**) suggested that the monthly flows of spending over the coming year would be close to those seen in recent months. The wide margin of spare capacity, tight credit conditions and uncertainty about future demand and plans for public spending and capital allowances had continued to restrain investment plans.

Chart 2 Business investment intentions



Set against that, however, there have been tentative signs that some businesses were considering resuming routine maintenance work, or increasing investment to improve productivity and reduce costs. And a few contacts had considered investing in new products, in preparation for an upturn in demand.

Exports

Looking through the impact of the inclement weather, export sales were reported to have risen only gradually during early 2010. Although external demand had continued to pick up, that mainly reflected growth in Asian markets, which account for only a small share of total UK exports. Demand in the United Kingdom's main trading partners — the euro area and the United States — remained subdued.

Inventories

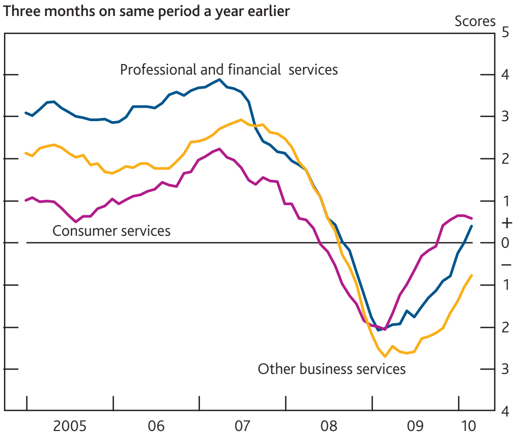
The majority of contacts reported that reductions in inventory levels had been largely completed by 2009 Q4, following rapid de-stocking earlier in the year. Concerns about the pace of the recovery in demand, along with restricted access to finance and the importance of preserving cash, were expected to keep stocks low relative to sales.

Output

Business services

Demand for professional and financial services had continued to recover, prompting a further rise in the Agents' scores (**Chart 3**). In part, that recovery reflected stronger demand for property-related services, following an increase in commercial property investment transactions during late 2009. But demand for legal services had also risen, as had demand for consultancy services (aimed primarily at cutting costs). M&A and corporate finance activity had also picked up slightly, albeit from a very low base. The recovery in other business services activity had, however, remained patchy, and turnover remained below its level a year earlier (**Chart 3**), as businesses continued to manage their overheads tightly.

Chart 3 Services output



Manufacturing

Looking through the volatility in the early months of 2010, the Agents' sense was that manufacturing output had continued to recover, prompting a further increase in the Agents' scores. Manufacture of food was strong, and demand for chemicals and pharmaceuticals had also picked up. Manufacturers supplying the construction sector, however, continued to face very weak demand.

Construction

Output in the construction sector remained depressed, although there were some signs that activity had stabilised in recent months. New homebuilding had picked up slightly, and repair and maintenance activity had increased, spurred on by the impact of the snow on buildings and transport networks. But these increases in demand had been offset by further weakness in commercial property construction, where the pipeline was shortening rapidly as projects were completed and not replaced.

Looking ahead, contacts in this sector remained particularly concerned about the impact of cuts in public spending, given the support provided by public sector projects over the past year.

Credit conditions

On balance, the Agents' sense was that the availability of credit had improved slightly, in part reflecting an increase in competition as foreign banks began to enter, or re-enter the market. But conditions remained both tight and polarised, with large and less risky businesses finding it easier to obtain credit than their smaller or riskier counterparts. Spreads and fees also appeared to have stabilised (albeit at high levels). The availability of trade credit insurance had improved marginally in recent months, although the level of cover available remained low, prompting many businesses to take risk onto their own books. Demand for bank finance remained weak, with many companies continuing to repay debt, and large businesses resorting to the capital markets for their financing needs.

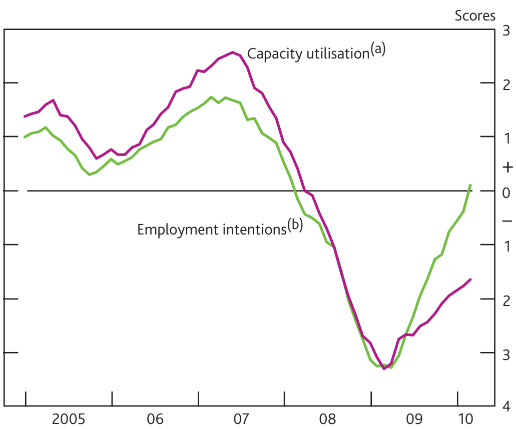
Employment

The outlook for private sector employment appeared relatively stable (**Chart 4**), with most large-scale redundancy programmes having been completed. Intentions were marginally stronger in the professional services and manufacturing sectors, where short-time working had been largely reversed and a few businesses were starting to recruit selectively in anticipation of a further rise in demand. In contrast, the employment outlook in the construction and public sectors remained downbeat, reflecting the likely impact of the forthcoming fiscal consolidation.

Capacity utilisation

The recent pickup in some firms' sales had led to a gentle rise in capacity utilisation. Nonetheless, there remained a significant margin of spare capacity in the economy (**Chart 4**), which could be deployed relatively swiftly should demand conditions warrant it (see box). Significant increases in output were more likely to require additional labour input than investment, but the majority of businesses felt confident that they would be able to fill positions quickly, given the deep pool of available labour.

Chart 4 Capacity utilisation and employment intentions



(a) Relative to normal. Manufacturing and services scores weighted together using shares of gross value added in 2005.
(b) Over the next six months. Manufacturing and services scores weighted together using quarterly employment weights derived from Workforce Jobs data.

Costs and prices

Labour costs

Overall, pay pressures remained muted. But reports of pay freezes had become less widespread and the prevalence of positive (but low) pay awards had risen slightly relative to 2009. In most cases, that slight increase in pay was aimed at rewarding better trading performance or at recognising employees' loyalty and boosting morale.

There was slightly more upward pressure on firms' total labour costs, reflecting both the restoration of full-time working and increased pension contributions, particularly among those companies with defined benefit schemes.

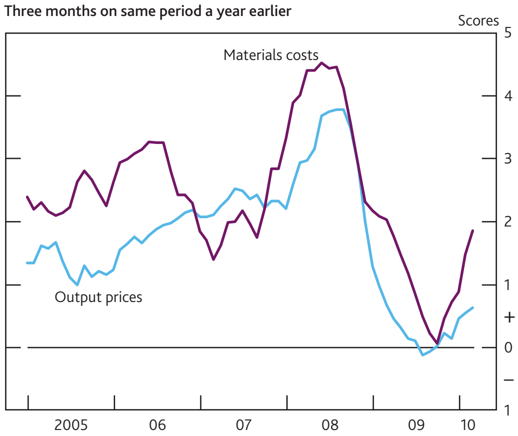
Non-labour costs

Raw materials costs continued to rise, prompting a further increase in the Agents' scores (**Chart 5**). Prices of globally traded commodities, such as steel, fuel and cotton, had risen further, in part on the back of higher demand from emerging economies. And transport and freight costs had picked up sharply, reflecting earlier reductions in global capacity as ships and container vessels were temporarily taken out of service. Imported finished goods prices also moved higher.

Output prices

Manufacturing output prices had risen slightly this month (**Chart 5**). Many contacts attributed these rises to the increase in input costs, which in some cases have fed through to prices automatically due to escalator clauses in customer contracts. That had served to offset, in part, the downward impact of the margin of spare capacity and the desire to gain market share.

Chart 5 Materials costs and manufacturing output prices



Annual business service price inflation remained negative, reflecting the significant margin of spare capacity and the strong degree of competition it had fostered. Prices in the construction sector had continued to decline.

Consumer prices

Retail prices remained well above their level a year earlier, reflecting the impact of higher VAT and fuel prices. But the rate of inflation appeared to have stabilised, and the Agents' scores were unchanged in March. Contacts reported that the rise in VAT had now been passed through by the majority of those planning to do so. Looking ahead, contacts noted that the combination of strong competition and price-sensitive consumers were expected to limit the scope for further price increases.

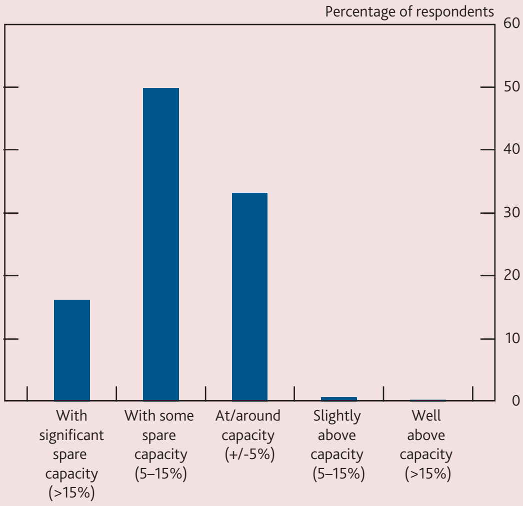
Agents' survey on spare capacity and output prices

The fall in nominal spending over the past 18 months is likely to have resulted in a significant shortfall in demand relative to supply capacity, which should result in downward pressure on inflation. But the extent of that spare capacity, its likely persistence, and its likely impact on inflation, are all difficult to judge.

As a result, the Agents surveyed contacts about the margin of spare capacity in their business, the speed with which it could be mobilised, and the extent to which it is expected to affect their output prices in 2010. Around 350 businesses responded to the survey. All figures shown are weighted by employment.

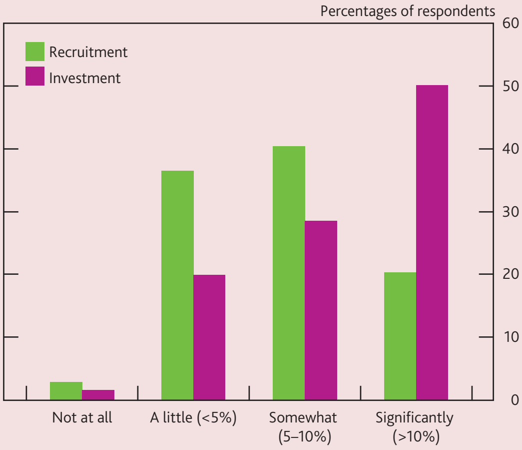
The survey results suggest that there remained a significant degree of spare capacity in the economy (**Chart A**). Those companies operating in the manufacturing and construction sectors reported the most spare capacity, while those in services, especially consumer services, were more likely to be operating at or around capacity.

Chart A How would you say your business is operating



The results also suggested that the margin of spare capacity could be mobilised relatively quickly. For example, the majority of businesses could increase output materially without additional investment and (to a lesser extent) recruitment (**Chart B**). And of the 60% of companies operating below pre-recession levels of production, nearly three-quarters thought they could recover the falls in output within six months, if demand was forthcoming.

Chart B Ability to increase output without additional investment or recruitment



On balance, contacts reported that the margin of spare capacity was expected to push down output prices during 2010. The margin of spare capacity, however, was only one factor influencing businesses' output price expectations. On balance, contacts reported that the desire to gain market share was also pushing down expected output prices. That was offset, however, by the impact of higher input prices and the desire to rebuild margins (**Table 1**), which had been squeezed following a sharp rise in costs during 2008.

Table 1 Factors influencing output price expectations(a)

Percentages of respondents

	Push prices down (1)	No effect on prices	Push prices up (2)	*Net balance (2)-(1)*
Market share considerations	32	63	4	*-28*
Spare capacity	28	60	12	*-15*
Availability and/or cost of finance	4	75	21	*16*
Input costs	12	52	36	*24*
Margin considerations	5	44	51	*46*

(a) Numbers may not sum to 100 due to rounding.

Overall, just over half of contacts expected their output prices to remain broadly unchanged during 2010. Of the remainder, around 30% expected prices to rise, compared with around 15% who expected them to fall. The majority of businesses expecting prices to rise were concentrated in the consumer services sector, where there was relatively little spare capacity. Firms in the manufacturing and construction sector were more likely to expect falls in prices during 2010.