BANK OF ENGLAND

Agents' summary of business conditions

June 2013

- Annual growth in retail sales values had continued at a slow pace. Consumer services turnover had also increased a little on a year earlier.
- The strengthening in housing market activity seen in recent months had continued.
- Investment intentions had remained very modest, though had strengthened a little in the services sector.
- Moderate growth in export volumes had continued, and to an expanding range of countries.
- Manufacturing output, both for export and domestic markets, had continued to grow slowly.
- Output of business services had edged higher.
- Falls in construction sector output had shown signs of slowing.
- There had been a further, if very gradual, improvement in credit conditions.
- Employment intentions among manufacturers and consumer services firms remained flat, but business services employers continued to plan to take on more staff.
- Capacity utilisation had remained broadly unchanged, and a little below normal in both manufacturing and services.
- The annual rate of growth in labour costs had continued to be subdued.
- Inflation in non-labour costs was broadly stable, with the rate of increase in imported finished goods prices somewhat stronger than for many commodities.
- The rate of increase in manufacturers' and business services prices had remained subdued.
- The rate of consumer price inflation had flattened off.

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 April 2013 and late May 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.

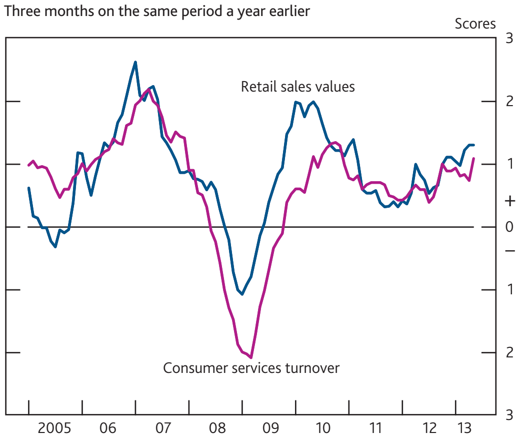
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the *Inflation Report*, obtained from: **www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx.**

Demand

Consumption

Nominal growth in retail sales values had continued at a slow pace. Contacts had continued to report tough trading conditions. But the expansion of on-line trading and polarising consumer demand, which favoured both premium and value goods, had enabled some firms to increase sales. Some retailers' sales of foodstuffs had strengthened at the expense of non-foods, in part because unseasonal weather conditions had held back demand for fashions and outdoor equipment. Demand for household durables had responded moderately to increasing housing market activity. But growth in sales of new cars, notably those offering more economical motoring, had remained strong. Consumer services turnover had strengthened very slightly (**Chart 1**), which reflected higher prices for some regulated services, but also the growing popularity of cafés and occasional luxuries such as visits to restaurants or attending special events. There had also been slight growth in demand for some transportation services, and for conveyancing. But delaying the purchase of services, or switching suppliers in pursuit of price reductions, had also been widely reported.

Chart 1 Retail sales and consumer services turnover



Housing market

The level of activity in the housing market had continued to grow, and some home builders had noticed a pickup in their enquiry rate following the announcements in the recent *Budget*. In the secondary market, fewer transactions were falling through. A number of contacts believed that vendors' price expectations had moderated somewhat, helping sales to progress, though outside London some higher-priced property remained slow to sell. There had been reports of prices firming somewhat in the new homes market. In the lower price brackets buy-to-let investors remained prevalent, reflecting a continuation of both strong demand and attractive rental returns, and there were some signs of institutions entering this sector. Most contacts expected activity in the housing market to continue growing during the year.

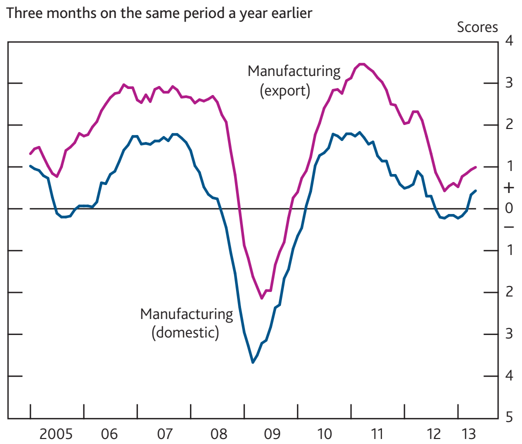
Business investment

The rate of growth in investment intentions remained subdued across the economy in aggregate. It had however strengthened a little in the services sector, where spending on refurbishment programmes and new formats had continued to be reported by hotels, restaurants and retail chains. Service sector investment in IT was also said to be strengthening, to improve both back-office efficiency and customer-facing services. And regulatory changes had continued to encourage the replacement of passenger transport and heavy goods vehicles. Investment in additional physical capacity remained uncommon among manufacturers outside the oil and gas supply chain or the automotive industry. But programmes with short payback periods, such as greater energy efficiency, or more efficient plant and equipment, were proceeding. And some contacts had reported a pickup in spending on research and development. Prospects for foreign direct investment were thought to be improving as the gap between costs of production in the United Kingdom and some developing economies gradually narrowed. To a certain extent, however, hedging strategies and the need to be close to end-customers would continue to motivate investment in offshore facilities. In an Agents' survey of a sample of companies with defined benefit pension schemes (see page 6), some companies reported that pension deficits were having an impact on their investment decisions and on mergers and acquisitions activity.

Exports

Gentle growth in export volumes had continued (**Chart 2**). Aerospace and oil and gas markets had remained strong and a period of de-stocking in the automotive supply chain had reportedly ceased, contributing to stronger demand from a number of developed economies. However, exports of manufactured goods to the core countries of the euro area had remained weak. A number of contacts had seen a slight improvement in sales to the euro-area periphery, though they had expressed concerns about payment prospects. Demand for consumer goods was strengthening from European markets outside the euro area. Some manufacturers that had previously repatriated production to the United Kingdom were

Chart 2 Manufacturing output



now exporting goods formerly produced overseas. In the services sector, sales of professional services associated with transactions, infrastructure and property construction had risen further, most notably in Asia, and exports of education services had continued to grow. Imports had also risen slowly. The late growing season had increased dependency on fresh produce imports from the euro area, and UK biofuel production was said to be more dependent on imported grain than in 2012.

Output

Business services

Growth in business services output had continued at a slow but steady rate. For professional firms, the market for certain core services had remained highly competitive but the gradual pickup in corporate transactional activity was continuing, and a number of firms had won new international contracts for the supply of engineering, architectural and business investment services. Business advice was also expanding gradually, as clients entered new markets. IT consultancy had continued to increase, as had asset finance, invoice discounting and some trade credit insurance. But demand for advertising and marketing services remained flat, and firms' tight budgetary control had also restrained growth in demand for conferences and corporate hospitality. While home delivery services had continued to expand and some goods storage services had picked up, haulage volumes had remained broadly flat overall.

Manufacturing

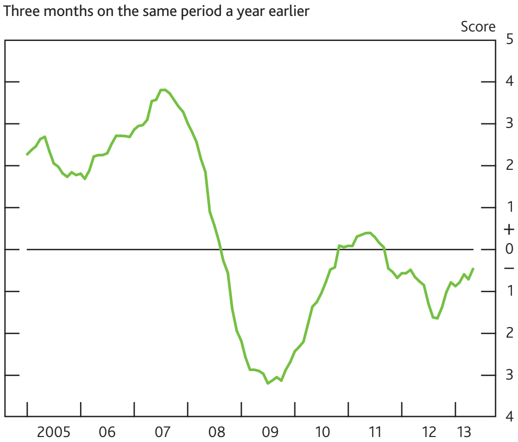
Output had continued to expand at a very moderate pace and some contacts expected order books to strengthen further as the year progressed. In addition to rising production for eventual export, such as in capital equipment, intermediate and luxury goods sectors, there had been signs of a gradual revival in domestic demand (**Chart 2**). For example, some suppliers of building materials had begun to see an increase in sales to home builders, and output of consumer goods for the domestic market had also risen slightly. A proportion of the overall increase in output of plant and machinery was also destined for the UK market, where domestic demand for capital equipment from the oil and gas sector had remained strong. Weaker areas of output had included food processing, which had remained flat overall, and output from the defence industries, where orders had fallen since last year and firms were seeking new markets.

Construction

Falls in output had continued to slow (**Chart 3**). Few contacts envisaged a general recovery in demand in the short to medium term. But some contacts had seen forward order books firm up and early-stage work, such as land purchasing, had risen. New private housing continued to provide the best immediate growth opportunities. Construction of new homes for sale had increased in response to market support measures and improved mortgage availability. A short-term pickup in construction of social housing was also in prospect, though a more general increase in output would only be likely when medium to longer-term funding streams became clearer. Private non-housing demand had remained weak, with only limited requirements for new industrial or commercial space, or for property renovation. Public demand had flattened off at a relatively modest level, with fewer projects and at lower values, and civil engineering volumes remained low. Some contractors had become increasingly dependent for work on repair, maintenance and building services. Contacts had also noted a continuing reduction in supply, as some other firms in the sector either failed or withdrew from the market.

Chart 3 Construction output

Three months on the same period a year earlier



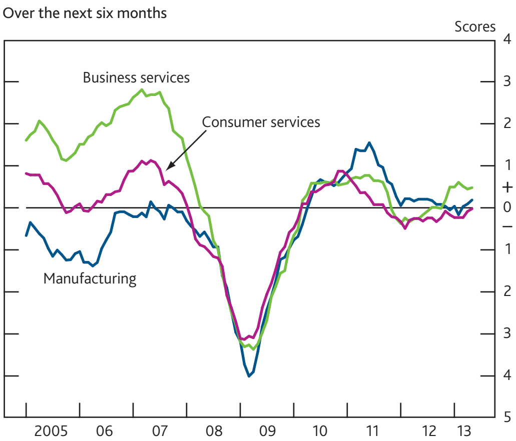
Credit conditions

The Funding for Lending Scheme had increased competition for the better commercial risks and continued to lower firms' borrowing costs. However, among the firms that had been offered new loans, a proportion had continued to decline them, either because of cash balances that they could draw upon or because they were reluctant to accept the terms and conditions on loan proposals. Some contacts regarded major lenders' risk appetite as little changed, so that firms with weak balance sheets, or in certain sectors, still struggled to obtain working capital or to finance growth. This was leading to the gradual expansion, albeit from a low base, of new, private sources of lending, particularly where business advisers had become familiar with the process. Additionally, some publicly backed local or regional funds had begun advancing finance. For households, eligibility for the best mortgage deals had remained somewhat restricted in spite of the general easing of loan terms and prices. Mortgage valuations were thought by contacts to have remained cautious, and stress testing of loan applications had reportedly increased, which had lengthened approval processes. Strong demand for new cars was said to have partly reflected growth in the take-up of consumer credit.

Employment

Employment prospects both in manufacturing and business services had firmed up a little. Contacts in the manufacturing sector had indicated that a period of planned headcount reductions was largely complete (**Chart 4**) and that employment prospects were now broadly flat. In the business services sector, employment was expected to edge up further, though tempered both by initial absorption of spare capacity, and by internal redeployments, as well as by the effects of some marginal further offshoring of facilities. Some continuing rationalisation of professional services was also envisaged. Employment prospects within consumer services firms had remained broadly flat at what contacts frequently characterised as a base level, but a better balance was now apparent between contracting and expanding firms. Recruitment had remained, on average, a little easier than normal, with good-quality applications reported for many vacant positions. However, some posts had remained hard to fill. This reflected continuing shortages of some technical skills, most notably, but not exclusively, in engineering and IT. Many contacts had highlighted the flexibility of the labour supply, with the acceptance by some employees of contracts guaranteeing no minimum hours' work providing one example.

Chart 4 Employment intentions



Capacity utilisation

Capacity utilisation had remained slightly below average both in manufacturing and services. This reflected the recent weakness in domestic demand as well as earlier investment in additional human and physical resources. Only limited (and usually very industry-specific) pressure was evident on plant, equipment, buildings or labour; and growth in productive capacity was reported to be slight. The supply of prime office stock in several regional centres had continued to tighten. And some contacts had commented on the gradual ageing of much of the underutilised secondary retail or office stock, which suggested a steady erosion of effective service sector capacity. A number of other contacts had highlighted skills shortages in certain trades, which could impinge on future supply growth.

Costs and prices

Labour costs

Regular pay in both manufacturing and services was increasing at a slow pace, broadly similar to the rates seen a year earlier, though there had been a slight increase in the number of pay freezes reported. Pay pressure from employees had remained weak. The practice of relating pay settlements either to past performance or to gains in productivity, rather than to the cost of living, had continued to spread. Some employers, motivated by retention, had made additional awards to key members of staff. But recent falls in bonuses and overtime payments, as well as labour flexibility, had enabled employers to restrain labour cost growth. Looking forward, many contacts remained uncertain about what impact auto-enrolment in pension schemes would have on their pay bills.

Non-labour costs

For most contacts, inflation in non-labour costs had now stabilised at a lower level than the previous year. Overall, inflation in imported finished goods prices had remained somewhat stronger than for raw materials. And some further impact from sterling's most recent depreciation was still expected over the coming months, given the usual duration of forward contracts. The prices of some metals, plastics and cotton goods, were said to have fallen back and falls in the price of other metals and oil-based products were still coming through. However for food processors, input price inflation had remained elevated and additional food commodities had risen in price. Many contacts had identified domestic overheads, such as waste management, business rates and particularly energy prices, as concerns, but the cost of insurance services remained weak.

Output prices and margins

The rate of inflation in manufacturers' and business services prices had remained subdued. Clauses governing the pass-through of annual efficiency gains, or volatility in the prices of materials and fuels, had continued to operate normally. A number of manufacturers had reported slightly easier price negotiations with their customers and some had adjusted their product mix to improve both average prices and margins. But supermarkets had continued to resist upward pressure from their suppliers, and only partial pass-through of recent cost increases for foodstuffs had been possible. Spare capacity in many parts of the business services sector had continued to restrain price growth, but a number of firms had begun to decline low-margin work. Similarly, a number of larger construction companies had become more selective about tender opportunities. Productivity improvements, tighter procurement policies, and an increase in the sterling value of foreign earnings, had all supported profitability.

Consumer prices

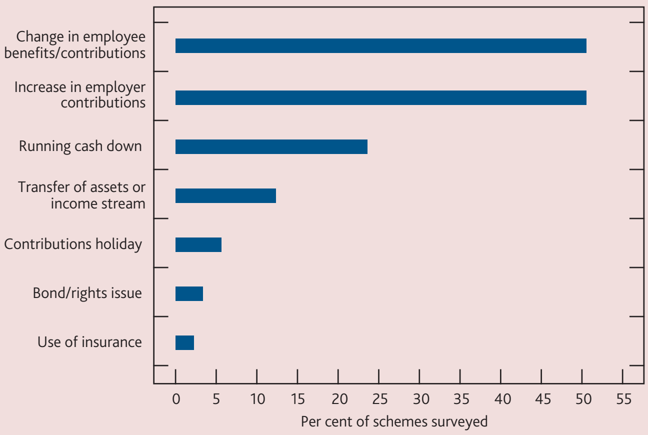
Contacts had reported a flattening off in the rate of consumer price inflation. The price sensitivity of many discretionary purchases and a fall in fuel costs had begun to offset some of the upward pressure coming from sterling's depreciation, earlier commodity price increases, and higher passenger transport and utility company charges. In the grocery market, further price rises were anticipated for some unprocessed foods, including certain meat and dairy goods, but inflation had softened for other products and a number of prices had fallen back. A build-up of unsold spring clothing was expected to be discounted at some point. But in the automotive market, a short supply of used cars was said to have caused prices to edge up. Peak season summer holidays were reported to be slower to sell than last year, holding prices flat. Price increases for other leisure services were tending to be restricted to specific hotels or restaurants. For some transport services the rate of inflation, and occasionally the price level, had eased, as a result of falls in fuel costs. And inflation in index-linked housing rents had slowed.

Agents' survey on defined benefit pension schemes

Defined benefit (DB) pension scheme deficits have grown since early 2011. The aggregate deficit of the 6,316 DB schemes eligible for the Pension Protection Fund (PPF) rose to £256.6 billion at the end of April 2013. Around 80% of those schemes are in deficit. In order to help the Monetary Policy Committee understand how firms are responding to the growth in DB pension deficits, the Bank's Agents conducted a survey of firms during April and May 2013, covering around 90 DB schemes. The survey was supplemented by discussions with specialist professionals, as well as a review of almost 380 records of Agents' visits to firms with DB schemes over the previous 18 months — these confirm the broad patterns emerging from the survey.

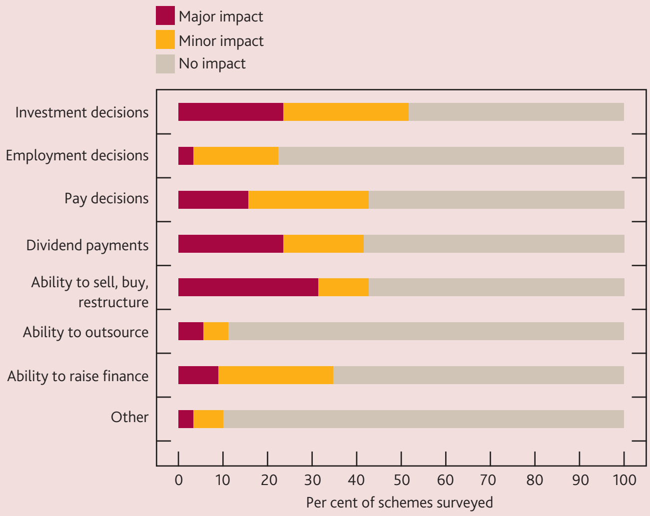
Companies with a DB scheme in deficit are required to submit a recovery plan to The Pensions Regulator, which expects a deficit to be eliminated as quickly as the employer can reasonably afford. Among the sample, employer contributions were widely reported to have increased, although a few firms had been able to maintain or reduce them, in some cases with a lengthening of the recovery plan. In addition, many firms were taking action to reduce both the current and future burden of deficits on their business, for example by sharing the burden with employees. Professional advisers noted a growing number of firms transferring assets or income streams to avoid locking cash in the pension fund, a dynamic that was also reflected in the survey responses (**Chart A**).

Chart A Firms' direct responses to DB deficits



As part of this survey, respondents were asked about the wider effects of deficits on their behaviour. In many cases firms reported that their DB pension deficits were having no impact on key business decisions (**Chart B**) as the scale of deficits and/or contributions were relatively limited. However, a number of firms reported a 'major' impact on their ability to buy, sell or restructure businesses. Some firms reported that they had less cash for acquisitions or, more commonly, that potential acquirers were reluctant to make bids for businesses with DB schemes, even where not in deficit, given uncertainty over ultimate liabilities. Around half of firms surveyed reported a somewhat negative impact from deficits on their investment spending, with the proportion doing so greater for small and medium-sized enterprises than for larger companies. Pension schemes could, of course, invest in other firms, who could in turn use the funds for capital spending, potentially offsetting some of the negative impact on investment reported in this survey.

Chart B Wider impact on firms' behaviour



A sizable proportion of firms reported a negative effect on dividends and pay. Lower dividends for some firms, in part, reflected pension fund trustees and the regulator seeking a balance between the distribution of cash/profits to shareholders and contributions to address pension scheme deficits. A number of firms also noted that deficits were reducing their appetite for credit, as increased borrowing would raise the costs of their PPF levy.(1)

(1) The pension protection levy is one of the ways that the PPF funds the compensation payable to members of schemes that transfer to the Pension Protection Fund.