BANK OF ENGLAND

Agents' summary of business conditions

August 2014

- Retail sales and consumer services values had continued to grow at a steady rate.
- The number of housing market transactions had eased over recent months. Market participants attributed that to shortages in housing stock and the effects of the implementation of the Mortgage Market Review.
- Contacts' capital expenditure plans suggested continued steady growth in investment over the next twelve months.
- Business services turnover growth had remained robust.
- Manufacturing output for the domestic market had continued to grow steadily. Growth of manufacturing export values had eased slightly, reflecting weaker global demand growth.
- Construction output growth had remained strong.
- Corporate credit conditions had improved slightly further.
- Employment intentions had continued to grow more slowly than output for most contacts, as they strived to improve productivity.
- Recruitment difficulties had edged up further, remaining modestly above normal.
- Capacity utilisation had been unchanged, remaining marginally above normal.
- Growth in total labour costs per employee had remained moderate.
- Materials costs and imported finished goods prices had fallen on a year earlier, partly reflecting the effects of sterling's appreciation.
- Output price inflation was stable in business services, but had eased back in manufacturing, partly reflecting easing input costs. Profitability had risen further, although the rate of growth had slowed slightly for services.
- Consumer price inflation had remained modest reflecting the persistent price-sensitivity of consumers, the slow recovery in real incomes and, consequently, intense retailer competition.

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 June 2014 and late July 2014. 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.

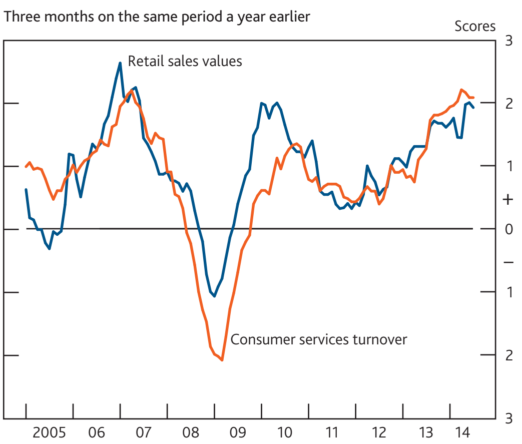
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the *Inflation Report*, obtained from: **www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx.**

Demand

Consumption

Annual growth in retail sales values and consumer services values had continued to grow at a steady rate (**Chart 1**). Within retail sales, contacts reported a patchy recovery across spending categories. In food, there appeared to be an increasing polarisation in the market towards the value and premium ends of the spectrum, but overall sales were thought to be relatively flat. The picture for non-food sales was generally more positive, with a gradual strengthening in durable items such as furniture, bathrooms, kitchens and home furnishings, due to pent-up demand continuing to unwind and the earlier recovery in the housing market. Fashion sales had received a boost from better summer weather than in recent years. But growth in new car sales had eased back from its peak earlier in the year. Consumer services growth remained fractionally ahead of retail sales, reflecting the relative strength of spending on leisure activities, such as pubs, restaurants and hotel accommodation. Some tourist attractions and coastal towns were reporting their strongest season in years, while airport passenger numbers were higher than a year ago.

Chart 1 Retail sales values and consumer services



Housing market

Housing market transactions had eased over recent months. Supply shortages were cited as the most common explanation for that slowing. The implementation of the Mortgage Market Review was also commonly cited as a factor, for the most part by lengthening the mortgage application process. There were signs of an easing of house price inflation, concentrated in the South, where some prices were lower than earlier in the year and there were fewer cases of sealed bids and offers over asking prices. The Help to Buy Equity Loan scheme remained popular among first-time buyers; especially for purchases of new-build properties.

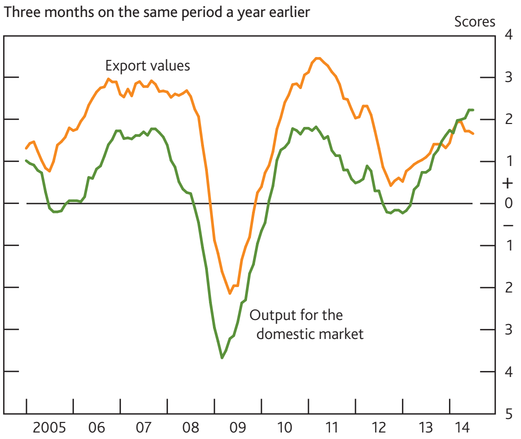
Business investment

Investment intentions had continued to point to steady growth over the next twelve months, remaining stronger in services than in manufacturing. Within the services sector, spending on IT improvements, hotel refurbishment programmes, investment by hauliers in new fleet and upgrades of car dealerships were commonplace as firms responded to an improving trading environment. Retailers had shifted investment towards online activities and the associated new warehousing and distribution capacity, along with further growth in convenience stores. In manufacturing the picture was more mixed with many firms focused on realising the benefits of earlier investment, while others — particularly in the food and drink sector — were spending to replace worn-out kit or improve productivity, rather than to grow capacity substantially. Investment in the UK oil and gas sector was reported to have peaked in 2013 and exploration activity was now low.

Exports

Manufacturing export volumes growth had eased a little (**Chart 2**), reflecting some softening of demand, especially in the emerging economies. More concerns were voiced this month by goods exporters about the impact of a further appreciation of sterling. However, at the current exchange rate exporters remained broadly positive and did not expect recent softening in demand to persist. Demand for exports had stabilised in Europe and the outlook there was now reported to be positive. Strong growth was expected from the United States over the next twelve months. But concerns about the wider effects of political tensions in Ukraine, and about developments in parts of the Middle East had increased. Services exports had continued to rise. Inbound tourism was a driver of growth with both US and Asian visitor numbers particularly strong, especially outside London. Spending by business travellers had also continued to rise. Digital and media exports had seen significant growth, which was expected to continue. Professional firms, particularly in the legal and architectural sectors, had reported a rise in exports, and the Middle East had maintained its appetite for engineering consultancy expertise from the United Kingdom. A box on page 4 presents the results of an Agents' survey on exports.

Chart 2 Manufacturing output and exports



Output

Business services

Business services turnover had continued to grow robustly. Initial public offering, private equity and merger and acquisitions activity were all buoyant, supporting increased demand for legal, accountancy, consultancy and other related services. The commercial real estate sector had continued to strengthen, with equity investors from the United Kingdom and overseas moving beyond London in a search for higher yields. Employment agencies, architects and civil engineering services also reported strengthening demand. Banks had benefited from increased activity in equity markets, but falling complexity in some financial markets had negatively affected demand for some investment banking services. Other business services turnover growth had remained strong, especially in IT, warehousing and distribution services. Demand for business accommodation and conferencing had continued to recover.

Manufacturing

Manufacturing output for the domestic market had continued to show steady growth (**Chart 2**), with the construction supply chain still reporting the strongest upturn in growth. Output growth across the transport sector remained strong, partly reflecting some new product launches in the automotive sector. This, together with continuing strength in the civil aerospace sector, was benefiting the engineering supply chain and other subsectors, such as electronics, plastics, metals and technical textiles. The pickup in consumer confidence and earlier rise in housing market activity had fed through to rising demand for home improvement and garden products. Food and drinks manufacturers reported higher sales due to recent warm weather and major sporting events.

Construction

Growth in construction output had remained strong. There were some reports that the pace of growth was being limited by shortages of materials and labour. That was said to have delayed some house building and infrastructure projects, although the extent of difficulties varied between regions and firms. The slowdown in housing market activity had not affected the appetite for output growth among the major house builders, and contacts reported that a shortage of Grade-A commercial property could lead to a ramp-up in activity in the next 6–18 months in some regional city centres. Infrastructure spending had continued to rise, notably on rail and highways.

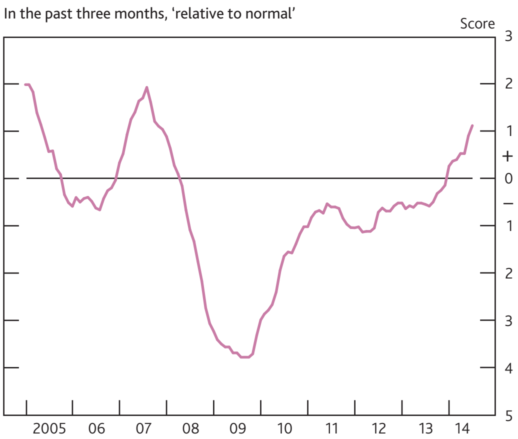
Credit conditions

Competition between the banks had intensified, particularly for low-risk business, which was putting some pressure on lenders' margins and leading to an easing of covenants in some cases. There were suggestions that in some cases 'pre-crisis' lending terms were being offered to those companies with the strongest balance sheets. For other types of borrowers, banks' risk-appetite was reported to be less changed. Firms with little collateral, or that were not yet cash-generative, continued to struggle to obtain credit or regarded the terms offered as too costly or onerous. Appetite for borrowing, especially for working capital, had increased as business confidence levels improved. More firms were exploring alternatives to bank borrowing or using improved conditions as an opportunity to repay bank debt. Refinancing, often for increased facilities, was common, with borrowers seeking to take advantage of the competitive market and low interest rates.

Employment

Employment intentions had been unchanged, pointing to modest headcount growth across all sectors. The main driver was improving activity levels, but the recruitment of apprentices and graduates to address skill shortages and the prospective retirement of older staff was gaining momentum, while additional regulatory responsibilities were an important factor for financial services firms. Intentions continued to grow more slowly than output for most contacts, as they strived to improve productivity. Intentions were strongest in services, where workforce growth was gradually becoming more broad-based across subsectors, including IT, real estate, professional services and leisure. Manufacturing employment growth was being tempered by a preference among some contacts to use overtime and/or agency workers to cope with peaks and troughs. Recruitment difficulties had picked up further (**Chart 3**) and were gradually spreading beyond the regularly cited shortages within IT, engineering and construction, to other sectors. These included qualified professional services staff with 3–5 years' experience, HGV drivers and senior management posts. Lower-skilled staff were still relatively easily available, with migrant workers filling many gaps. While employee retention remained higher than pre-recession norms for many contacts, labour mobility had edged up, prompting some to take pre-emptive action on pay and benefits.

Chart 3 Recruitment difficulties



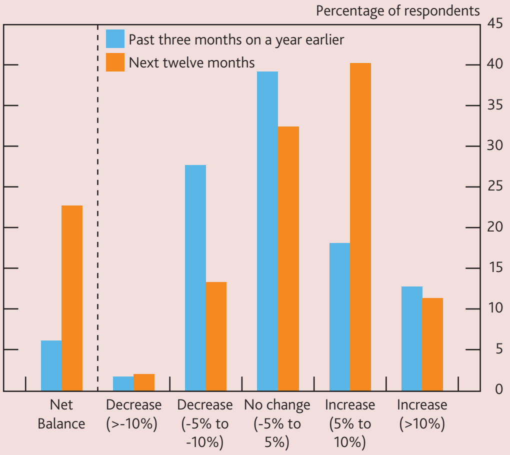
Agents' survey on exports

Sterling's trade-weighted exchange rate has risen by over 10% since its trough in March 2013. Against that background, the Agents conducted a survey in June and July to ask contacts how the sterling value of UK exports had changed over the past three months on a year earlier, their expectations for the next year and the factors likely to affect the sterling value of exports. Contacts were also asked about the impact of sterling's appreciation in particular on sterling export values, volumes and margins.

Some 330 companies participated, including nearly 80 services firms, with export destinations that were broadly representative of UK trade patterns, based on companies' principal reported export market. The results were weighted by companies' export values.

A net balance of respondent firms reported a modest increase in sterling export values over the past year, but expectations of growth were more positive for the next twelve months (**Chart A**).

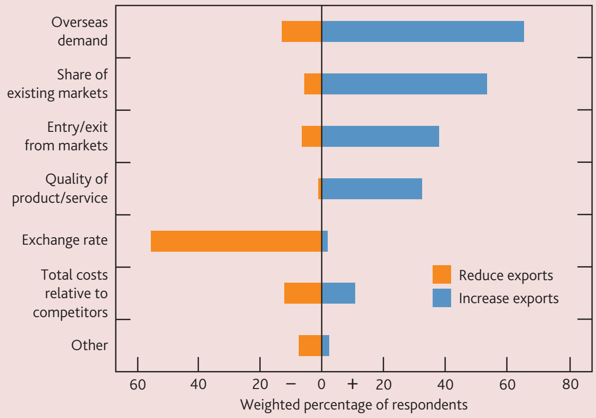
Chart A Export values growth and expectations



Growth in export values to the euro area was reported to have been positive, as was that to the United States, albeit to a lesser degree. However, net balances for firms whose principal markets were in Asia or other markets were negative. A similar geographical split was seen for expectations of growth of export values: expectations were strongly positive for those whose principal market was the United States and the euro area, but negative for Asia and other markets. By sector, there was marked strength in the expectations of goods exporters, especially those whose principal market was the euro area, while services firms expected more modest growth.

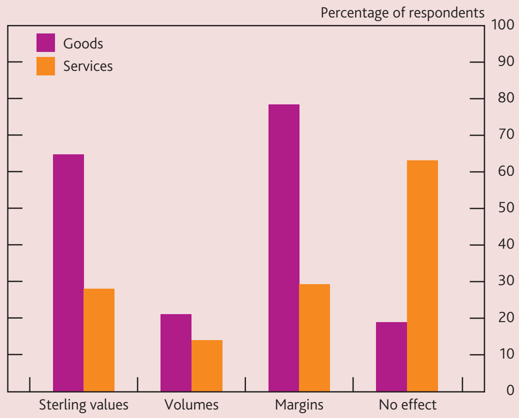
Looking at the factors affecting exports over the next twelve months, overseas demand, market share, entry to new markets and quality of product were expected to be positive influences on growth (**Chart B**). The exchange rate was expected to have a negative effect, in marked contrast to findings of the previous Agents' exports survey of April 2013 before the bulk of the appreciation, and more so for goods than services exports.

Chart B Factors affecting exports over the next twelve months



Contacts were also asked about the impact on export performance of: sterling's appreciation in the past twelve months, sterling remaining at current levels for a year and sterling appreciating by a further 10% over the next year. For the past year, the majority of goods exporters reported an adverse impact on sterling values and a squeeze on margins, with limited impact on volumes (**Chart C**). For services, most reported no effect. That pattern was expected to remain the case if sterling remained at current levels over the next year. However, in a scenario where sterling appreciated by a further 10% over the next twelve months, a markedly higher number of respondents expected an adverse impact on goods export volumes. The potential adverse impact on services export volumes of that scenario was seen to be less pronounced, with a sizable number of services exporters reporting no expected effect.

Chart C Impact of sterling appreciation, past twelve months



Capacity utilisation

Firms' capacity utilisation had been unchanged, remaining marginally above normal. In manufacturing, the utilisation of staff was often higher than that of physical capacity and, subject to acquiring additional skilled labour, contacts often said that they could readily scale up output from existing physical capacity. Some contacts in automotive, oil and gas, and construction-related production had reported an increase in capital utilisation, such as bringing mothballed brick manufacturing capacity back into use. There was less divergence between physical capital and labour utilisation in the services sector. In professional services, to the extent there were constraints binding, those were usually shortages of skilled staff. But in some sectors, such as retail, parts of the capital stock had become obsolete or inefficient given structural shifts in the economy. Firms in some technology-focused sectors such as IT and online retailing saw that their output could be readily scaled up from existing capacity.

Costs and prices

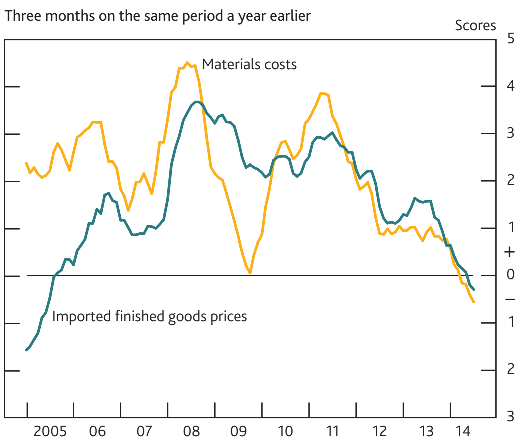
Labour costs

Pay settlements had edged higher, providing some signs that wage pressures were starting to increase. The majority of settlements remained in the 2%–3% range, but in contrast to a year ago, pay freezes were rare and an increasing number of contacts were reporting settlements above 3%, particularly in sectors where skills shortages were most acute such as construction, IT, HGV drivers, oil and gas and engineering. Professional services firms were also modestly increasing pay settlements as staff churn increased, although the pattern of replacing experienced leavers with more junior recruits was restraining total labour cost growth. Low rates of opting-out from auto-enrolment pension schemes were reported, which was pushing up on total labour costs.

Non-labour costs

Materials cost inflation had remained negative, in part reflecting the impact of the appreciation of sterling, and the majority of contacts expected the relatively benign cost environment to continue (**Chart 4**). Construction materials had been an exception to that pattern, with reports of double-digit cost increases not uncommon. The cost of imported finished goods had been drifting down more slowly than for materials imports, reflecting the propensity of retailers to buy several seasons ahead and to enter longer-term hedging arrangements. Some cost increases had been apparent in the service sector from regulatory compliance, waste disposal, utilities and other overheads, including business rates and rents.

Chart 4 Raw materials and imported finished goods prices



Output prices and margins

The rate of inflation in manufacturing output prices had eased. For most manufacturers it had remained difficult to raise prices when inflationary pressures from materials and labour were benign and competition heightened, including from imports due to the appreciation of sterling. The main supermarkets had continued to resist any pass through of cost increases by food manufacturers. But prices of building materials, such as bricks, had continued to rise briskly as a result of supply shortages. Business services output price inflation had remained stable. Some companies, including in the transport, IT consultancy and recruitment sectors, reported that it was becoming slightly easier to implement modest fee increases as clients' own activity levels had picked up. However, across the bulk of the business services sector there was sufficient capacity to meet current levels of demand and, therefore, limited ability to increase prices. Pressure on commercial property rents had remained muted outside of prime locations.

Modest growth in manufacturing profitability had continued. Improved volumes, a subdued cost environment and greater efficiency had allowed most manufacturers to grow their margins slightly, despite an inability to increase pricing. There had been a slight easing in service sector profitability growth, although it had remained positive. Service companies were relying on cost-cutting, increased productivity or, in some cases, a move to higher margin business as activity increased to generate profitability. Some exporters reported that sterling's appreciation had squeezed their margins. Although many had been partially cushioned from exchange rate movements as a result of hedging, there were concerns about the impact of a further appreciation of sterling.

Consumer prices

Consumer price inflation had remained modest, with retailers citing high price sensitivity of demand and the slow recovery of consumers' real incomes as reasons for price restraint. Intense competition among retailers, especially in food, and the price transparency afforded by internet retailing also continued to exert downward pressure on inflation. Meanwhile, inflation in footwear and clothing prices had picked up due to tighter stock control and warm weather that had enabled sales to be later, and discounting shallower, than a year before. Gradual price increases had also been apparent for some non-regulated transport, leisure and personal services due to stronger demand.