BANK OF ENGLAND

Agents' summary of business conditions

July 2013

- Annual growth in the value of retail sales and consumer services had risen slightly over the first six months of the year, but remained modest.
- Activity in the housing market had continued to strengthen.
- Investment intentions continued to be largely aimed at raising efficiency, with very little large-scale capacity expansion under way.
- Manufacturing exports continued to grow at a moderate rate.
- Growth in manufacturing output for the domestic market had increased a little in recent months.
- Modest growth in business services turnover had continued.
- The annual rate of decline in construction output had eased as house building had increased. Output in the sector overall was little changed on a year earlier.
- Corporate credit conditions had continued to improve very gradually, but many companies reported a desire to rely on internal or non-bank funding.
- Employment intentions had edged higher in recent months, but were flat for consumer services.
- Capacity utilisation had remained slightly below normal both in manufacturing and services.
- Labour costs per employee had grown at modest but stable rates over recent months.
- Inflation in materials costs had fallen to low levels and had remained stable for imported finished goods prices.
- The rate of increase in manufacturers' and business services prices had remained subdued, though profitability had edged higher as output had risen.
- The rate of consumer price inflation had been unchanged.

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 May 2013 and late June 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.**

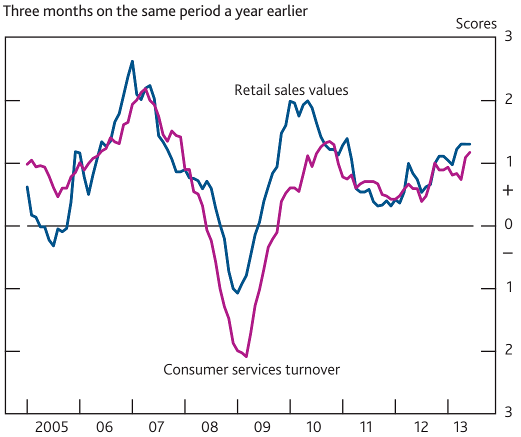
Demand

Consumption

Annual growth in retail sales values had edged higher over the first half of the year, but remained modest (**Chart 1**). Disposable incomes had remained tight, reflected in reports from some retailers of 'payday spikes' in consumer spending. There were some reports of a mild strengthening of household durable sales, though that might have partly reflected the effect of some major retailer failures on the sales of others. Growth in new car sales remained robust, driven by promotional activity, discounts and relatively easy terms for motor finance. But poor weather was reported to have led to weak clothing and footwear sales, with some customers delaying purchases in expectation of heavy summer sales discounting to come. Growth in the value of consumer services, though still modest overall, had edged up, in part reflecting a slight increase in demand for tourism, travel and visitor attractions.

Chart 1 Retail sales and consumer services turnover

Three months on the same period a year earlier



Housing market

There were continued reports of rising housing market activity both for new and existing homes. In the new-build market, improving conditions were partly ascribed to the effects of the new Help to Buy scheme (applying to England only). Mortgage availability and pricing had continued to ease, though some contacts reported stringent conditions on higher loan to value loans, including those to first-time buyers. Buy-to-let investors were reported to be highly active reflecting a combination of perceptions that downside risks to house prices had abated, easing credit availability and a desire for higher returns than were available on bank deposits. A substantial number of those investors were cash buyers and so did not require mortgages for house purchase. The wider pickup in housing market activity was expected to be reflected more noticeably in mortgage approvals in the coming months, notwithstanding some reports that strict criteria and insufficient staff at lenders had slowed the mortgage approval process. Some contacts also reported that shortages in sites for new house building and in existing properties for sale were starting to hold back transaction volumes.

Business investment

Investment intentions continued to point to only modest growth in capital spending and had edged lower on the month as some earlier projects had been completed. Investment was said to be dominated by efficiency-enhancing expenditures with a short payback period, with very little large-scale capacity expansion. For firms that were investing, that was often reported to be financed from internal sources, partly reflecting constraints on long-term financing or a desire not to be dependent on bank finance. Larger international companies were often reported to be focusing investment spending closer to fast-growing emerging markets. In some cases, replacement expenditures were reported to have been long-delayed. In the transport sector, however, substantial replacement of older vehicles was under way with a focus on increasing fuel efficiency.

Exports

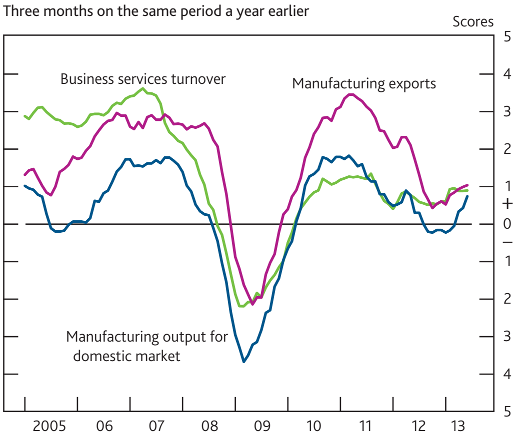
Modest growth in manufactured export volumes had continued (**Chart 2**), with weakness in euro-area demand offset by growth in sales to other European markets, the United States and the emerging markets. Export growth remained concentrated in products for the oil and gas industry, premium brands with a broad international reach or high value-added niche products. Some automobile exports had been negatively affected by the continuing weak demand in the euro area. There were continued reports of rising services exports, including from some law firms delivering work in global markets and from accountancy firms who had benefited from an international recognition of UK professional standards. IT services exports had risen further, as had engineering and construction consultancy services exports to the Middle East in particular. Inbound tourism to the United Kingdom was also reported to have strengthened. A steady, albeit subdued, flow of production relocation to the United Kingdom continued, in part reflecting rising labour costs in some emerging markets.

Output

Business services

Growth in business services turnover remained moderate and little changed (**Chart 2**). Alongside steady growth in IT services, related in part to growth in e-commerce, there were reports of some rising activity in marketing, advertising and corporate hospitality as firms sought to gain business in a highly competitive business environment. There were also reports of some increase in haulier demand for home deliveries related to internet sales. And hiring of construction equipment had risen as activity in some parts of the construction sector had picked up. A gentle increase in professional and financial

Chart 2 Manufacturing output and business services turnover



services turnover was reported, due in part to a rise in activity related to mergers and acquisitions and international tax consultancy. There were also reports of increased work related to land deals and around residential and industrial real estate investment. More generally, accountancy work was reported to have risen moderately as confidence in the wider economy had recovered somewhat, and as some banks had taken further efforts to restructure companies on their 'intensive care' lists.

Manufacturing

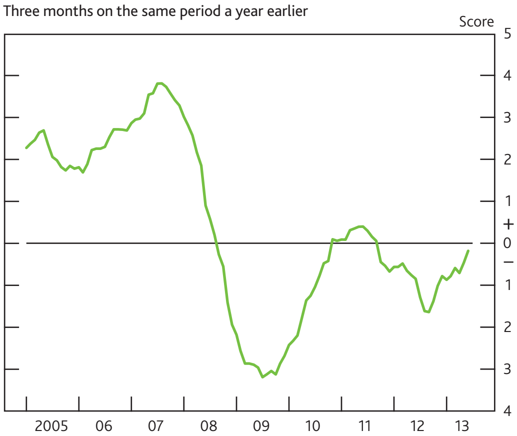
Annual growth in manufacturing output for the domestic market had risen (**Chart 2**). In particular, some strengthening had been seen in the production of certain construction materials and aggregates used in the early stages of building, though the level of output remained subdued. Car production had benefited from a buoyant domestic market, though some supply chains had been adversely affected by weak production in the euro area. Output was said to be rising in parts of the capital goods sector, particularly those related to the oil and gas industry. In aerospace, some contacts noted an easing in the recent strong growth of production, albeit one that was expected to be short-lived. But some defence firms reported that their production was being affected materially by a contraction in both international and domestic military spending.

Construction

The annual rate of decline of construction output had continued to ease so that output in the past three months was little changed on a year earlier (**Chart 3**). House builders reported an improvement in sentiment, in part reflecting the introduction of the Government's Help to Buy scheme, with activity up in recent months and expected to accelerate further. Social housing build activity had also increased, with Housing Associations seeking to use the public funding available in the current financing cycle. Elsewhere in the sector, public sector construction activity was reported to be broadly stable, but low relative to pre-crisis levels and often focused on smaller-scale education and health projects.

Infrastructure work remained robust, particularly for renewable energy development, though some regulatory-driven investment demand in rail and water utilities had started to wane. Private commercial activity remained weak outside London, with little or no speculative development under way.

Chart 3 Construction output



Credit conditions

A slow improvement in credit availability and pricing continued, with some signs that strong competition among banks to meet lending targets was starting gradually to increase lending appetite beyond the largest companies and strongest credit propositions. For example, there were reports of some increase in appetite among banks for lending to medium-sized companies or to commercial property companies. Some small companies said that they had accessed bank funding while resisting demands for high levels of personal guarantees and security. But banks were reported to have remained reluctant to lend to small businesses or start-ups with few assets, and even where balance sheets were strong, extended loan approval times were reported. There were also reports of difficulty in accessing international trade finance in particular. Demand for bank finance remained subdued, reflecting muted economic growth and a desire by companies to limit their reliance on bank debt, though it was reported to have increased a little among medium and large firms, as mergers and acquisitions and property-related activity had edged higher. A build-up of cash balances by firms was widely reported, in some cases reflecting companies' desire to satisfy auditor requirements for demonstrating they were 'a going concern'. For companies that were not large enough to access bond markets, other forms of non-bank finance were reported to be increasing, albeit from a low base. More widely, invoice payment times were reportedly rising further, putting smaller companies' working capital under strain.

Employment

Employment intentions had edged higher over recent months alongside some improvement in business confidence. In manufacturing, employment intentions were said to be rising slightly as output had increased, concentrated in export supply chains or among firms bringing out new products. Some business services employers also reported rising employment alongside higher turnover, with greater replacement where natural attrition had taken place and with some increase in recruitment activity, often aimed at raising the employment of more junior staff to restrain labour costs growth. There were also reports within the business services sector of employees being moved back to more immediately productive roles from the 'business development' positions to which they had been assigned while demand was particularly weak. Consumer services staffing was widely reported to have remained at the lower bounds consistent with firms' effective functioning and employment intentions were flat. However, there were some reports of increases in employment in discount retailing and IT offsetting the negative effects on employment of gradual consolidation in some other parts of the retail sector and reduced staffing at some high street banks. Most employers reported that recruitment conditions were a little easier than normal outside IT and engineering, though there were increasing reports of localised shortages in certain construction skills and sub-contractor labour, as well as in advanced marketing or customer service skills.

Capacity utilisation

Capacity utilisation had remained slightly below normal, though it had risen marginally in manufacturing in recent months. In many cases, both in manufacturing and services, investment aimed at enhancing efficiency was providing marginal increases in capacity to match gently rising output; alternatively, any increases in output were able to be readily met by the reconfiguration of existing capacity or flexible use of existing staff. That could involve added shifts in some manufacturing firms and, in business services, some return of staff to more 'front-line' roles. Some legal sector contacts reported that conveyancing capacity at legal firms had been removed over time and that staff were working longer hours as housing market activity had picked up. In the construction sector, some contacts expressed concerns that spare capacity could diminish quickly in the event of a sustained upturn in demand as supply chain capacity had been eroded over time and some skills had moved into other sectors, though might return with a lag.

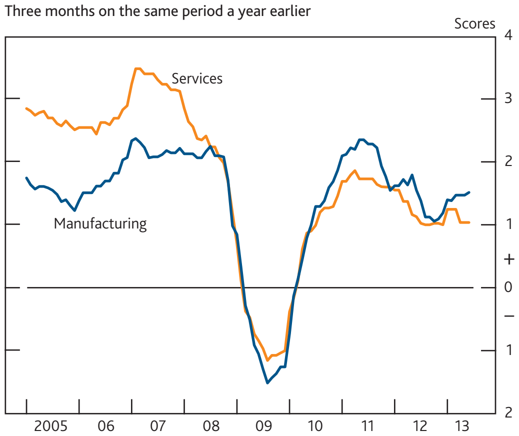
Costs and prices

Labour costs

The rate of increase in labour costs per employee was reported to be little changed on the previous year (**Chart 4**), with settlements continuing to be centred around 2% in recent months. Outside engineering, IT or the oil and gas industry, little upwards pressure was reported, with many employees prepared to accept weak wage growth for employment given, for example, the ready availability of migrant labour and the visibility of high unemployment even among graduates. In a number of cases, companies reported lower starting salaries and the increased use of A-level entrants instead of graduates, alongside a wider shift in mix towards more junior staff. Manufacturing wage inflation remained somewhat stronger than in services, with fewer staff on pay freezes and a stronger bias reported towards performance or hours-related pay — components which had edged higher in recent months. Uncertainty remained about the ultimate effect of auto-enrolment pensions on overall labour costs.

Chart 4 Total labour costs per employee

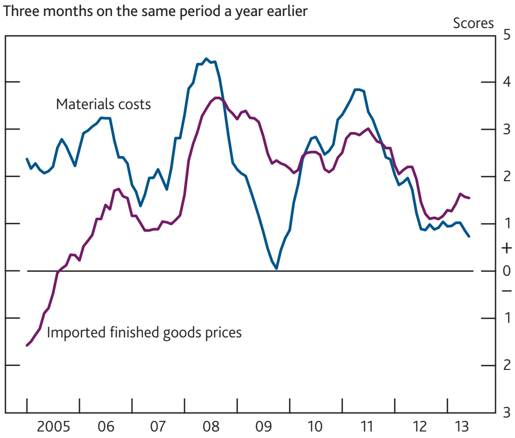
Three months on the same period a year earlier



Non-labour costs

Annual inflation in material costs had edged lower, as global demand growth had eased (**Chart 5**). Many materials costs were reported to be broadly flat on a year ago, with a number of metals prices having fallen and with recent declines in oil prices expected to feed through to oil-intensive materials in coming months. The main exception to that pattern remained food price inflation, which had been boosted by the effects of poor weather conditions on UK yields. Some non-oil energy costs had risen further. And the price of some construction materials, such as speciality bricks and aggregates, had risen sharply as house builder demand had picked up. Inflation in imported finished goods remained moderate, if above that of raw materials (**Chart 5**). Price rises reflected the effects of sterling's depreciation around the turn of the year and increases in production costs in some emerging markets. However, those upward pressures were being offset to some

Chart 5 Input costs



extent by the effects on import prices of weak demand in the euro area.

Output prices and margins

The rate of inflation in manufacturers' output prices had remained subdued. Some manufacturers reported being able to raise prices in the face of cost increases, but generally those increases at best protected existing margins. However, profitability for the sector overall was reported to have edged higher. Some niche manufacturers had been able to raise prices as improved conditions had allowed them to exit low margin work and for some producers higher output had led to a decline in unit costs. Business service price inflation remained low, though in some cases business conditions had allowed some long-delayed pass-through of earlier cost increases to be made. That, alongside reports of a slight increase in productivity as output in the sector gradually rose, had allowed profitability to edge higher. An Agents' survey of companies' margins indicated that margins were slightly lower than normal, albeit by less than in the survey a year earlier (see page 6).

Consumer prices

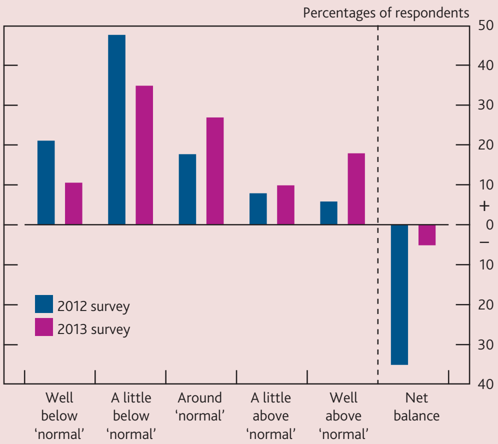
Retail goods and services price inflation had been unchanged. Food prices were said to be pushing up on inflation, though inflation in other goods prices was often reported to be subdued. For example, clothing and footwear prices were expected to be broadly flat through to next year and, while list prices on new cars were said to be up, transaction prices paid by the customer were flat to falling after the effects of forecourt discounts. On-line competition was seen as constraining future non-food price rises more generally. And some contacts' expectations of future goods price inflation had edged down with a recent stabilisation of the exchange rate and as consumer demand outturns had disappointed expectations. Services price inflation remained higher than for goods prices, partly reflecting increases in administrative and regulated prices, such as those in social housing and public transport. Some contacts also reported price rises in the leisure sector alongside some greater demand, as well as in restaurant prices as food price rises were passed through. More generally, outside some luxury sectors, contacts reported widespread discounting and difficulty in passing through price increases against a backdrop of tight consumer disposable incomes.

Agents' survey on profit margins

To help assess possible future upwards pressure on inflation from companies' efforts to raise profitability, the Agents conducted a survey to investigate corporate profit margins. The Agents asked how current operating profit margins (defined as operating profit as a proportion of turnover) compared to normal (defined as the pre-crisis long-term average). Where margins were below normal, respondents were asked whether margins were sustainable and how long it would take before they returned to normal. The survey also explored how margins had changed over the past year and were expected to change in the coming year, the main drivers for changes, and the sensitivity of prices to changes in demand. A total of 406 companies responded to the survey, with turnover of over £61 billion. The sample was more heavily weighted in retail and consumer services, and less in business services, relative to sectoral contributions to output in the economy as a whole.

Weighting the results by turnover, 45% of respondents described their margins as below normal (**Chart A**), yielding a modest negative net balance, albeit a smaller one than found in a comparable survey in 2012 (for an unmatched sample). Within the sample, larger firms' margins were closer to normal than those of smaller firms and exporting firms reported that their margins were, on balance, higher than normal.

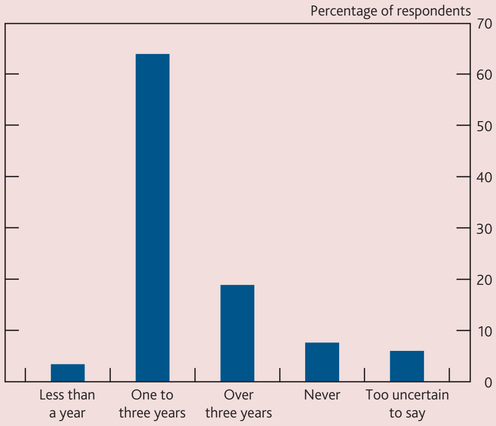
Chart A Profit margin compared to normal



The majority of the subset of firms reporting below-normal margins considered their margins to be sustainable given, for example, current low levels of interest rates on debt. But most also thought a return to normal margins would occur over the next one to three years, and only 8% envisaged margins never returning to normal (**Chart B**).

Around half of all respondents reported a rise in margins over the past year, with a greater share of larger firms (defined as turnover over £50 million) than smaller firms indicating an increase. All sectors, other than manufacturing, appeared to be reporting less of a squeeze on margins this year. As in the 2012 survey, profits in construction were reported to be particularly weak compared with normal.

Chart B Expected time for margins to return to normal(a)



(a) For those respondents reporting margins below normal.

Over the next year, a similar slight improvement in margin was expected overall, as positive expectations from manufacturing, retail and business services contacts outweighed an anticipated narrowing of margins in consumer services and construction.

Among the drivers of changes, productivity gains were cited more frequently than price as raising margins over both the past and coming year (**Chart C**). That was also the case when looking only at the subset of firms expecting to increase their margins, though for these firms the net balances expecting productivity and price increases to raise margins was higher than for the sample overall. Other factors acting to increase margins included a reduction in fixed costs per unit as output rose, a shift in companies' output mix towards higher margin products, and the introduction of new products, which often carried higher margins than existing outputs. Over 90% of respondents judged their output prices to be mildly or highly sensitive to changes in demand, broadly evenly split between those two categories.

Chart C Factors influencing margin