BANK OF ENGLAND

Agents' summary of business conditions

March 2014

- Annual growth in the value and volume of retail sales had increased slightly over the past three months. Consumer services turnover growth had also edged higher.
- The recovery in housing market activity had continued.
- Investment intentions had continued to point to moderate growth in capital expenditure in the year ahead.
- Turnover in business services had edged a little higher.
- Manufacturing output for the domestic market had continued to grow steadily. Manufactured exports growth had increased.
- Construction output growth had risen further.
- Credit availability had continued to increase gradually and demand had edged higher.
- Employment intentions over the next six months pointed to modest headcount growth. Recruitment difficulties had edged higher, and were marginally above normal.
- Capacity utilisation had remained close to normal.
- Labour costs per employee had continued to grow moderately.
- Inflation in materials costs and imported finished goods prices had fallen further.
- Output price inflation had edged lower for manufacturing companies, but had risen slightly for business services firms. Profitability had continued to improve overall.
- Consumer price inflation had slowed further, particularly for goods.

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 January 2014 and late February 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.**

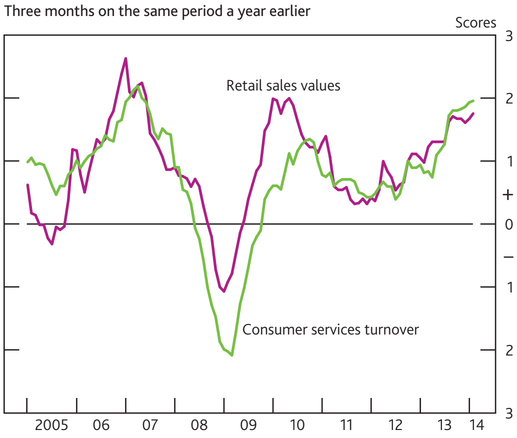
Demand

Consumption

Annual growth in the value and volume of retail sales had increased slightly over the past three months (**Chart 1**). Contacts reported a steady start to the year overall, albeit with differing trends in durable and non-durable consumption. Food sales values were reported to be weak, albeit in part related to falling prices due to intensive promotional activity. In contrast, contacts reported gradual strengthening in household durables sales growth, attributed in part to a stronger housing market. New car sales had started the year strongly, supported in part by leasing finance that was seen as readily available at low cost. Dealers were also attempting to boost sales by encouraging the early replacement of cars previously bought on monthly payment plans. The wet weather had had a limited impact so far on retail sales outside the most affected areas. Consumer services turnover growth had also edged higher. Consumers had become slightly more willing to spend on leisure activities, with pubs, restaurants and hotels reporting increased demand. Demand for rail travel had also risen, although some services had been affected by line closures following flooding. Some indoor attractions, such as cinemas and bowling, had traded exceptionally well in the wet weather and forward holiday bookings were reported to be strong.

Chart 1 Retail sales and consumer services turnover

Three months on the same period a year earlier



Housing market

The recovery in housing market activity had continued at a steady pace, fuelled by improved mortgage availability for first-time buyers and growing household confidence. Transactions were substantially higher than a year ago across most regions, albeit still below pre-recession levels. Estate agents' instructions to sell had risen, but there had remained a shortage of properties for sale on the secondary market. That had, so far, mainly affected activity levels rather than prices. House price inflation had continued to vary across the United Kingdom, with double-digit percentage rises in London contrasting with more modest growth in most other regions.

Business investment

Investment intentions had continued to point to moderate growth in capital expenditure in the year ahead. Manufacturers' intentions had picked up a little, with an increasing number of contacts looking to invest in new capacity, in addition to ongoing spending to improve efficiency or productivity. Some firms, though, were cautious about making substantial expenditures until they were more certain that the recovery in demand would be sustained. Investment in commercial real estate was picking up, including outside London, although much of the focus was on enhancement of existing stock rather than on new building projects. In retail, that reflected an overhang of existing space, whereas in office and industrial markets, rental levels and lease terms were often said not yet to have recovered sufficiently to make new building viable. Plant hire firms had increased investment on the back of a strong pickup in demand from the construction sector. An Agents' survey on the Bank's forward guidance (page 4) indicated the policy had had a positive influence on companies' investment intentions.

Exports

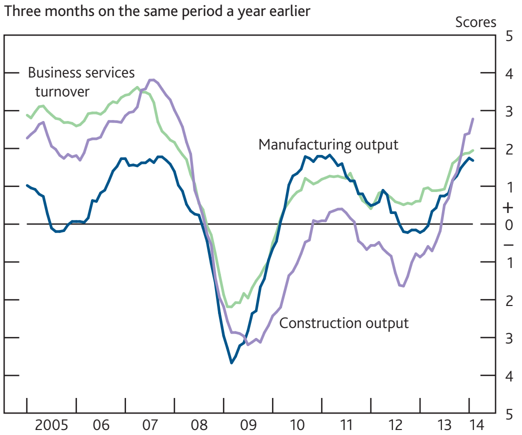
Manufacturing export volumes growth had picked up further. Sales to continental Europe had remained broadly flat, though on a forward-looking basis were showing some slight signs of improvement. Contacts reported moderate growth in exports to the United States overall and growth to emerging economies had remained firm, with increases in market share offsetting a modest slowing of growth in some markets, such as Brazil. Growth continued to be concentrated in higher value-added products, such as those in the oil and gas, automotive and branded goods subsectors. Services exports growth had persisted, with IT services reporting strengthening overseas demand, alongside continued robust growth among energy and engineering consultancy firms. Overcapacity in the global mining industry, coupled with softening demand from China, had dampened export demand for some related services, however. Rising investment in UK property, together with company acquisitions by overseas investors, were boosting demand for related services. Inbound tourism and business travel to the United Kingdom were up on a year earlier.

Output

Business services

Growth in business services turnover had edged a little higher (**Chart 2**). In financial and professional services, transaction-related work was being supported by the pickup in initial public offering and mergers and acquisitions activity, the latter fuelled largely by domestic companies' cash reserves and foreign buyers. There was also strength in demand for tax planning, corporate finance, consultancy and due diligence. Recruitment consultants, training providers and advertising firms had benefited from rising confidence and a loosening of

Chart 2 Manufacturing, business services and construction output



budgets among clients. Strengthening occupier and investment demand for commercial real estate, spreading beyond London, had increased demand for a range of related services. The rate of growth in other business services had also edged up, though activity levels were often uneven across subsectors and geographical areas. The strongest growth was still being reported in IT services, driven by demand for software and system upgrades, consultancy, mobile technology and web-based infrastructure. The recovery in construction was bolstering workloads for contacts in a variety of subsectors, including hauliers, builders' merchants, and plant hire firms. Corporate travel bookings and conferencing had remained well below pre-crisis levels, but hoteliers reported signs of improvement as companies started to increase discretionary spending.

Manufacturing

Output for the domestic market had continued to grow steadily overall (**Chart 2**), although the experience across subsectors was mixed. Output growth was strongest for manufacturers of construction products, particularly those related to house building. Automotive and energy supply chains continued to grow robustly on the back of strong domestic and overseas sales. Demand for non-durables and textiles had remained flat, however. Companies supplying the public sector, especially defence, had continued to report subdued demand conditions.

Construction

Construction output growth had risen further (**Chart 2**). House building had remained the primary driver of growth. Improved sentiment in the commercial property sector outside London had, so far, principally led to an increase in refurbishment projects rather than new building. But plans for larger projects were reported to be taking shape and some contacts had started to talk about the start of a return of speculative development in a few hotspots. Investor appetite for student accommodation schemes had remained undiminished. The wet weather had adversely affected output in some areas, but nationally the picture was one of more favourable conditions for builders than a year ago, given the heavy snowfall at that time. Contacts expected a sharp pickup in repair and reconstruction work in flood-hit areas in the coming months.

Credit conditions

Credit conditions had eased slightly further. Demand for corporate credit had edged higher, although a significant proportion of contacts were reported to be using cash reserves rather than credit for capital expenditure projects and acquisitions. Banks were said to be actively seeking to grow their loan books, primarily among larger firms, or those with strong balance sheets. Most large and medium-sized borrowers reported little difficulty in raising finance at reasonable cost through bank or non-bank sources. Conditions had remained tight for smaller firms, though, and some banks were still reported to be averse to lending to certain sectors, such as construction, retail and hospitality. Availability of funding for commercial property companies had improved, but was still reported to be restraining activity for some developers. Asset finance availability appeared to be good, with no reports of contacts struggling to finance machinery. Non-bank finance had continued to grow in importance as a source of corporate credit.

Employment

Employment intentions over the next six months pointed to further modest headcount growth, albeit at a rate below that of output growth, as contacts sought productivity gains to help meet rising demand. That said, some companies seeking to increase the recruitment of trainees in response to skills shortages anticipated a temporary negative impact on productivity as skills were developed. For some contacts, there was scope to cope with higher activity levels by increasing hours worked rather than employment. Headcount growth appeared strongest in professional services, IT and construction, but was being dampened in some manufacturing firms by consolidation of factories aimed at cost reduction. Recruitment difficulties had edged up, and were marginally above normal (**Chart 3**). Skills shortages were most pronounced in IT, engineering and construction, but there were increasing reports of a spread to other roles, such as senior management positions.

Capacity utilisation

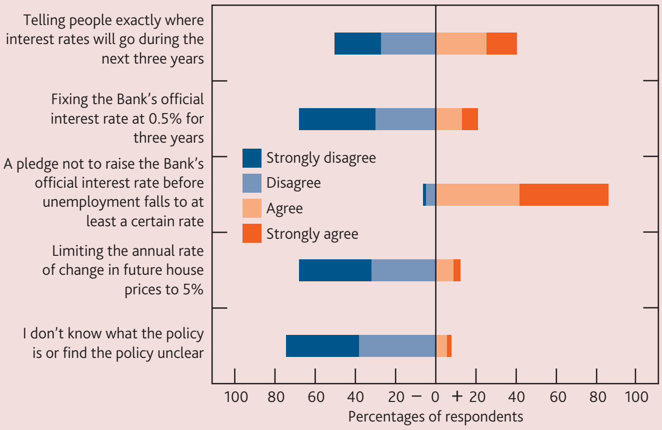
Capacity utilisation had remained close to normal, though there was evidence of a small, but growing, number of constraints emerging as demand continued to improve. Those were most evident in housing-related construction, where

Agents' survey on forward guidance

In August 2013, the Monetary Policy Committee provided guidance about the future path of policy, stating its intention not to raise Bank Rate at least until the unemployment rate fell to a threshold of 7%, provided this did not entail material risks to either price or financial stability. In order to gauge how well businesses understood the Bank's policy of forward guidance and whether the policy had affected their confidence and behaviour, the Agents ran a poll of their principal contacts in January 2014, with a total of 1,574 responses.(1) The main results from this survey were contained in a box in the February 2014 *Inflation Report*.(2) Some care is required in interpreting the survey results given that Agents' contacts might be expected, on average, to have a better understanding of monetary policy than for the corporate sector as a whole. Nonetheless, the results suggest that companies have a good understanding of forward guidance and that the policy has had a positive effect on confidence, spending plans and staffing.

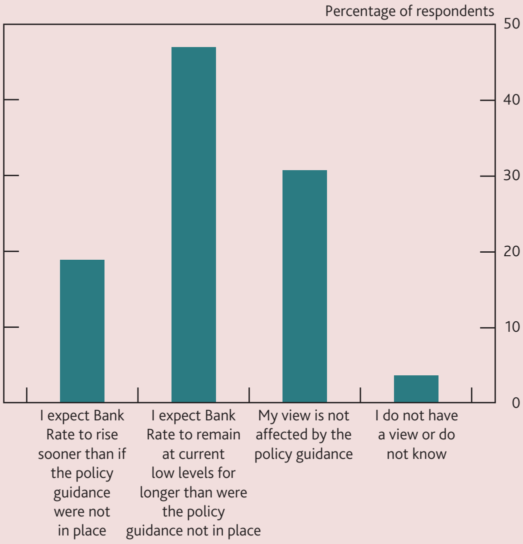
The survey asked companies how well a number of statements described the key message of the policy. Some nine in ten respondents agreed with the correct description of forward guidance (**Chart A**). Of those, around half indicated that they knew all alternative descriptions were incorrect or had 'no view' on the alternatives. Less than 10% of respondents stated that they didn't know what forward guidance is, or that they found the policy unclear.

Chart A Company understanding of the central message of forward guidance



Contacts were asked how forward guidance had changed their views of future Bank Rate. Almost half of respondents expected Bank Rate to remain at current low levels for longer than if the guidance were not in place (**Chart B**), with just under 20% who, conversely, expected Bank Rate to rise sooner than if the guidance was not in place. Nearly a third of respondents reported that their views were not affected by the policy. Overall, a net balance of nearly 30% of respondents expected Bank Rate to remain at low rates for longer than they would have in the absence of guidance.

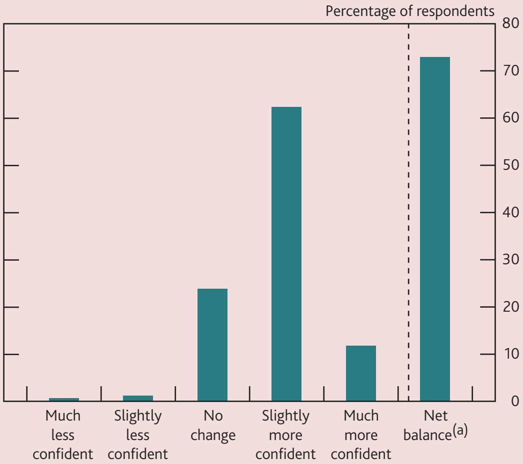
Chart B Changes in contacts' expectations of the next change in Bank Rate



Some two thirds of respondents thought the next change in Bank Rate would be an increase in 12–24 months' time, with the rest of respondents split between an increase in 6–12 months (19%) and an increase after two years (13%). Only 1% of respondents believed that interest rates would rise within 1–6 months.

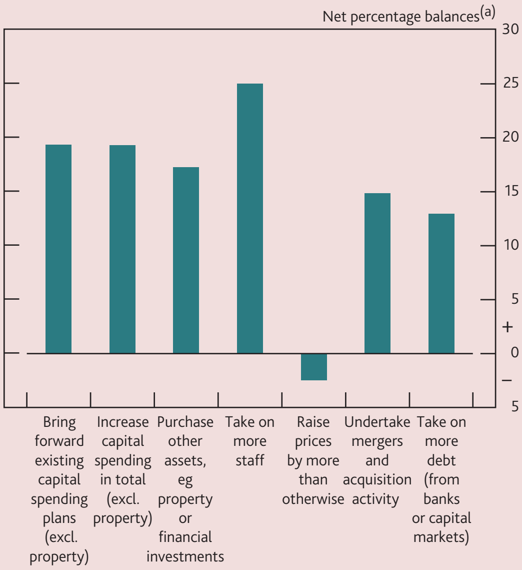
The survey asked about the effect from the policy guidance on contacts' confidence about near-term (one to two year) prospects for the economy. A net balance of just over 70% of companies reported a positive effect (**Chart C**), with 12% saying the policy had made them much more confident.

Chart C Effect on companies' confidence



(a) Net balance is the difference between the percentages of respondents that are more confident and less confident.

Chart D Company decisions influenced by the Bank's policy guidance

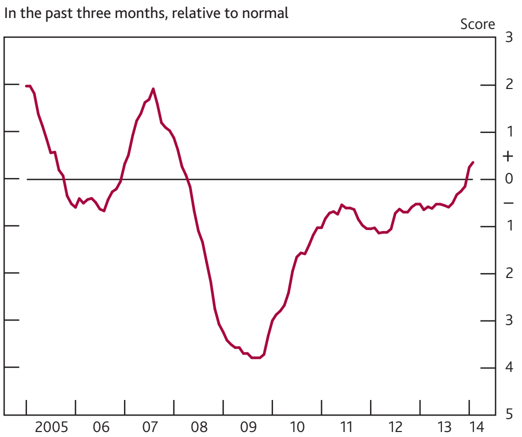


(a) Net percentage balances are the differences between the percentages of respondents that are more likely and less likely to take the listed action as a result of the Bank's policy guidance.

Questioned about their response to the Bank's policy guidance, companies reported a positive influence in bringing forward their capital spending, increasing their capital spending in total, and on their purchasing of other assets (**Chart D**), with net balances for each of nearly 20%. But the single largest positive effect reported — with a net balance of one quarter of respondents — was on staff numbers. A positive influence was also reported on mergers and acquisitions activity and in terms of debt levels.

(1) The survey was conducted through an online poll of principal contacts between 9 and 21 January. Responses were anonymous.
(2) See page 12 of the February 2014 *Inflation Report*, available at www.bankofengland.co.uk/publications/Documents/inflationreport/2014/ir14feb.pdf.

Chart 3 Recruitment difficulties



shortages of materials had persisted as mothballed capacity had been brought back on line only gradually. A growing, but still small, minority of manufacturing companies were increasing physical capacity as they approached full capacity. Utilisation in services had edged up a little on the month. Professional services firms were increasing headcount in response to growing demand, although there were some expectations that mergers and acquisitions activity might increase effective capacity through greater efficiency. Slack in the economy was often reported to be concentrated among consumer services firms, where some retailers were consolidating floor space and redirecting resources into multi-channel operations, such as 'click and collect'.

Costs and prices

Labour costs

Labour costs per employee had continued to grow moderately. Pay settlements had remained muted in the majority of cases, albeit with fewer pay freezes than in recent years. However, there were some reports of concerns about pay pressures starting to build. For example, many contacts reported having to pay more than they had expected to attract new recruits and a few had brought forward awards or made specific awards to retain key staff. For the most part, though, emerging skills shortages had led to targeted increases in pay rather than any general increase. Variable elements of remuneration, such as commission, bonuses and profit-related pay had also started to increase alongside rising activity. Total labour costs per employee had continued to grow faster than pay because of the ongoing impact of auto-enrolment into pension schemes.

Non-labour costs

Materials cost inflation had eased, with costs little changed on a year earlier. That had reflected a weakening of commodity prices, with fuel prices in particular, having fallen. The major exception to that pattern had remained construction materials, where supply shortages had led to increased prices. Contacts continued to express concern about the level, if not the growth, of energy costs. Inflation in the costs of imported goods had also fallen back. Some food processors and other importers had reported a weakening of import prices recently as a result of the appreciation of sterling. For others, however, a tendency to order up to twelve months ahead and the prevalence of hedging contracts would delay the pass-through of the recent appreciation. Downwards pressure on some import prices was also reported from the effects of weak European demand on Far Eastern manufacturers' pricing.

Output prices and margins

Manufacturing output price inflation had edged down, with prices remaining slightly higher than a year ago. Easing commodity prices and strong competition had continued to put downwards pressure on output price inflation for many contacts. Output price rises among construction product manufacturers and reports of increasing pricing power among some producers of highly specialised products were exceptions to that pattern. Business services price inflation had edged higher, continuing a gentle upwards trend seen over the past year. Price increases had continued to be contained by competition, particularly within some 'commoditised' areas. But resistance to gentle price rises from customers was reported to be easing for some contacts, and increasing volumes had enabled some contacts to skew their output towards higher margin work. Changes in pricing structures had improved fee incomes in some professional services. Overall profitability had edged up further for both manufacturing and services, due to a combination of higher volumes, easing cost pressures and efficiency gains.

Consumer prices

Consumer goods price inflation had continued to slow (**Chart 4**). Food price inflation had abated further, reflecting weaker world commodity prices, the recent appreciation of sterling, and the effect of heavy discounting by supermarkets. An increasing use of price comparison websites was reported to be restricting the scope for price increases for some other goods. Vehicle fuel prices were broadly flat on the year before. Retail services price inflation had eased slightly, but by less than for goods prices (**Chart 4**). A slight improvement in discretionary spending was resulting in a gentle increase in price inflation for some holidays and leisure attractions. But a number of inflation-linked price increases had been lower than in the previous year (eg public transport fares, some utility company charges). Private housing rental growth had showed some signs of easing off as owner occupation picked up. And competition for limited stocks of homes on the secondary market had put downward pressure on some estate agents' fees.

Chart 4 Retail price inflation