BANK OF ENGLAND

Agents' summary of business conditions

October 2013

- Growth in demand and output had gathered pace.
- Underlying consumer confidence and spending had picked up a little further on a year ago.
- Demand for housing had continued to strengthen.
- Investment intentions remained modestly positive and showed signs of improvement.
- Growth in manufacturing output for domestic and overseas markets had picked up.
- Business services turnover growth had strengthened as work volumes increased.
- Construction output growth had continued to increase as house-building activity rose, though there were rising reports of capacity constraints starting to bite.
- Corporate credit availability and demand had increased a little. Payment terms between companies had lengthened in some cases, notably in retail and construction.
- Employment intentions had risen in business services. Recruitment difficulties had tightened a little but remained marginally below normal.
- Capacity utilisation had continued to recover towards normal in manufacturing. There remained some slack in services, more so in consumer-facing than in business-to-business firms.
- The annual rate of growth in labour costs per employee remained modest, but there were early signs of upward pressure for some roles.
- Annual growth in the cost of raw materials had eased.
- Inflation in manufacturers' output prices and business services prices remained muted.
- Consumer price inflation had remained stable, but was expected to ease in food.

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 August 2013 and late September 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.

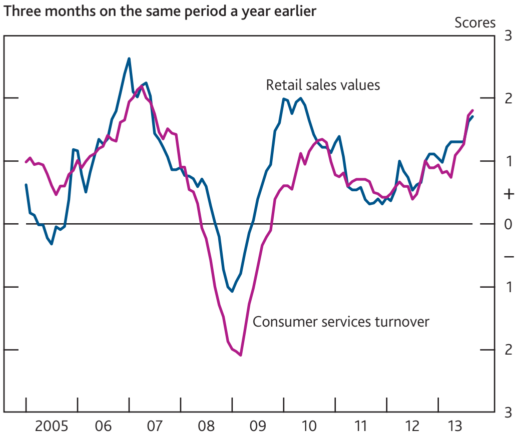
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the *Inflation Report*, obtained from: **www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx.**

Demand

Consumption

Underlying consumer confidence and spending had picked up a little further on a year ago (**Chart 1**). Expenditure on household durables such as furniture had risen, driven by a pickup in demand for housing; average spend in shopping centres had increased slightly. New car sales continued to show strong growth, assisted by manufacturer incentives. But there were some reports of a slight softening of growth in retail sales values in the most recent weeks as the boost from summer weather to spontaneous purchases of items such as seasonal clothing and food had faded, and consumers had reverted to more careful budgeting. Consumer services turnover had received a greater fillip than retail sales from higher summer footfall to hotels, outdoor attractions and leisure facilities. Discretionary spending on overseas holidays and for luxury services, such as spas, had risen, but expenditure on lower value transactions had remained tight.

Chart 1 Retail sales and consumer services turnover



Housing market

Demand for housing continued to gather pace, driven by greater mortgage availability, confidence (both in economic recovery and that house prices would not fall) and the Help to Buy scheme. The pickup in demand looked set to attract a stronger flow of instructions onto the secondary market. Prices of existing houses had risen more rapidly in London than elsewhere in the United Kingdom, where price rises were forecast to stay modest unless supply shortages arose. Vendors were more likely to achieve their asking price than a year ago, but prices remained well below pre-crisis peaks outside of South East England.

Business investment

Investment intentions in both manufacturing and services continued to point to modest growth in capital spending over the next twelve months (see page 5). Manufacturing investment had centred on efficiency gains (often linked to energy costs), or was regulation-led, with little (major) capacity expansion unless related to exports or acquisitions. But looking forward, there were indications that plans for additional capacity and product development — in some cases put on hold since the crisis started — were being reconsidered due to growing demand and confidence. IT spending — often to replace ageing equipment — accounted for much of the gradual increase in services investment intentions. In business services, such investment was often aimed at raising efficiency, while in consumer services spending was more focused on enhancing customer experience and online capability. A slight uplift in retailers' spending on premises refurbishment and/or rebranding was also reported, reflecting competition for business in a tough trading environment. Investment in ports and transport facilities had risen.

Exports

Growth in manufacturing exports had risen, including for sectors such as oil and gas, medical equipment, aerospace and automotive. Export growth was said to have been strongest to the United States, Middle East, Asia, Australia and Russia. There had been continued signs that euro-area demand was stabilising. Sales growth to some developing economies had started to moderate, partly as lower commodity prices had slowed mining activity. Services exports growth had continued to improve, led by demand for engineering consultancy related to construction and energy projects in the Middle East and Australia. Overseas visitor numbers were ahead of a year earlier.

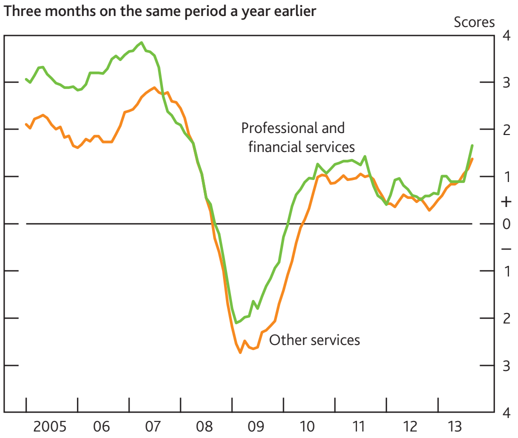
Imports had continued to increase in consumer goods, due to demand for products such as cars; imports of construction materials had also risen, reflecting pressures on UK production capacity.

Output

Business services

Growth in business services turnover had strengthened, particularly for professional services, reflecting rising volumes rather than prices (**Chart 2**). Demand had risen for higher

Chart 2 Business services turnover



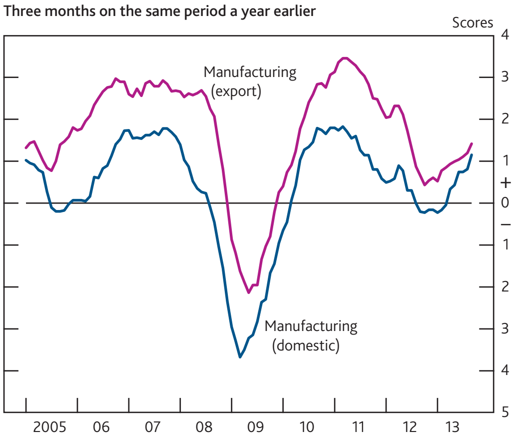
value added advice from lawyers and accountants around mergers and acquisitions and corporate finance. Strengthening demand in the economy was translating into higher usage of IT providers, marketing (for example by house builders for new sites), and of residential property-related services. Recruitment agencies also reported higher demand as staff started to move employer again, and hauliers noted greater workloads from higher online spend by consumers and stronger house building activity.

Manufacturing

Output growth for the domestic market had picked up moderately (**Chart 3**). Demand among house builders for early stage construction materials and aggregates had widened to fit-out products such as windows and doors. Improved consumer demand for household goods had raised output a little, and capital goods manufacturers reported higher orders. Export growth in aerospace, automotive, food and pharmaceutical products also continued to contribute positively to supply chains. Food volumes growth remained subdued as consumers reduced wastage in the face of price inflation.

Chart 3 Manufacturing output

Three months on the same period a year earlier

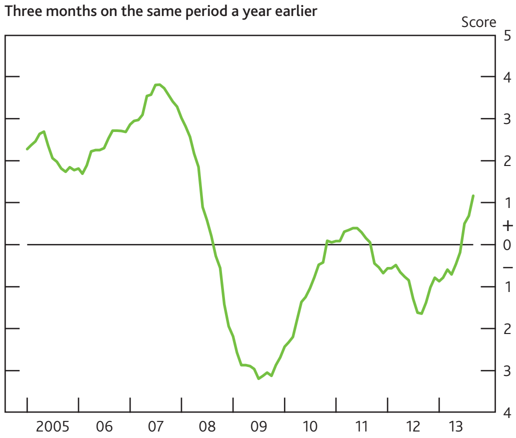


Construction

Annual growth in output had continued to strengthen (**Chart 4**). Private house building activity had risen robustly on a year ago in response to demand, and social housing starts were also supporting growth. Both trends were set to persist, though there was a risk that growth could be curtailed by emerging capacity constraints in both skills and materials. Development of new office, hotel and logistics space had started to rise slightly as finance gradually became available again. That reflected a paucity of vacant or new prime space, which was also helping to stimulate refurbishment of attractive secondary sites. Health, education and infrastructure projects, as well as utilities' capital programmes, remained a cornerstone of work for many contractors, given the lack of speculative property development activity.

Chart 4 Construction output

Three months on the same period a year earlier



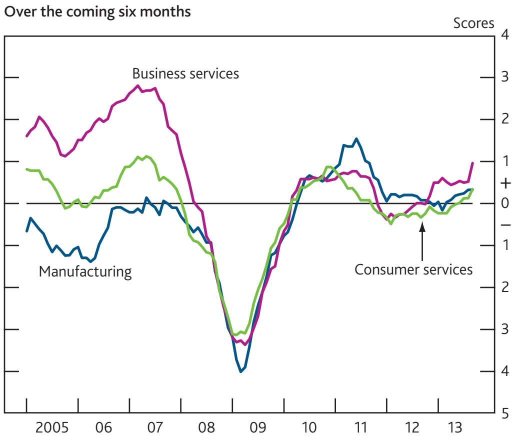
Credit conditions

Corporate credit demand and supply had edged higher. Banks had become more proactive in speaking to customers, but the collateral requirements for bank lending were often a stumbling block for smaller businesses. Reliance on non-bank funding continued to grow, either from internal resources, assisted by higher cash balances, or external providers, including pension funds and insurance companies on larger transactions. Commercial property lending had started to recover modestly. Working capital had become more strained for some smaller businesses as larger customers' payment terms had lengthened, notably in the construction and retail sectors. In some cases the impact on suppliers' cash flow was mitigated by larger customers offering early payment in return for a discounted price. Invoice discounting provided another method to improve cash flow, but some businesses facing low profit margins reported that the costs of this form of finance were high.

Employment

Employment intentions had risen in business services but remained subdued overall (**Chart 5**). The wholesale and distribution sector was expanding headcount, but often through temporary labour, and IT providers were taking on more contractors. Although professional services firms saw demand strengthening, contacts remained reticent to raise staffing overheads, and planned to focus recruitment on junior staff, or to exit less profitable work. Many consumer services firms reported that higher demand would first be met by increasing hours of existing staff at peak times, though estate agents had increased staffing as housing activity had risen. Manufacturers expected to respond to rising demand through increases in productivity rather than staffing. Apprentice numbers were growing as employers responded to ageing workforces whilst maintaining prudent control of labour costs. Recruitment difficulties had tightened beyond engineering and IT to include other skills: construction trades, HGV drivers and sales and marketing. Staff churn was starting to rise above recent record lows. However, recruitment difficulties remained marginally below normal overall and were not an issue for the majority of unskilled roles.

Chart 5 Employment intentions



Capacity utilisation

Capacity utilisation had continued to recover towards normal in manufacturing. Spare capacity remained more pronounced in capital than labour, and many manufacturers felt confident that higher demand over the next six months could be met by adding temporary labour or shifts, and, to a lesser degree, plant. Capacity constraints had already become an issue in construction, particularly for materials such as bricks, causing delivery times to lengthen and imports to rise. Such constraints might be temporary, particularly for materials; the growth of skills shortages caused by employees having left the industry and a lack of training since the onset of the crisis appeared likely to be more persistent, however. Some slack remained in services sector companies, more so in consumer-facing than in business-to-business providers. Professional services firms looked to manage greater demand by concentrating more on value added, higher margin work as fee rises remained difficult. Consumer services firms' usage of labour had stayed tightly controlled, and staffing was expected to be stable in the near term, with employees working more intensively to meet any increase in demand.

Costs and prices

Labour costs

The annual rate of growth in labour costs remained modest, but there were early signs of upward pressure for some roles. Pay rises continued to remain in the 2%–3% range in manufacturing, and slightly lower in services, as consumer services firms' pay awards were often either tied to the national minimum wage or had stayed low. Professional services firms had sought to offset pay rises by changing the mix of staff towards lower paid trainees. Improvement in companies' performance overall was likely to translate more directly and quickly than in the past to remuneration as the proportion of staff on performance-related pay continued to rise. In addition, some above average pay rises and pay drift were reported where there were skill shortages or rising staff turnover — for example, in construction, engineering and IT. It remained difficult for firms to judge the implications of auto-enrolment pensions for future pay as staging dates approached.

Non-labour costs

Annual increases in the cost of raw materials had eased. Cost inflation had become less of an issue for contacts, with the exception of energy and, in particular, construction materials, where price inflation had picked up. The cost of most metal products had fallen, and improved global harvests had lowered grain prices. Business overheads such as rent and insurance remained broadly flat but business rates had continued to rise. Inflation in the cost of imported finished goods had edged lower, in part reflecting some easing of world demand growth. Most contacts reported that the depreciation of sterling at the start of the year was continuing to feed through positively to imported prices. But the more recent rise in the value of sterling was expected to put downwards pressure on imported goods price inflation in the future, albeit with the usual lags.

Output prices and margins

Price increases in manufacturing and business services had remained subdued. Slowing cost inflation gave most suppliers less ground for raising prices, and most firms preferred to hold prices to avoid the risk of customers searching for alternative suppliers. It was considered easier to build profitability gradually through volume and productivity growth, or by exiting less profitable work, for 'commodity' goods production and services such as haulage. Margins had risen modestly, but remained weak, notably in services.

Consumer prices

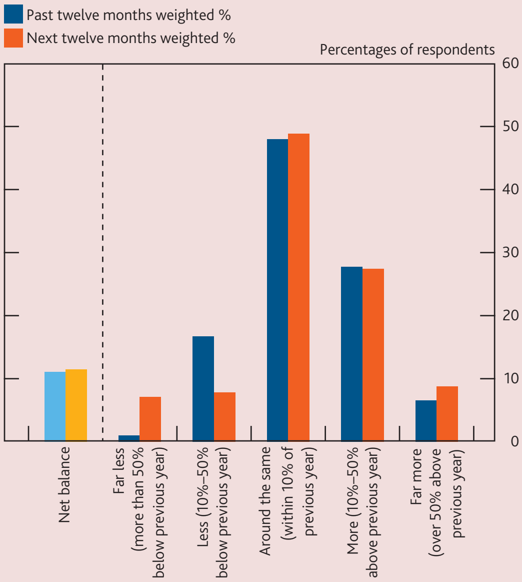
Consumer price inflation remained stable, but was expected to ease in food. Administered and regulated prices such as energy continued to be prime contributors to upward price movements. Furniture and flooring prices had increased slightly as sales improved. Food price inflation had persisted for some products but was expected to slow following strong global harvests. However, red meat and dairy product prices were expected to remain high. Consumers' willingness to search for the best deal was not expected to change, and the importance of price points continued to encourage re-engineering of products where costs had advanced — for example in food. The warmer summer weather — and resulting better demand — had allowed some tourism and leisure operators such as hotels to raise prices, and there had been less discounting in clothing, reflecting lower stock overhang.

Agents' survey on investment intentions

The Agents asked businesses about the change in their capital expenditure over the past year and their intentions for the next twelve months. Firms were also asked about factors that were affecting investment plans over the next twelve months and about the proportion of planned investment that was expected to be funded from internal sources of finance. Four hundred and ninety six companies participated in the survey, with a combined turnover of almost £150 billion and employing a total of 577,000 staff. Results are weighted by employment unless otherwise stated.

Overall, firms reported there had been a modest increase in investment over the past twelve months and expectations were for a similar increase in the coming twelve months (**Chart A**).

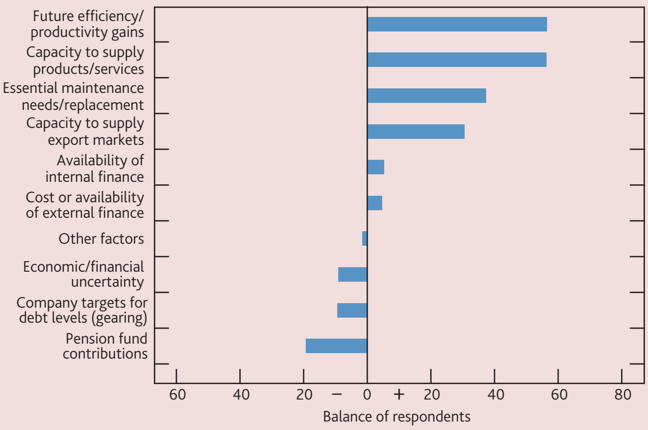
Chart A Investment over the past twelve months and intentions for next twelve months



The outlook for manufacturing, business services and utilities and extraction companies' investment had weakened relative to the previous twelve months. But this was counterbalanced by a pick up in consumer services firms' investment plans and an end to the decline in construction contacts' investment seen over the prior twelve months.

In terms of the factors affecting investment spending (**Chart B**), the majority of respondents, weighted by employment, reported that their investment plans for the coming twelve months were boosted by a desire to add to capacity, either for domestic or export markets. A quest for future efficiency/productivity gains, as well as the essential maintenance or replacement of assets, were also expected to

Chart B Factors affecting investment plans over the next twelve months[(a)]



(a) A negative balance indicates more respondents answered that a factor would push down investment than boost investment.

boost investment over the next twelve months. In addition, the availability of external and internal finance was expected to provide positive support for investment for a small balance of firms surveyed. Pension fund contributions, company targets for debt levels and uncertainty about the economic environment were reported to be pushing down on investment plans over the next year.

The vast majority of respondents expected to fund over 75% of their investment from internal finance, slightly above pre-crisis norms (**Chart C**). The shift towards the internal funding of investment, relative to the pre-crisis period, was most marked for small firms (up to 50 employees). That appeared consistent with tight credit conditions reported by smaller firms, relative to larger firms with greater access to non-bank finance, and with reports from smaller firms that they remained reluctant to rely on bank funding.

Chart C Proportion of investment funded internally