BANK OF ENGLAND

Agents' summary of business conditions

December 2013

- Growth in the value of retail sales and consumer services had eased in recent months.
- Housing market activity had continued to strengthen but remained below pre-crisis levels.
- Investment intentions had continued to point to modest growth in capital spending over the next twelve months.
- Growth in business services turnover had risen further.
- Growth in manufacturing output for the domestic market had edged higher. Growth in manufacturing exports had remained unchanged.
- Construction output had continued to accelerate from a low base, largely reflecting rising house building activity.
- Corporate credit availability and pricing had continued to improve, though conditions remained tight for many small companies.
- Employment intentions pointed to modest employment growth over the next six months. Recruitment had remained slightly easier than normal, though for a number of skilled occupations some difficulties had been reported.
- Capacity utilisation was approaching normal levels in manufacturing and services.
- The annual rate of growth in labour costs per employee had remained unchanged.
- Inflation in materials costs had remained subdued. Imported finished goods price inflation had fallen, largely reflecting the effects of sterling's recent appreciation.
- Output price inflation had remained muted, but profitability had edged higher.
- Consumer price inflation had edged down, partly reflecting lower fuel prices.

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 October 2013 and late November 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 the value of retail sales and consumer services had remained steady. However, the pace of month-on-month growth had eased back recently as the boost to sales from good summer weather had faded. Contacts reported continuing growth in sales of a variety of household durables as housing market activity — and confidence more generally — had increased. But there were some reports from retailers of softening consumer demand, sometimes attributed to consumers 'reining in' ahead of Christmas. New car sales growth was reported to have remained robust, albeit some contacts had reported a recent easing in its pace. Consumer services turnover growth had remained unchanged. A gradual increase in appetite for leisure spending was reported, reflected by steady growth in hotel, restaurant and travel demand. However, consumers' disposable incomes had remained tight.

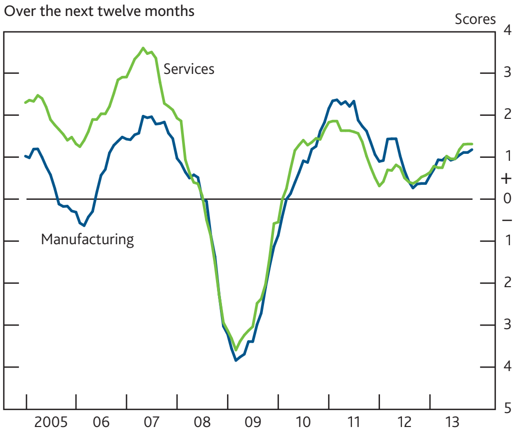
Housing market

Housing market activity had continued to strengthen, though remained below pre-crisis levels. Demand for house purchase was being buoyed by improved mortgage availability and pricing, rising household confidence and the Help to Buy scheme. Buy-to-let demand was also reported to have remained firm, with some isolated reports of overseas investor interest spreading beyond London. Estate agency and conveyancing activity was picking up alongside transactions. But some estate agents reported falling levels of stocks of homes for sale, as sales outpaced new instructions. That was leading to some upward pressure on house prices overall, though house price inflation outside London was generally reported to remain modest.

Business investment

Investment intentions pointed to modest growth in capital spending over the next twelve months (**Chart 1**). But although economic uncertainty had fallen and credit availability had gradually improved, many firms remained cautious about prospects and some continued to delay expenditure. Manufacturing investment intentions had edged up, with increasing reports of plans to expand capacity in areas such as automotive and aerospace supply chains, alongside a continuing focus on efficiency and automation across many firms. In services, investment continued to be dominated by IT spending, as systems were renewed or the interface with customers improved. Investment in large commercial vehicles had also remained strong, partly reflecting tighter emissions regulations to come. Some consumer-facing businesses were increasing investment to refurbish premises, or to improve energy efficiency. More generally, there were reports of investment to consolidate businesses, alongside gently increasing mergers and acquisitions activity.

Chart 1 Investment intentions



Exports

Growth in manufacturing exports had continued at a steady rate. There were reports of continuing growth in manufacturing exports to the United States. Exports to the Middle East and emerging markets had also continued to grow, though reports on demand from China were mixed. Some contacts had said that Northern European markets were strengthening, and those in the euro area overall were broadly stable. Export growth was often reported to be strongest in aerospace, automotive and energy supply chains. In contrast, exports of mining equipment were said to have weakened alongside a retrenchment of activity in the sector globally. Services exports had continued to grow, including demand for consultancy services related to construction and energy projects in the Middle East, and numbers of foreign tourists in the United Kingdom had risen.

Output

Business services

Growth in business services turnover had risen further (**Chart 2**). Demand for a range of professional advisory services had risen, including those related to mergers and acquisitions, corporate finance and business strategy, as well as more specific issues such as auto-enrolment pensions. Commercial property related activity had picked up alongside a rise in investment and signs of a recovery in occupier demand. Recruitment agency activity was picking up. Construction and planning-related services had seen accelerating turnover as house building had strengthened. Some areas of financial services also reported growth, including non-bank asset finance and asset management. However, demand had remained weak for many smaller legal firms, with gradual consolidation continuing in the sector. Growth in other business services had been broadly stable and widespread across subsectors. Areas experiencing rising turnover included haulage and distribution, linked in part to the pickup in construction activity. IT services growth had remained strong. Business travel had picked up and companies' willingness to spend on corporate hospitality had edged higher, albeit from a low level.

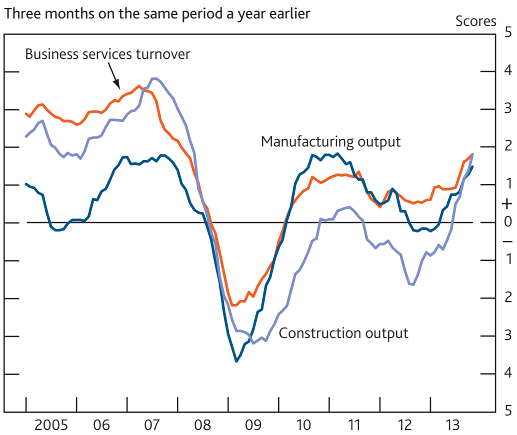
Manufacturing

Output growth for the domestic market had edged higher, but remained below rates seen during 2011 (**Chart 2**). Aerospace, automotive and energy-related manufacturing continued to show robust growth and, overall, domestic food manufacturing was increasing as demand for UK-sourced product had risen. Growth in construction materials production had increased further. However, the production of basic household goods had remained subdued, as had steel production.

Construction

Annual growth in output had increased further (**Chart 2**), largely reflecting rising house building, both private and social. The pace of recovery in house building had led to recruitment difficulties in the sector and to shortages of certain building materials (bricks, blocks), though the effect on output growth was yet to be significant. There were also reports of increasing construction of home extensions, and of rising interest in the conversion of old office space to residential use, following an earlier easing of planning regulations. Outside of residential activity, construction output had generally remained subdued, though there were some early indications of recovery spreading. Office refurbishment activity had picked up somewhat, alongside gradually increasing churn among corporate tenants. And there were widespread — if still patchy — reports of rising activity in the pipeline of commercial development outside London for perhaps the first time since the financial crisis. However, some contacts reported that a number of major infrastructure projects had passed their peak in terms of activity, and public sector spending — in particular by local authorities — remained subdued.

Chart 2 Manufacturing, business services and construction activity



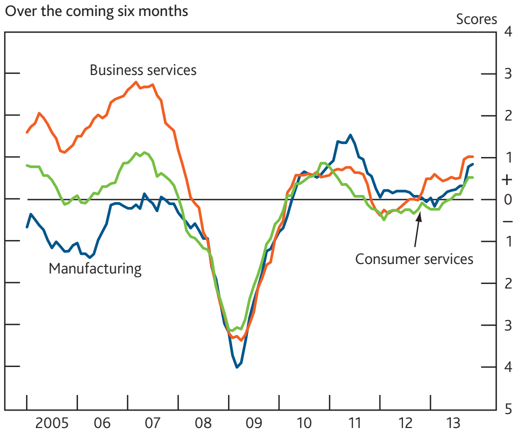
Credit conditions

Credit availability and pricing had continued to improve for companies, though remained tight for many small firms. There were increasing reports of companies with strong balance sheets being approached by banks to change their lender, consistent with rising competition among banks. But small companies still often reported difficulties accessing affordable bank finance in a timely way. That, alongside a desire to reduce dependence on banks in the longer term, was encouraging the use of non-bank sources for new funding needs. Bank credit availability for commercial property investment was reported to have eased, with private non-bank funding increasingly available for development activity. There were signs of gradually increasing credit demand as companies' confidence and investment intentions edged higher, alongside low interest rates. Sizable gross repayments of bank debt by small and medium-sized enterprises (SMEs) had continued, largely reported to be in line with existing loan schedules rather than a deliberate acceleration of debt reduction.

Employment

Employment intentions pointed to modest employment growth over the next six months (**Chart 3**). With growth in the workforce lower than the rate of output growth, productivity had risen somewhat. Employment growth had been faster in professional services than in other services or manufacturing, reflecting strong growth in turnover and rising capacity utilisation. But professionals also reported that winning new work continued to require high levels of staff input, given competitive conditions, and some firms were hiring staff in preparation for entering new markets. Manufacturers often reported aiming to increase productivity before taking on further staff, but overall expectations were for modest headcount increases. In some cases, recruitment and training of apprentices or new graduates were taking place ahead of older employees retiring. Rising house building activity was leading to increasing employment in construction

Chart 3 Employment intentions

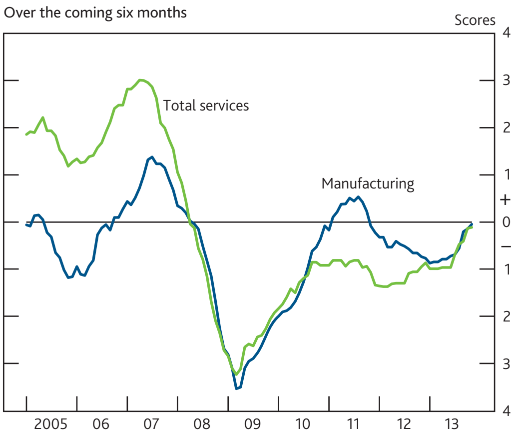


and related businesses. In consumer services, increases in headcount were largely confined to new store openings or were associated with the development of on-line sales infrastructures. In many cases companies planned to increase the hours of existing staff before increasing employee numbers. Overall, recruitment had remained slightly easier than normal, but continued difficulties were reported in a range of skilled occupations, including IT and engineering, some mid-ranking professional roles, a number of house building trades, as well as nursing and care home staff.

Capacity utilisation

Capacity utilisation was approaching normal levels in manufacturing and services, as activity in the economy increased (**Chart 4**). Within manufacturing, utilisation was highest in automotive, aerospace and energy supply chains, but in some other parts of manufacturing there remained considerable slack. Less slack was reported by business services firms than in consumer services. In the latter there was evidence of utilisation increasing, for example hotel occupancy rates. In general, utilisation of physical capacity was reported to be lower than that of labour, where some skills shortages were apparent. But there were few signs as yet of capacity constraints binding. However, in the house building sector and its associated supply chains and services there were concerns that capacity constraints could begin to restrain output growth in the near term. A box on page 5 summarises the results of a wider survey of contacts' capacity utilisation and constraints on firms' ability to respond to rising demand.

Chart 4 Capacity utilisation



Costs and prices

Labour costs

The annual rate of growth in labour costs per employee had remained moderate, with pay rises continuing to be clustered around 2%–3%. However, labour market churn had increased alongside rising confidence, and a range of contacts had reported having to increase salaries in order to fill individual vacancies, or retain key staff in areas where skills were in short supply. There were fewer reports of pay freezes, and on balance, contacts expected some gentle upward pressure on labour costs per employee next year as company profitability gradually rose. The effects of auto-enrolment on future labour costs were increasingly mentioned as a concern by SMEs, with some expecting to bear down on pay increases in response.

Non-labour costs

Inflation in materials costs had remained subdued. Prices for most materials were reported to be stable or falling. However, increases in overheads costs, such as energy prices and business rates, had continued to cause concerns for many businesses, and the prices of a range of basic house building materials were rising. Imported finished goods price inflation had fallen, largely reflecting the effects of sterling's recent appreciation and also a dampening effect from weaker growth in emerging markets.

Output prices and margins

Output price inflation had remained muted. In manufacturing it was often reported to be subdued, though the significant price rises seen for some construction products used in house building were an exception. Business services price inflation had been unchanged, with contacts reporting considerable pressure against price increases from strong competition and tight procurement processes. In both sectors, companies that provided high-value added products, or were introducing new outputs, had greater scope to raise prices. Profitability was widely reported to have increased from a low base, however, often as increasing activity reduced average unit costs or companies felt more able to turn away lower-margin work.

Consumer prices

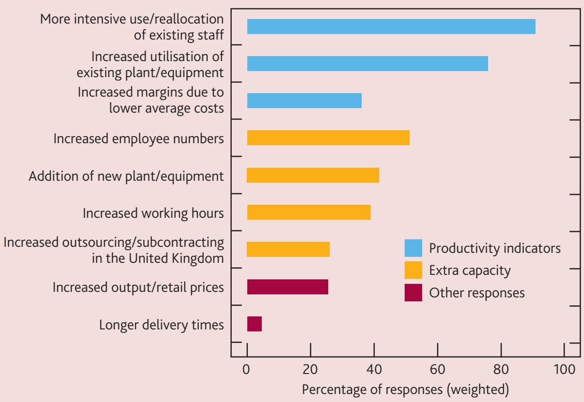
Consumer price inflation had edged down. That had partly reflected lower road fuel prices — which had also fed through to some transport services pricing. Food price inflation was reported to have edged lower overall, alongside improved harvests in 2013. The energy price rises now scheduled would provide some upward pressure on inflation to come, though it was likely that inflation in some other administered and regulated prices linked to the retail prices index (RPI) would ease in the early part of next year, as earlier falls in RPI inflation fed through with a lag. More generally, little inflationary pressure was reported, given the cost-consciousness of consumers and the tightness in their disposable incomes.

Agents' survey on capacity utilisation

In October and November 2013 the Agents surveyed their contacts to help assess how firms are responding to increased demand in the economy, and firms' capacity to respond to future growth in demand. Business contacts were asked how they had reacted to increased demand (when relevant) in the past twelve months, how they would react in the event of a sharp increase in demand over the next six months, and about constraints on their ability to respond to rising demand now or in the next six months. A total of 525 firms participated in the survey, with a combined turnover of £86 billion and employing a total of 430,000 staff. Results are weighted by employment unless otherwise stated.

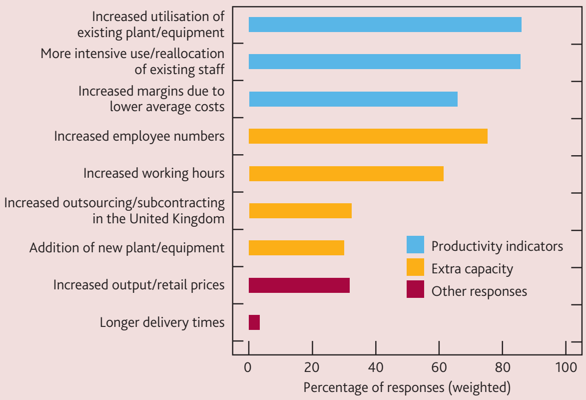
Among firms that had seen demand increase in the past twelve months, a large majority indicated that they had made greater use of existing resources, particularly of staff but also of plant and equipment (**Chart A**). Smaller but still significant proportions of firms had added staff or new plant and equipment. This suggests that, while many firms had responded to higher demand over the past twelve months by increasing their productivity, some may already have reached or foreseen some constraints on their capacity. Only a minority of firms had increased prices or had stretched out delivery times in response to higher demand.

Chart A Responses to higher demand in the past twelve months



The Agents asked firms how they would respond to a scenario where demand increased by 10% over the next six months, as a way of probing firms' ability to cope with a large and rapid uplift in demand. A large majority reported that they would increase utilisation of capital and labour further — indicating potential scope for additional productivity gains in response to higher demand (**Chart B**). Compared to the backward-looking results discussed above, in this scenario a larger number of firms reported that they would add labour, both by recruiting more employees and by increasing working hours. This could reflect the large increase in demand over a short time period posited in this question, but it might also suggest that some spare labour capacity has already been eroded. Across sectors, construction firms reported facing the greatest difficulties responding to 10% demand growth with existing resources: over 80% of firms would need to add extra staff and/or subcontract more, and were more likely to increase output prices than in other sectors. Consumer services firms saw the least scope to respond to increased demand by raising prices (14% would do so).

Chart B Responses to a 10% increase in demand in the next six months



Constraints to responding to higher demand now or in the coming six months were not particularly widespread (**Chart C**). On an unweighted basis, a third of firms did not acknowledge any constraints to growth, and 75% of firms saw no constraints that they class as severe. By far the most commonly reported barrier to growth was the difficulty in recruiting new staff. This was most acute in construction, where intelligence suggests that some workers have left the industry, but was also reported as a constraint in manufacturing and business services. A minority of firms highlighted difficulties obtaining new finance as a constraint, with the share greatest among small firms (17%). However, even for small firms, that share was substantially below the proportion reporting recruitment difficulties (over 40% of small firms).

Chart C Constraints to meeting higher demand now or within six months