BANK OF ENGLAND

Agents' summary of business conditions

December 2014

- Retail sales values growth had eased, although there was some optimism about seasonal trading prospects. Consumer services values growth had been steady.
- Housing market activity had continued to slow and house price inflation had softened.
- Investment intentions for the next twelve months had eased slightly but remained consistent with moderate growth overall.
- Business services turnover growth had remained relatively strong and broad-based across subsectors.
- Manufacturing output growth for the domestic market had eased, and manufacturing export growth had slowed further.
- Construction output growth had remained robust, with activity continuing to shift towards commercial development.
- Corporate credit conditions had improved further, with signs of an increase in lenders' risk appetite.
- Employment intentions had eased slightly for manufacturers, but overall remained consistent with modest headcount growth.
- Recruitment difficulties had remained somewhat above normal.
- Capacity utilisation had remained broadly around normal.
- Growth in total labour costs per employee had been steady, although there was some evidence of increasing wage pressures in some subsectors with skills shortages.
- Materials costs, other than for certain construction inputs, had continued to fall on a year earlier. Imported finished goods prices had declined.
- Output price inflation had remained subdued in manufacturing, but had increased for business services.
- Consumer price inflation had eased further for goods and remained subdued overall.

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 2014 and late November 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.

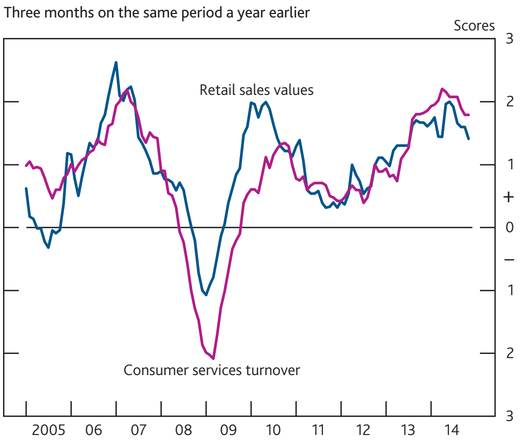
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the *Inflation Report*, obtained from: **www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx.**

Demand

Consumption

Annual growth of retail sales values had continued to ease (**Chart 1**), partly reflecting the impact of lower retail price inflation. Unseasonably mild weather had continued into November, reducing demand for autumn clothing and footwear lines. The pattern of demand growth for household goods, such as furniture and flooring, had been mixed. New car sales growth had eased from the elevated rates seen in the first half of the year. Looking ahead to the Christmas trading period, retailers were, on balance, optimistic about the outlook, suggesting that the recent softening in activity growth might be temporary. Some of the larger retailers had forecast a significant uplift around 'Black Friday' this year (28 November), especially in the electrical sector. Consumer services turnover growth had been steady. Demand had continued to grow for restaurants, pubs and leisure attractions. Consumer demand for wealth management and pensions planning had remained strong. Rail and road journeys had continued to increase.

Chart 1 Retail sales values



Housing market

Housing market activity had slowed and house price inflation had softened. This included in the new-build market, where some developers had increased incentives for buyers, to boost sales and prevent stock overhang. The slowdown was most evident in London and parts of the South East, with a drop in new enquiries and some deals falling through. Contacts cited a range of factors for the softer environment including: the effects of the *Mortgage Market Review* on mortgage availability and approval times, softening foreign demand in central London and a waning impetus from earlier pent-up demand. Nonetheless, some estate agents had continued to report stock shortages as an issue. The rental market remained buoyant, with shortages of supply boosting rents in certain areas. And the buy-to-let market had remained robust.

Business investment

Business investment intentions had eased slightly, but remained consistent with moderate growth overall. In manufacturing, intentions had softened where international orders had been below expectations or when existing investment projects had been completed. Productivity improvements, efficiency gains and replacement programmes were generally seen as higher investment priorities than new capacity. Service sector firms' intentions had also eased. In retail, several large chains were looking to consolidate across stores rather than expand, with investment plans focusing instead on distribution and IT. However, discount retailers had maintained or increased strong expansion plans. UK oil and gas investment had shown tentative signs of weakening due to falling oil prices and relatively high exploration costs.

Exports

Manufacturing export growth had continued to slow, with weak euro-area demand cited as the principal driver. Other contributory factors included a broader slowing of world activity growth, geopolitical tensions and sterling's appreciation. However, there had been little mention of a slowdown in exports to China. Services exports, though also affected by subdued euro-area demand, had continued to grow at a faster rate than for goods. Inbound UK leisure and business tourism had continued to grow robustly. Engineering consultancy had continued to grow strongly and professional services firms maintained their strong growth in work for overseas clients.

Output

Business services

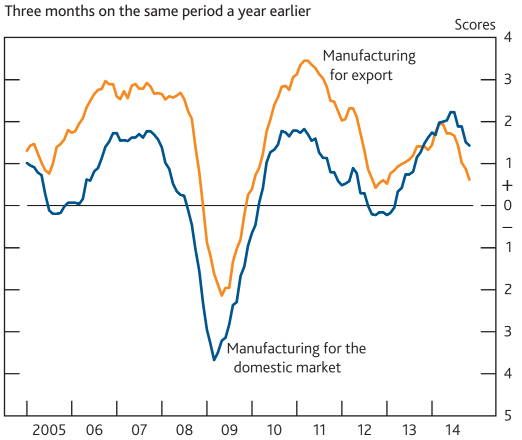
Business services turnover had continued to expand robustly. Continuing strength in commercial property activity and infrastructure construction had generated increasing demand for a wide range of associated professional services. Demand from the financial sector for legal, accountancy and audit work had increased, reflecting legacy asset disposal and transactional work. There were reports, however, of some initial public offerings having been put on hold as a result of increased equity market volatility and there had been signs that decisions on some large mergers and acquisitions deals had started slowing in the run-up to the General Election, potentially affecting future workloads. Growth in other business services had continued at a steady rate. Robust online sales and a busy construction sector had together boosted demand for ports, haulage and warehousing. Corporate travel, hospitality and conferencing had continued to recover, and bookings for Christmas entertainment had increased on a year earlier. IT services had been supported by growing demand from the finance sector and increased interest in cloud services from most sectors. Digital advertising had grown strongly but print media continued to shrink.

Manufacturing

Growth in manufacturing output for the domestic market had eased (**Chart 2**), due in part to slowing demand for intermediate products in export supply chains. Contacts had reported a slowdown in a number of subsectors since the summer, including automotive components, plastics, printing and chemicals, with some contacts suggesting that a period of UK restocking was coming to an end. Growth in the food and drink sector had remained moderate. In contrast, suppliers of goods for infrastructure construction had continued to report strong growth. The immediate outlook was uncertain and many small and medium-sized companies reported poorer-than-usual visibility on future orders.

Chart 2 Manufacturing output growth

Three months on the same period a year earlier



Construction

Growth in construction output had remained robust, with a continuing shift towards commercial development offsetting an easing of house builders' output, as some responded to the softening of demand. Growth in commercial development had been broad-based, including industrial property, warehousing, infrastructure spending. Office construction remained modest in most regional markets but was expected to increase as existing capacity was used up.

Credit conditions

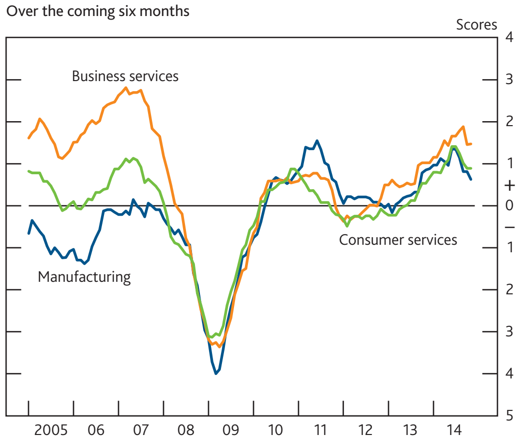
Corporate credit availability had improved further, with signs of an increase in lenders' risk appetite. Capital market finance remained readily available for larger companies at low cost. Banks had continued to compete fiercely for high-quality lending business, and reported significant refinancing activity, sometimes involving an extension of facilities. Some covenants had eased under competitive pressures. Banks' interest in lending to smaller firms appeared to be increasing, suggesting some increase in lenders' risk appetites, although unsecured lending remained rare. In sectors where access to finance had been very difficult, such as hospitality, there were some reports of companies once again being able to access bank credit.

Employment

Employment intentions had eased in recent months (**Chart 3**) but had remained consistent with modest headcount growth. In manufacturing, easing plans had been attributed to softening orders, particularly for exporters, alongside the effects of automation. The recent moderation in business services intentions had in part reflected a move to more normal hiring patterns following a period of strong recruitment earlier in the year. But hiring intentions remained stronger there than for other sectors, reflecting the relative strength of activity. Intentions in consumer services had also moderated in recent months with fewer new retail and leisure venue openings. Recruitment of apprentices, school leavers and graduates had intensified across all sectors, partly to address current or future skill shortages, but also to restrain wage bill growth by adjusting the composition of workforces towards more junior or lower-skilled roles.

Chart 3 Employment intentions by sector

Over the coming six months



Recruitment difficulties were unchanged, remaining somewhat above normal. Skill shortages had remained most acute for IT, engineering, some professional services, haulage, and construction employers, although there continued to be a ready supply of labour for unskilled work that often included migrant workers. Some contacts, particularly in business services, had reported that staff churn was rising as employees were becoming more confident about changing employers, whether in pursuit of a higher salary or career progression. For the majority of contacts, however, staff turnover had remained lower than pre-crisis levels. Only in a small number of cases had recruitment difficulties led contacts to turn work away.

Capacity utilisation

Capacity utilisation had remained at broadly normal levels. Manufacturing capital utilisation had eased slightly in recent months, probably as a result of weakening output growth, particularly among some export-focused firms. The construction sector had continued to be the area with the most notable capacity constraints, although constraints on the supply of materials had loosened slightly. Service sector capacity utilisation was little changed on the month. Contacts had continued to report intensive use of labour in professional and financial services, with less pressure evident elsewhere. Capital utilisation in services had also increased, with lower void rates for commercial property, higher occupancy rates for business hotels and rising loads for airlines. In retailing, however, there had been a growing recognition of excess capacity and this had led to a consolidation of physical store presence, demand having been met instead through online distribution channels.

Costs and prices

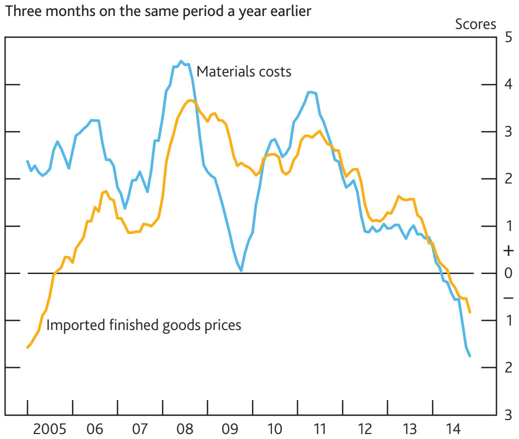
Labour costs

Growth in total labour costs had remained moderate, but contacts reported further evidence of some upward pressure where skills were scarce. The 3% increase in the National Minimum Wage (NMW) had increased pay growth for affected businesses, either directly or in order to maintain differentials relative to the NMW. Those businesses introducing autoenrolment into workplace pension schemes also reported higher labour cost growth, although a small minority of these had reduced this year's pay awards to offset at least part of the increased cost. The majority of pay settlements had remained in the range of 2%–3%, with very little pressure for higher increases outside areas affected by skills shortages. Some businesses were concerned that next year might see an increase in average pay awards, although they noted that lower retail price inflation might offset at least part of that pressure. There had been a number of multi-year deals, where employers had looked to secure longer agreements while inflation remained very low. The results of an Agents' survey on paybills are detailed in the box on pages 6–7.

Non-labour costs

Materials costs, other than for certain construction inputs, had generally continued to decline (**Chart 4**). This reflected lower commodity prices, sterling's appreciation and heightened price competition from suppliers targeting the United Kingdom in the wake of weakness in euro-area demand. The most marked decreases had been in products derived from crude oil or wheat. Energy costs had also declined but some contacts expected unit costs of gas and electricity to increase due to tight UK generating capacity. Costs of imported finished goods had also continued to decline in response to sterling's recent appreciation, as hedges unwound and earlier forward orders were renewed. Retail contacts had reported falling costs for imported clothes, food and drink.

Chart 4 Raw materials and imported finished goods prices



Output prices and margins

Manufacturing output price inflation had remained subdued with little upward pressure on prices from input costs. Suppliers to the supermarket sector had reported intensifying pressure to reduce prices. In contrast, construction materials manufacturers had continued to increase prices, albeit at a slower rate than earlier in the year. Business services price inflation had increased. As demand had picked up, the pricing environment was gradually improving for many contacts. For example, fee rates in some areas of professional services, such as architects, specialised audit work and fund management had risen as a result of growing business volumes, although legal sector fee inflation had been muted as a result of excess capacity. Rents on new commercial property lettings had edged up, as incentives such as rent-free periods had been reduced.

Manufacturing profitability growth had slowed further. Although higher volumes, efficiency gains and lower input costs had supported manufacturing profitability, margins had remained compressed and sterling's appreciation had hit margins for many exporters. Service sector profitability had continued to grow modestly. In construction, fixed-price contracts agreed previously had depressed profitability for some contacts as material and labour costs had risen sharply; some firms had responded by raising prices on future tenders and holding prices for shorter periods.

Consumer prices

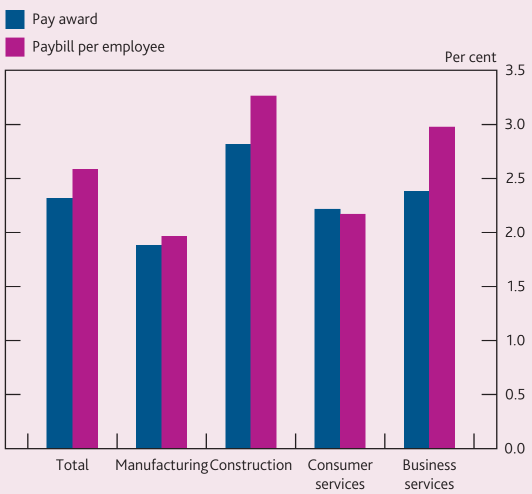
Consumer price inflation had remained subdued. Food prices were generally reported to be under downward pressure across many lines due to heightened competition among grocery multiples and the pass-through of lower food commodity costs. But prices for some less frequently purchased foodstuffs had firmed a little, as retailers offset the reductions being offered for 'everyday' items. The influence of discount grocery retailers had reportedly begun to spread to the pricing of some categories of non-foods. There were reports of widespread discounting of autumn clothing, unsold because of warm weather. Domestic heating oil, petrol and diesel had continued to fall in price. Inflation for consumer services prices remained somewhat stronger than for goods, supported by stronger demand for some services, including leisure, accommodation and premium holidays. Prices at some restaurants and cafés were also said to have ticked up a little. In the near term, the slowing in headline inflation indices, such as RPI, was expected to result in lower increases in some regulated prices than last year, such as those for commuter travel and social housing.

Agents' survey on paybill growth

To gain insights into the recent disparity between growth in pay awards and average wages, the Agents asked businesses about their latest pay settlements, the annual growth in paybills per employee in the latest quarter, and factors causing any differential between the two. The survey also asked about the expected impact of recruitment and retention difficulties on the growth of firms' paybills per employee in 2015. Some 420 companies participated in the survey, with a combined employment of just over 700,000 staff. The results were weighted by employment, and then re-weighted according to Office for National Statistics (ONS) employment sector weights to adjust for differences in the composition of the survey compared with the economy as a whole. Given the nature of the Agents' contact base, larger firms accounted for a bigger share of employment in the sample than in the economy as a whole.(1)

Overall, respondents' latest reported pay settlements averaged 2.3% (**Chart A**), little changed on the comparable figure of 2.2% in the Agents' pay survey conducted in the previous December and January. The survey recorded average annual growth of paybills per employee of 2.6% in the latest quarter, substantially higher than the latest comparable official data for annual growth of total private sector pay (average weekly earnings) of 1.1% in the three months to September. There are a number of factors that might explain the difference. For example, the survey would not capture any compositional shifts in the employed labour force towards lower-paying industries in the past year. In addition, the ONS' Annual Survey of Hours and Earnings suggested that small firms, which were under-represented in the survey, had particularly low annual growth of total earnings in April 2014.

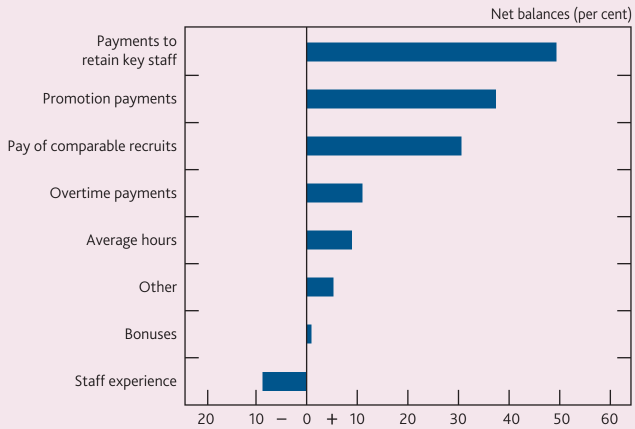
Chart A Pay settlements and growth of paybill per employee by sector



Across sectors, differentials between growth of paybills per employee and settlements were most marked in business services and construction (**Chart A**). Settlements and paybill per employee growth were reported to be broadly similar in manufacturing and consumer services.

Firms were asked about the factors pushing up or down annual growth of paybills per employee, relative to their latest annual settlement. **Chart B** summarises the results, expressed as net balances of firms reporting upward pressure from each factor on paybills per employee relative to pay settlements, minus those reporting downward pressure. Positive net balances were recorded for seven of the eight categories, with the need to reward key staff (+49%), promotion payments (+37%) and pay rises for comparable recruits (+31%) the most important factors. Only staff experience recorded a negative balance (-9%), suggesting growth in employment of less skilled or more junior staff relative to more senior workers.

Chart B Factors causing differential growth of paybill per employee and pay settlements



Finally, firms were asked whether recruitment and retention difficulties were expected to put upward or downward pressure on the growth of their paybills per employee in the year ahead, compared with the past year (**Chart C**). About 40% of firms reported anticipated upward pressure on paybills arising from prospective recruitment and retention difficulties, with a 'slight' effect reported much more frequently than a 'major' impact. Only a very small proportion of firms reported anticipated downward pressure on paybills arising from these sources.

(1) Firms with fewer than 50 employees accounted for less than 1% of employment in the survey, compared with over one third of private sector employment according to business population estimates of the Department for Business, Innovation and Skills. Given a relatively low number of small firms in the survey, the results were not re-weighted according to firm size.

Chart C Impact of recruitment and retention difficulties on prospective paybill growth