



BANK OF ENGLAND

# Agents' summary of business conditions

June 2014

- Annual growth in **retail sales** values had picked up sharply following a recent weakening. Growth in **consumer services** turnover had been stable.
- Activity in the **housing market** had eased. There were fewer mortgage completions and approvals, reflecting a shortage of supply of properties on the market and the impact of the implementation of the Mortgage Market Review.
- **Investment intentions** had moderated, with some firms scaling back capital expenditure from above normal levels. But commercial property investment had picked up.
- Growth in **business services** turnover had eased slightly.
- **Manufacturing** output for the domestic market had continued to grow at a steady pace. The appreciation of sterling had tended to affect export margins rather than volumes.
- **Construction** output had continued to grow strongly, and growth was widening out beyond house building.
- **Corporate credit conditions** had continued to improve, helped by increased competition between lenders.
- **Employment intentions** had been little changed and still pointed to modest growth in the next six months. **Recruitment difficulties** had remained slightly above normal.
- **Capacity utilisation** was marginally above normal overall, although significant spare capacity remained in some parts of the economy.
- Growth in **total labour costs per employee** had increased slightly, remaining moderate.
- **Materials costs** had fallen slightly, with the exception of those used in the construction industry. **Imported finished goods prices** had remained stable.
- **Output prices** had continued to increase modestly, and **margins** on domestic sales were expected to improve over the coming year.
- **Consumer price inflation** had edged lower.

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 April 2014 and late May 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](http://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.

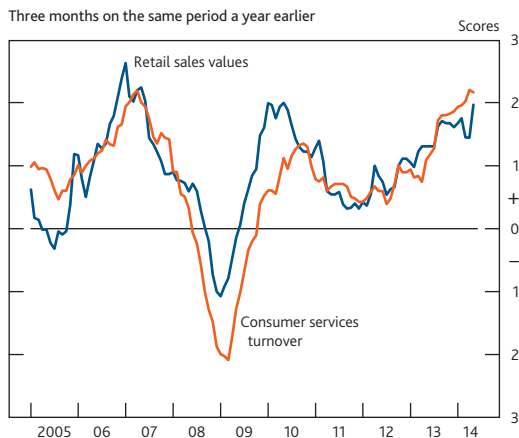
The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the *Inflation Report*, obtained from: [www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx](http://www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx).

## Demand

### Consumption

Annual retail sales values growth had picked up sharply, following a recent weakening — a pattern that reflected the later timing of Easter than last year (**Chart 1**). Sales had been particularly strong at both the value and premium ends of the retail spectrum. Demand for home-related durable goods such as fitted kitchens, bathrooms, furniture and flooring had continued to strengthen. And better weather than a year ago had boosted the annual growth rate of demand for seasonal clothing and footwear, DIY goods and garden furniture and equipment. Demand for new cars had remained elevated due to competitive pricing and the ready availability of affordable leasing finance. Growth in demand for consumer services had been broadly stable, and remained slightly stronger than for retail sales. Consumers were increasingly willing to spend on leisure activities, such as pubs, restaurants and hotels. The travel industry had reported a robust start to the season for both domestic and foreign travel. Signs of growing household confidence were also evident in stronger demand for financial advice and private medical insurance.

**Chart 1** Retail sales values and consumer services turnover



### Housing market

Activity in the housing market had eased, with a number of reports of lower levels of mortgage completions and approvals than last month. This was thought to be due to a continued shortage of properties for sale and the implementation of the Mortgage Market Review (MMR), which had slowed the processing of mortgage applications. It was unclear to what extent the MMR would have a longer lasting or structural impact on the mortgage market. The softening in activity had been most pronounced in parts of London, where past increases in stamp duty and concerns about prospective increases in housing taxes had also reduced demand for houses priced over £2 million, including from foreign buyers. In the rest of the United Kingdom, there had been sustained demand growth for new houses, especially from first-time buyers using

the Help to Buy equity loan scheme. House price inflation had remained modest outside the South East.

### Business investment

Investment intentions of manufacturers and service sector firms had moderated slightly, having increased throughout most of the previous twelve months. In some cases this was because businesses had already invested heavily in recent years and were now scaling back capital expenditure to more normal levels. Meanwhile, investment in some of the most capital-intensive manufacturing sectors was still being held back by expectations of poor profitability. There were increasing numbers of reports of consumer-facing businesses wishing to invest in new capacity, reflecting a recovery in demand and profitability. Commercial property development had also picked up a little, as available supply of prime space in industrial and office markets had become increasingly tight. Some firms, however, preferred acquisition to capital investment as a means of expansion, perceiving the associated risks to be lower.

### Exports

Annual growth in manufacturing export values had continued, albeit at a slightly slower rate. That had partly reflected the negative effect of the recent appreciation of sterling on export margins, though volumes were reported to have been little affected as exporters had tended to hold their foreign currency prices constant. Demand had improved modestly in the euro area — although some of the pickup had been in intermediate goods, such as those into the automotive sector, ultimately exported elsewhere. Sales had continued to rise steadily to the United States across a wide range of sectors. But a slowdown in construction activity in emerging economies had lowered demand for capital goods, while defence spending in the euro area had continued to decline. The crisis in Ukraine had so far had little impact on goods exports. Services exports growth had remained stable. Inward tourism, both business and leisure, had strengthened, notably from the United States. Foreign investment in UK property had continued to increase, boosting demand for related professional and financial services.

## Output

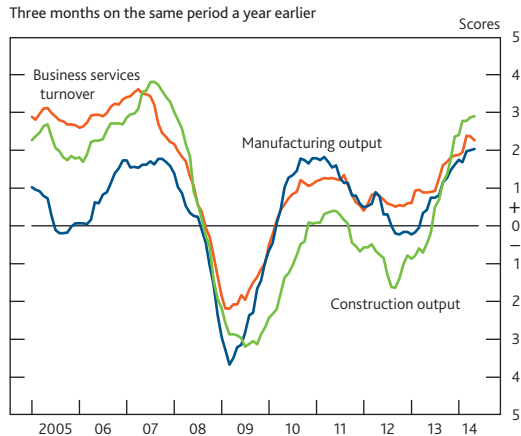
### Business services

Business services turnover had continued to grow, but at a marginally slower rate than in recent months (**Chart 2**). Demand for professional and financial services was being supported by improving economic prospects and a slowly recovering commercial real estate market, with rising occupier demand. However, some contacts reported that the recent boost to corporate deals from a release of pent-up merger and acquisition activity might start to wane in the coming quarters. Output growth of investment banking services had declined, reflecting ongoing structural changes in the industry that had

reduced capacity, coupled with easing demand. The number of corporate and personal insolvencies had also continued to fall, reducing demand for business turnaround and restructuring activities. In contrast, consultancy, marketing and recruitment firms reported stronger growth. And contacts in the construction supply chain, such as architects, surveyors and real estate advisors, had seen a steady increase in activity. Logistics and IT companies reported accelerating demand, but corporate spending on travel, conferencing and car hire remained subdued, reflecting a keen focus on cost control.

**Chart 2** Output growth

Three months on the same period a year earlier



## Manufacturing

Manufacturing output for the domestic market had continued to strengthen. Output of construction-related products had accelerated on the back of growth in house building and an improving pipeline of civil engineering work. Consumer-facing manufacturers had benefited from a pickup in volumes, notably for big-ticket consumer durables such as cars, floor coverings and furniture. Automotive, civil aerospace and energy supply chains reported elevated, if steady, growth. Food processors reported weaker growth, however, partly associated with fewer 'multi-buy' promotions by retailers that had reduced sales volumes. The weakest growth had been seen among manufacturers of defence equipment, the heavy vehicles supply chain (due to the impact of new emissions regulations), and the paper and printing industries, as media activity continued to move online.

## Construction

Growth of construction output was steady and above its long-term average rate, with reports of stronger activity starting to spread beyond house building. Infrastructure investment was increasing, particularly on railways and at ports, and there was more optimism surrounding the prospects for construction projects in the energy sector. Development of new industrial property outside London was increasing, albeit from a low base, and a few speculative office projects had commenced. Housing starts had continued to increase strongly, but shortages of materials and skilled labour were

causing some delays, and housing completions, though significantly up year on year, had remained well below longer-term averages.

## Credit conditions

Credit availability had improved further, aided by increased competition between lenders. Credit conditions had improved for firms of most sizes, though conditions remained tight for the smallest businesses. Although demand for credit had risen, many firms had continued to seek to reduce their debt levels and preferred to fund expenditure out of retained cash, despite a fall in the cost of bank finance. Lending by challenger banks and crowd funders had continued to grow. The availability of finance for real estate projects other than speculative development had widened with finance from specialist funds or insurance companies available where traditional lenders had stepped back. The availability of funds for corporate deals such as mergers and acquisitions had increased. Although there had been isolated examples of working capital tightening, insolvencies had remained at low levels.

## Employment

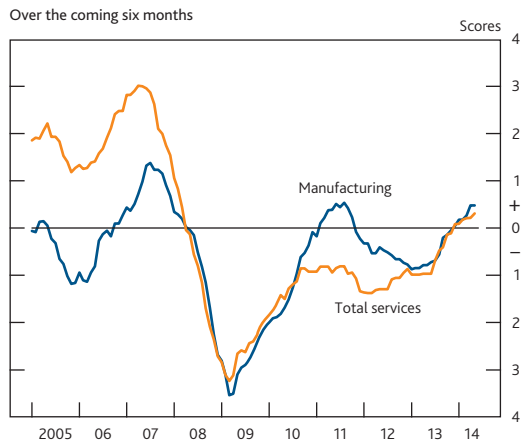
Employment intentions had been little changed and still pointed to modest growth in staff numbers over the next six months. Contacts expected to grow headcount in order to raise output, alongside anticipated productivity improvements. For some manufacturers, further automation and greater use of temporary workers was expected to be sufficient to meet near-term rises in demand. Employment prospects in business services had remained relatively firm, despite announcements by some investment banks suggesting significant job losses in that sector. Recent job creation had been strongest in IT, real estate and construction-related services, but had now started to broaden out to other professional services where increased workloads were stretching capacity. Employment intentions in consumer services had edged up further, driven primarily by the need to staff additional retail capacity and to support the development of online platforms. Recruitment difficulties had remained a little above normal, due mainly to shortages in IT, engineering, and construction/property and related services. However, unskilled and semi-skilled labour had remained readily available. Professional services firms reported a dearth of experienced staff in the labour market, due to low levels of hiring in recent years. More generally, some firms were recruiting apprentices/trainees in anticipation of future skills shortages. Low barriers to entry in some services, such as business consultancies and estate agencies, were reported to have facilitated increased self-employment in these areas.

## Capacity utilisation

Capacity utilisation had continued to edge higher and was now marginally above normal (**Chart 3**). However, there had

remained a significant amount of under-utilised capital in some firms — especially in retailing. In manufacturing, capital investment had often created additional capacity over the past year and there was the potential for some businesses to add further labour shifts to better utilise existing plant. Some contacts noted there remained scope to increase productivity by reallocating staff to more productive work from back office or business development roles now that demand was increasing robustly. Capacity constraints were most notable in the construction sector and its supply chain. House builders reported falling behind build programmes due to a lack of skilled labour and, to a lesser extent, delays in the delivery of bricks and blocks. Service sector capacity utilisation had continued to edge higher, reflecting increased labour utilisation. Capital asset utilisation in the service sector had also increased, with, for example, growing demand for office space and higher hotel occupancy rates.

**Chart 3** Capacity utilisation

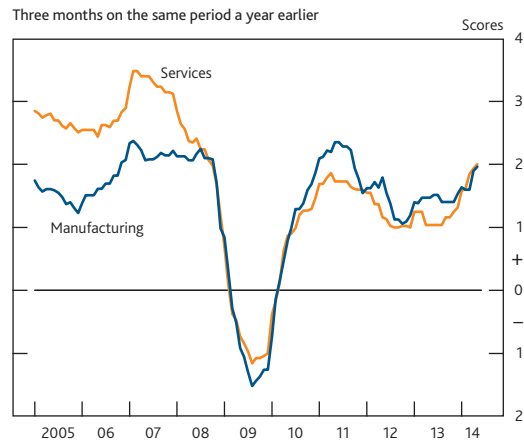


## Costs and prices

### Labour costs

Growth in labour costs per employee had edged up slightly, remaining moderate (**Chart 4**). Reports of pay freezes had fallen, and there were some cases of significant increases in awards, but the majority of settlements had remained within the 2%–3% range. There was evidence of firms responding to concerns about losing staff as levels of labour churn increased, with some introducing more targeted pay awards for key performers. And skill shortages were putting upward pressure on pay growth in sectors such as construction, engineering and some professional services. More generally, pay was also being boosted by performance-related awards, usually linked to profits and sales. Auto-enrolment in workplace pension schemes had provided a modest stimulus to the growth of labour costs per employee. The increase in the National Minimum Wage due in October was likely to lead to some further compression of differentials at the lower end of pay scales, and some contacts expected it to reduce the rewards they could afford to give to higher-paid staff.

**Chart 4** Total labour costs per employee



### Non-labour costs

Materials costs had declined slightly compared with a year ago. The main exception remained construction materials, where price inflation had remained elevated due to supply shortages. The appreciation of sterling over the past year had increasingly become reflected in lower sterling prices paid for many imported materials. But for a minority of materials, foreign suppliers had looked to restore margins by raising prices set in foreign currency, leaving sterling prices little changed. The costs of imported finished goods were stable. Prices had not fallen in line with sterling's appreciation, mainly due to firms' hedging strategies and rising labour costs of overseas producers. And some contacts were still locked into fixed-price contracts based on the exchange rate a year or more ago.

### Output prices and margins

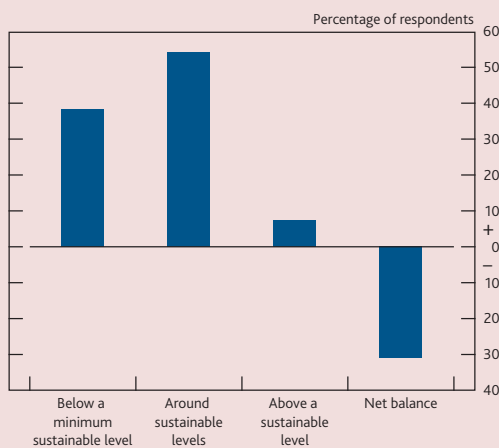
Manufacturing output price inflation had increased modestly, with more firms able to pass on limited price increases as demand recovered. For most, significant rises were only possible when new lines were introduced, or for niche products in short supply. Some food manufacturers had seen supermarkets reduce their prices as a result of greater competition in the sector, with further price cuts expected in the future. Following recent large price increases, inflation rates for building materials had eased a little, perhaps reflecting previously mothballed capacity coming back into production. Business services price inflation had remained modest, and pricing was still under downward pressure for commoditised services. But there was greater scope to raise prices in some recovering markets — such as prime commercial property and construction services. Margins on domestic sales were reported to be improving slowly, as output volumes and productivity grew and input costs declined, especially for manufacturers. For exporters, however, sterling's appreciation had compressed margins. The results of an Agents' survey on profit margins are reported in the box on page 5.

## Agents' survey on profit margins

To help to 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 levels that companies saw as 'sustainable' over the medium term. Where margins were not at sustainable levels, respondents were asked how long it would take before they returned to being sustainable. The survey also explored how margins had changed over the past year, how they were expected to evolve over the next twelve months, the main drivers for any changes in margins and the motivations behind companies' pricing plans. A total of 429 companies responded to the survey, employing over 572,000 people.

Weighting the results by employment, just over half of respondents described their margins as being around sustainable levels (**Chart A**), but a sizable net balance of companies — approaching a third — reported that their margins were below a sustainable level. Across sectors, only manufacturing yielded a positive balance of firms reporting margins above a sustainable level.

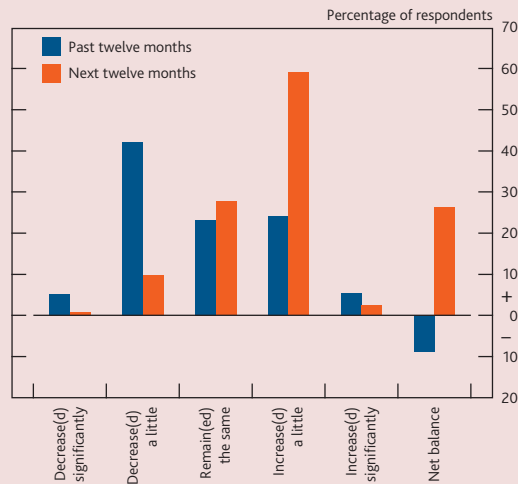
**Chart A** Sustainability of margins



Some 80% of those firms reporting margins as not at sustainable levels expected that margins would return to sustainability over the next 1–3 years. Only 4% envisaged that margins would return to sustainable levels within the next twelve months.

Almost half of all respondents reported a decrease in margins over the past twelve months, yielding a negative net balance of nearly 10% (**Chart B**). The decline in margins was broadly-based across sectors with only consumer services firms reporting a positive net balance. Looking over the next twelve months, however, some 60% of respondents expected margins to increase a little, with a positive net balance of

**Chart B** Margins over the past and next twelve months<sup>(a)</sup>

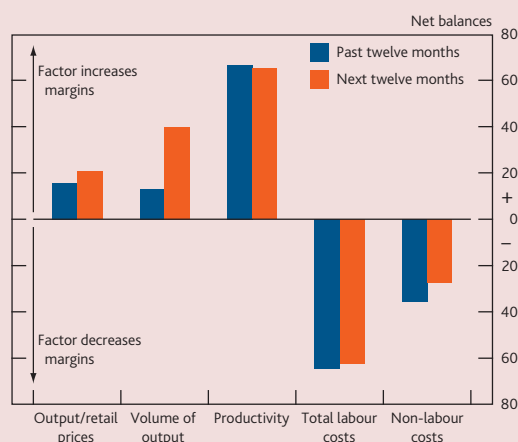


(a) Results are weighted by whether changes are reported to be 'little' or 'significant'.

around a quarter of firms. Net balances for expected changes in margins were positive across all sectors.

Among the drivers of change over the past twelve months, output/retail prices, volumes and productivity gains in particular had acted to increase margins, with labour and non-labour costs providing downward pressure. Over the next twelve months, a greater number of respondents expected higher business volumes to affect margins positively than over the past twelve months, and non-labour costs were expected to have less of a drag in the next twelve months, perhaps reflecting some pass-through of sterling appreciation (**Chart C**).

**Chart C** Factors influencing margin



In terms of motivations for pricing plans, some nine out of ten respondents reported that they were not planning to cut prices to increase market share in the next twelve months. There was a more balanced response as to whether companies intended to increase prices as the economy recovered, with 45% indicating that they would and 47% saying they would not. Some three quarters of respondents reported that they did not expect margins to increase when interest rates begin to rise.

**Consumer prices**

Consumer price inflation had fallen slightly, driven by services prices. Retail goods price inflation was stable. National supermarkets had started to lower the prices of essential items, in order to improve competitiveness. There had been a further move away from 'multi-buy' promotions or time-limited discounts towards outright price reductions. Car dealers were pursuing market share by offering more attractive

deals. But in other retail sectors, including durables and household goods, an uptick in demand had enabled retailers to implement fewer price discounts and promotions. Consumer services price inflation had declined slightly. Insurance premiums had softened further and competition for housing stock had continued to exert downward pressure on estate agency fees. In the leisure sector, improving demand had resulted in a modest increase in price inflation.