BANK OF ENGLAND

Agents' summary of business conditions

October 2014

- Retail sales values growth had eased, reflecting a continued fall in food price inflation. Consumer services values growth had also edged lower.
- Housing market demand and supply had become more closely aligned and house price inflation had moderated across much of the United Kingdom.
- Investment intentions for the next twelve months had remained consistent with moderate growth in capital spending.
- Business services turnover growth had been robust and broad-based across subsectors.
- Manufacturing output growth for the domestic market had been steady. Manufacturing export volume growth had continued to slow, reflecting softening global demand, adverse geopolitical developments and sterling's appreciation.
- Construction output growth had remained strong.
- Corporate credit conditions had remained close to normal overall, though they continued to vary by firm size and across sectors.
- Employment intentions had increased further for business services, but had eased in manufacturing and consumer services.
- Recruitment difficulties had picked up, reflecting a broadening of skills shortages as the economy strengthened.
- Capacity utilisation had been close to normal for both manufacturing and services.
- Growth in total labour costs per employee had increased slightly.
- Material costs and imported finished goods prices had continued to fall on a year earlier, reflecting lower global commodity prices and the effects of sterling's appreciation.
- Output price inflation had slowed further in manufacturing, but was little changed for business services. Profitability had continued to rise gently.
- Consumer price inflation had remained modest.

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 2014 and late September 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.**

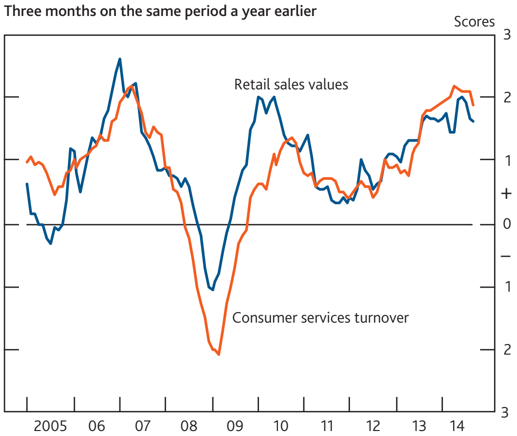
Demand

Consumption

Annual growth in retail sales values had continued to ease (**Chart 1**). That in part reflected a fall in food price inflation, which had turned negative for some products, as large retailers vied for market share. Warm weather in September had resulted in a challenging start to autumn for clothing and footwear retailers. But sales growth had held up well for furniture, kitchens and bathrooms, which continued to benefit from the recovery of the housing market and some catch-up in previously deferred replacement spending. Consumer services demand growth had slowed, but remained ahead of retail sales. After a good summer, domestic tourism spending was reported to have eased slightly in September. Spending volumes had continued to grow in many restaurants, hotels and leisure attractions, albeit sometimes generated through the use of discounting and promotions.

Chart 1 Consumer spending growth

Three months on the same period a year earlier



Housing market

The balance of housing demand and supply was reported to be more closely aligned than earlier in the year, as demand had eased. But transactions were still reported to be restrained by shortages of homes for sale, albeit by varying degrees across regions and by less than earlier in the year overall. Some contacts thought that the slower market seen during the summer months indicated a return to a normal seasonal pattern and there were mixed views about whether activity had picked up in September. The Mortgage Market Review had affected both the availability of finance and mortgage approval times, which were thought to have permanently increased by several weeks. House price inflation had moderated across much of the United Kingdom. In the prime London market, both prices and transaction levels had been lower than a year earlier, in part reflecting a fall in overseas buyer activity as sterling had risen. More generally, some housebuilders reported a reduction in sales and site visitors in recent months.

Business investment

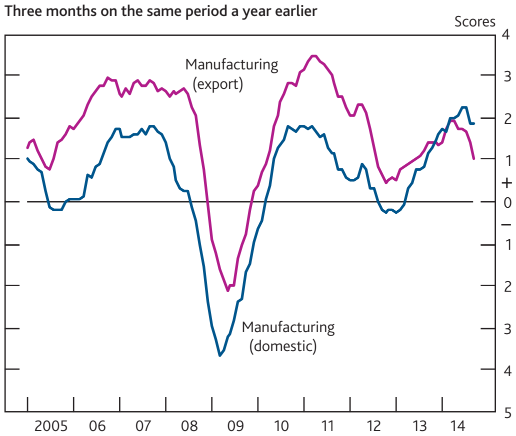
Business investment intentions had continued to suggest moderate growth in capital spending for the year ahead. Those contacts looking to increase investment were most often motivated by the need to increase capacity in light of stronger demand. These included some services firms that had taken the decision, often long delayed, to upgrade existing buildings or move into new premises. For many businesses, easier credit conditions than in recent years had meant that finance was no longer a significant barrier to investment. And contacts reported making more widespread use of government initiatives such as research and development tax credits and Regional Growth Fund investment grants. The results of an Agents' survey on investment spending are summarised in a box on pages 6–7.

Exports

Manufacturing export volumes growth had slowed further (**Chart 2**) due to the effects of softening global demand, geopolitical problems and sterling's recent appreciation. Adverse geopolitical developments had started to affect export sales and confidence. Some contacts were concerned about the effects of political instability in Ukraine, with some UK farmers being affected by trade restrictions between the European Union and Russia, more often indirectly than directly. Despite rising tensions in the Middle East, overall export sales there had risen. Exports to North America had continued to grow moderately, but sales to the euro area had flattened off and sales growth to emerging markets had slowed. There were increasing reports of sterling's appreciation reducing export volumes, as well as margins, and concerns that the full impact would only be felt when annual contracts were renewed over the next few months. Growth in services exports had continued at a steady rate. For example, professional services firms continued to report growing demand from overseas clients, including for services associated with a pickup in UK mergers and acquisitions and commercial property deals.

Chart 2 Manufacturing output growth

Three months on the same period a year earlier



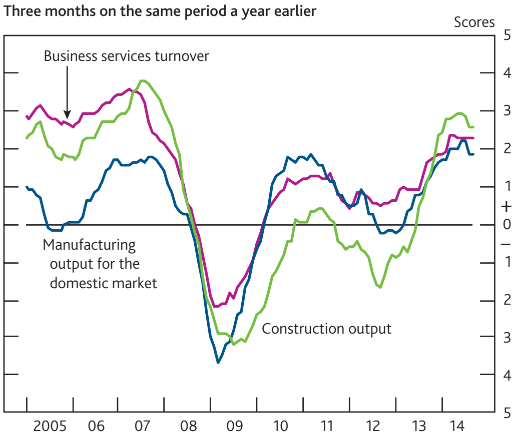
Output

Business services

Business services turnover had continued to grow robustly (**Chart 3**). Stronger activity across a broad range of financial and professional services had reflected higher levels of deal activity in both corporate finance and commercial property. That in turn had generated healthy growth in a range of associated services. And employment agencies reported strong activity, particularly in areas where there were skills shortages. But growth in other professional services, such as litigation and insolvency work, had been more subdued. Among other business services, IT services growth had remained healthy, driven by website and app design, alongside the continuing shift to cloud technology. Business travel and accommodation had also grown strongly, although the recovery in demand for conferencing facilities had been more muted. Logistics activity, including among hauliers, port operators and warehousing, had continued to be supported by the pickup in construction and online retailing.

Chart 3 Agents' scores for output growth

Three months on the same period a year earlier



Manufacturing

Growth in manufacturing output for the domestic market had remained steady (**Chart 3**). The strongest growth was generally reported in the supply chains for construction, automotive, aerospace and non-nuclear energy. Growth in the food and drink sector had remained moderate overall. There had been more positive reports from producers of durable consumer goods, particularly furniture; and also from suppliers of goods to the hospitality sector, such as ceramics and catering equipment. Sales of defence equipment had been broadly flat.

Construction

Growth of construction output had remained stronger than for other sectors (**Chart 3**), with increasing numbers of commercial projects adding to the earlier impetus from housebuilding. Areas of particular strength had included industrial development, particularly logistics, and work on education and healthcare facilities. But demand for new office and retail space in some regional centres had also improved as existing stocks of available prime accommodation were being depleted. And some areas had seen significant growth in infrastructure projects. Residential development had been maintained at a steady pace despite weaker demand in some areas, helped by quicker planning decisions from some authorities. However, the reduced availability and increasing cost of materials and labour had posed a significant challenge to the sector, particularly where prices for projects had been agreed before the recent upturn. Financial pressures among some construction companies had risen as a result, and some commercial and residential schemes had been put on hold because higher costs had rendered them economically unviable.

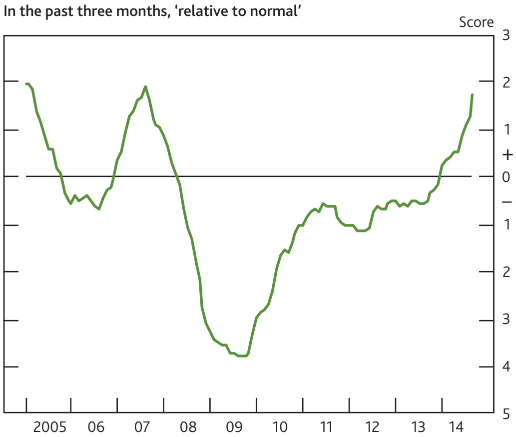
Credit conditions

Credit conditions had remained close to normal overall, but continued to vary by company size and sector. Large corporates described credit conditions as easy, but not as loose as in the run-up to the financial crisis, as covenant standards had been maintained for the most part. Small and medium-sized enterprises (SMEs) reported that a number of banks were typically willing to offer finance, but that many companies had maintained their cash surpluses partly to avoid dependency on banks. Some SMEs had also looked at alternative forms of funding such as supply chain finance, vendor finance, crowdfunding or venture funds. Credit had remained more difficult to obtain for the smallest firms, and also for particular sectors including contractors, hospitality, and some legal firms. Contacts continued to report some extension of payment terms. There were mixed reports as to whether pressures on cash flow were increasing as a result.

Employment

Employment intentions had remained consistent with moderate headcount growth. Expanding workloads had led to stronger intentions in business services — particularly in IT, accountancy, legal and property — than in consumer services or manufacturing, where planned growth of staffing had eased a little. Consumer services' employment intentions were generally modest. Manufacturing employment intentions had eased back a little, but remained positive. Within the sector, intentions had been strongest where contacts were confident that higher output would be sustained, although even here, there were cases where investment in automation had reduced employment plans. Recruitment difficulties had picked up further (**Chart 4**). Skills shortages had remained most apparent in IT, engineering, construction, professional services and haulage, but had gradually become more widespread as the economy strengthened. Many companies had been increasing their intake of apprentices, graduates and trainees as a result. In other cases, however, businesses had been focused on targeted, experienced hires that would improve their skill mix. Although most contacts reported staff attrition remaining relatively low, there was some concern that it had started to pick up. Unskilled workers had continued to be readily available, in some cases from other parts of Europe.

Chart 4 Recruitment difficulties



Capacity utilisation

Capacity utilisation had remained close to normal for both manufacturing and services. In manufacturing, labour had still been the dominant constraint, with the utilisation of capital remaining lower. Some manufacturing contacts were concerned that limited availability of skilled labour would make it difficult to increase production through the addition of extra shifts. Capacity utilisation in the service sector had been tightest for professional and financial services firms, especially those relating to property and construction where it was difficult to find experienced staff. But for some service sector firms, investment and increases in employment had eased pressures on existing assets and employees. Capital utilisation in many services companies had increased, as shown in lower void rates for commercial property, higher occupancy rates for business hotels, and higher load factors for airlines. There remained spare capacity in parts of the retail sector, and indeed capacity utilisation had fallen for some retailers. High demand for building materials and labour had led to a number of capacity constraints in the construction sector.

Costs and prices

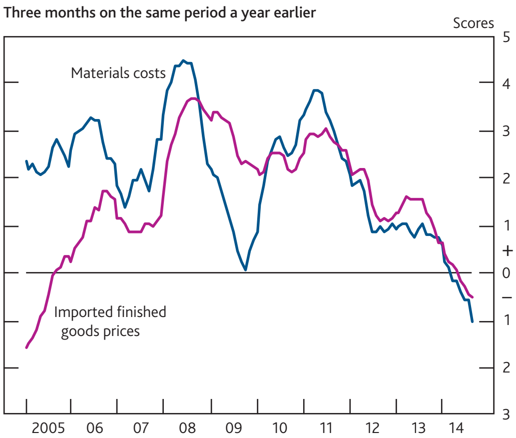
Labour costs

Pay settlements had remained modest in the majority of cases. But there had been signs of pressures starting to build where there were skills shortages or where attrition had picked up, such as in construction, IT, engineering and parts of professional and financial services. In some cases, higher labour cost growth had reflected special awards to particular groups of staff on top of more general awards. Some businesses had been forced to offer higher salaries to attract new recruits. While in most cases growth in labour costs had not yet shown any significant increase, contacts often expected awards in 2015 to be a little higher than in 2014, reflecting concerns about staff retention combined with improved profitability. Contacts thought changes in the composition of the workforce, such as replacing senior staff with more junior employees, or taking on new recruits at a lower level than before, could be pressing down on average weekly earnings, but it was difficult to quantify many of these factors with any precision. And in some cases an opposite trend was reported, such as where greater use of IT or automation of processes reduced the proportion of low-skilled labour. Contacts reported mixed views on the short-term impact of the forthcoming increase in the National Minimum Wage.

Non-labour costs

Materials costs had fallen on a year earlier (**Chart 5**). Sterling's appreciation had increasingly fed through as currency hedges and contracts were renewed. Global commodity prices had softened further, particularly for agricultural goods. And lower oil prices had reduced transport costs. Imported finished goods costs had also fallen, as prices of new season stock had more fully reflected sterling's appreciation. Foreign currency import prices had remained broadly flat. But reports of double-digit inflation in construction material prices had continued to be widespread.

Chart 5 Raw materials and imported finished goods prices



Output prices and margins

Manufacturing output price inflation had slowed further in the face of falling input costs and limited pricing power, particularly for food manufacturers dealing with supermarkets that were seeking lower prices to win market share. Construction product suppliers had remained an exception, where increased activity had allowed for further price increases. Business services output price inflation had remained modest. Professional and financial services companies reported that clients were a little more receptive to higher fees, if less so for the more standard services they offered. Corporate room rates, especially in city centre hotels, had risen marginally as business travel increased. Commercial property rents were stable or rising for prime sites, but remained under downward pressure elsewhere. And insurance premiums were flat or falling on a year earlier.

Manufacturing profitability growth had remained modest, benefiting from higher volumes, efficiency gains and subdued input costs. But the exchange rate had kept exporters' margins under pressure. Service sector profitability had also benefited from higher volumes, as well as from new services provided to existing clients and increasing opportunities to take on higher margin work.

Consumer prices

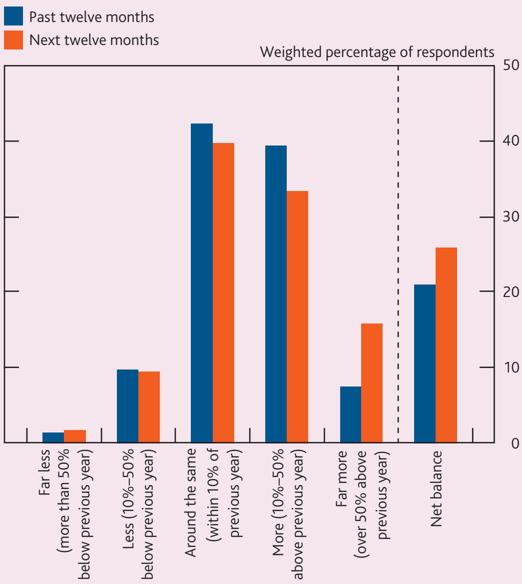
Consumer price inflation had remained moderate and softer for goods than for services. Food price inflation had continued to weaken, with falls in fresh produce prices reflecting both competition between retailers and good harvests. Some contacts expected that weaker export demand, in part following trade restrictions between Russia and the European Union, would lead to further downward pressure on domestic food prices in the coming months. And fuel prices had remained well below last year's levels. But stronger sales of some high street goods had reduced the need for discounting by a number of retailers, and new car prices had crept up a little. Consumer service providers reported that their customers had continued to focus on value for money, maintaining the pressure for discounts and promotions to support sales volumes where spending flagged. But in certain cases, higher spending had allowed some increase in realised prices, including among providers of accommodation, meals and transport. Stronger demand for rental property in some areas had supported moderate increases in rents. Consumer energy prices appeared likely to remain flat in the coming quarters.

Agents' survey on UK capital investment intentions

The Agents asked businesses about the change in their capital investment over the past twelve months, relative to the previous year, and their plans for the twelve months ahead. The survey also explored the factors that were driving firms' investment spending or were acting as constraints. In addition, firms were asked to describe the amount of slack in their total physical capacity, relative to current levels of demand for their products or services. Some 400 companies participated in the survey, with a combined turnover of over £98 billion and total employment of around 450,000 staff. The results were weighted by employment, and then reweighted according to ONS employment sector weights to adjust for differences in the composition of the survey compared with the economy as a whole.

Overall, firms reported there had been a modest increase in their capital investment over the past twelve months, with expectations for the next year consistent with slightly stronger growth in spending (**Chart A**).

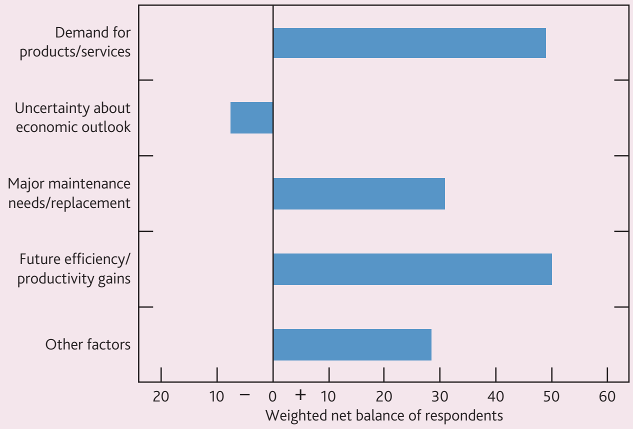
Chart A Investment over the past twelve months and intentions for the next twelve months



The outlook for investment was strongest within construction and consumer services, but manufacturing investment was also expected to increase, and the biggest improvement in expectations, relative to actual spending growth over the past year, was in business services. This was partially offset by an expected decline in investment within the utilities and extraction sector.

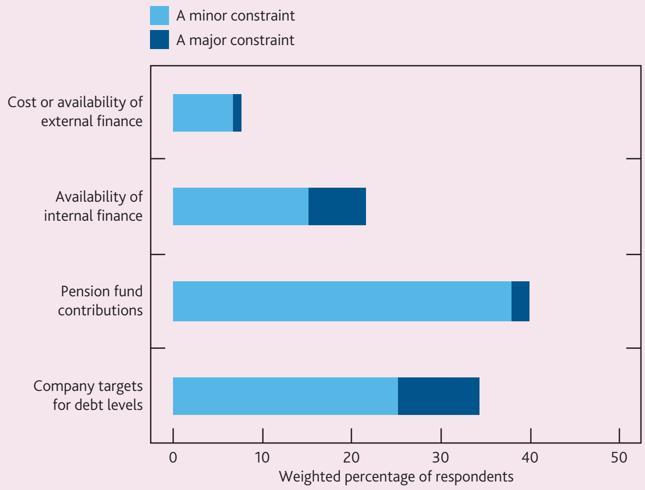
The primary drivers of investment growth over the next year were expected to be demand for firms' products and services, and the pursuit of future efficiency and productivity gains, with around half of all respondents citing these as important (**Chart B**).

Chart B Drivers of investment



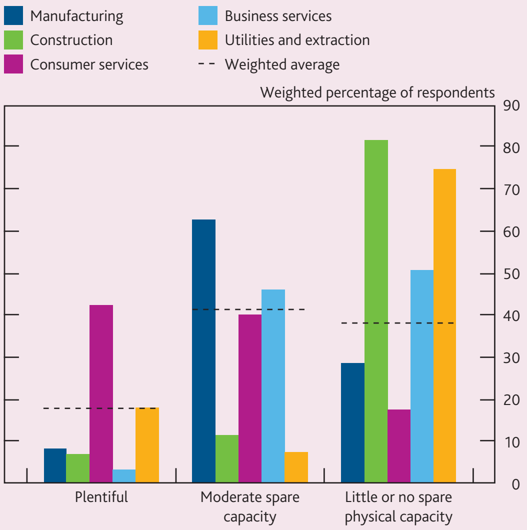
Very few firms indicated that financial factors were a major constraint on their investment plans (**Chart C**). The cost or availability of external finance were pushing down investment for only a small proportion of the weighted sample, although it was constraining a slightly higher proportion of small and medium-sized firms. Pension fund contributions were primarily a constraint for large firms, although the effect was reported to be minor for the vast majority of those affected. Debt levels and gearing were a limiting factor for just over one third of all respondents, but only to a minor extent for most of these firms.

Chart C Constraints on investment



A relatively small number of firms described their physical capacity levels as 'plentiful', with the exception of consumer services (**Chart D**), despite strong investment plans in that sector. In some cases this represented a mismatch between firms' spare capacity and the type of physical capital that was

Chart D Availability of physical capital



required to meet the changing structure of demand and distribution. Physical capacity was tightest within construction and utilities, and around half the weighted sample of business services firms also reported little or no spare physical capacity.