BANK OF ENGLAND

Agents' summary of business conditions

2015 Q4

- Activity had generally grown steadily on a year earlier, alongside rising real incomes and resilient consumer confidence. However, manufacturing output growth had slowed as the strength of sterling and sluggish world growth had adversely affected export supply chains.
- Corporate credit availability had increased slightly further for many contacts, although some very large companies reported that risk appetite in corporate debt markets had eased back a little recently. Credit demand had remained subdued, reflected in high levels of cash holdings among companies.
- Employment intentions had eased overall, reflecting some increased uncertainty about business prospects and a greater focus on raising productivity to offset expected increases in labour costs. However, an increasing number of contacts reported that low inflation had started to hold back wage growth.

Consumer spending growth had remained steady, supported by rising incomes, resilient consumer confidence and increasing availability of low-cost finance.

Business services turnover growth had remained buoyant overall, albeit stronger among professional services firms than for many other services, where competitive pressures were restraining price inflation more.

Manufacturing output growth had slowed, reflecting weak demand in export supply chains due to sterling's appreciation and sluggish global demand growth.

Construction output growth had remained moderate in recent months, although there were some mixed signals from different sectors. While some contacts reported some easing of housing starts during recent months, commercial construction activity had continued to strengthen.

Investment intentions remained consistent with modest growth in capital spending. Service companies' intentions had remained buoyant, but manufacturers' intentions had eased, consistent with the relative strength of activity growth.

Credit availability had increased slightly for many firms, although some very large firms reported a reduction in risk appetite in corporate debt markets. Businesses continued to report soft demand for credit, reflected in high levels of holdings of cash (see Box 1 on page 3).

Occupier demand had risen further in the **commercial real estate market**, and investor demand had remained strong.

Housing market activity had remained relatively subdued, albeit generally above levels reported a year earlier. Demand among buy-to-let investors had remained robust, reflected in strong buy-to-let mortgage growth.

Capacity utilisation had risen slightly further above normal in services, but had fallen in the manufacturing sector.

Employment intentions had fallen on the quarter and were consistent with modest growth in staffing numbers outside the manufacturing sector. **Recruitment difficulties** had broadened somewhat, but growth in **labour costs** had remained moderate, with evidence that downward pressures from low inflation were offsetting upwards pressures from skills shortages (see Box 2 on page 5).

Materials costs had remained lower than a year ago, reflecting price declines across a wide range of inputs. **Imported finished goods prices** were slightly lower than a year earlier.

The rate of decline in manufacturing **output prices** had increased as falls in input costs were passed through. Business services price inflation had edged higher, as increasing demand had allowed some professional services to increase prices. A survey on corporate pricing indicated expectations for output price inflation remained subdued (see Box 3 on page 6).

Consumer price inflation for goods had remained negative, mainly reflecting falls in prices earlier in the year. Consumer services price inflation had edged lower, remaining modest.

This publication is a summary of monthly reports compiled by the Bank of England's Agents between late August 2015 and late November 2015. It generally makes comparisons with activity and prices a year earlier. The report does not represent the Bank's own views, nor does it represent the views of any particular company or region. More information on the Bank's Agencies can be found at www.bankofengland.co.uk/publications/Pages/agentssummary/default.aspx.

Consumer services and retail sales

Annual consumer spending growth had remained steady overall, supported by rising incomes, resilient consumer confidence and an increasing availability of low-cost consumer credit. Annual retail sales values growth had remained modest, restrained by declines in retail goods prices on a year ago. Contacts reported subdued demand for clothing and footwear due to the mild autumn weather, and some possible delay in purchasing electrical goods ahead of Black Friday. Retailers were reasonably optimistic about prospects for the Christmas period. Demand growth for new cars had continued to moderate. Consumer services turnover growth had picked up a little. Leisure travel was reported to be growing strongly and hotel occupancy had risen. Pubs and restaurants had continued to report robust growth.

Business and financial services

Businesses services turnover growth had remained buoyant (**Chart 1**), particularly among professional services firms. Some companies reported a recent strengthening in activity growth, as some mergers and acquisitions and corporate finance activity, that had been delayed prior to the general election, had fed through with a lag. Strong commercial real estate activity was boosting demand for property-related services. Consultancy and project management services were supported by a continuing drive for cost-cutting and digital transformation, but demand for oil and gas-related consultancy had fallen. Turnover growth in some parts of the financial sector had been held back by slow growth in credit demand from small and medium-sized enterprises (SMEs), alongside downward pressures on fees and spreads in corporate lending. Other business services turnover was also generally weaker than for professional services, reflecting clients' focus on costs and a competitive environment, embodied in relatively weak price inflation. Among the areas of strongest growth were warehousing and logistics, supported by general economic growth and the expansion of e-commerce. Demand for IT services was reported to be increasing rapidly, but excess capacity in some parts of the sector — such as data storage — was weighing down on pricing. And falls in ticket prices had dampened revenue growth in business air travel. Business services export growth had moderated, reflecting sterling's strength and a slowing in demand from emerging economies.

Production

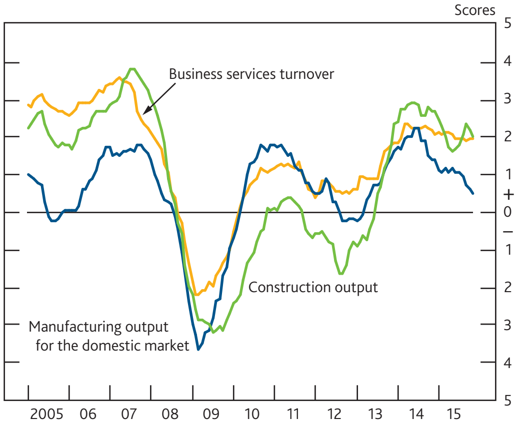
Manufacturing output growth for the domestic market had slowed but remained positive overall (**Chart 1**). Moderate demand growth was reported in a range of subsectors, including construction materials, pharmaceuticals, scientific products, consumer goods, automotive and the civil aerospace supply chain. But the strength of sterling and sluggish world demand growth had adversely affected exports, which were reported to be below levels seen a year earlier, with second-round effects on the associated supply chains. Businesses supplying the oil and gas sector had seen sharp contractions in activity. And domestic steel output had fallen as a result of rising imports and global overcapacity. More generally, tougher competition was reported from imports from continental Europe, limiting the growth potential of many UK manufacturers.

Construction

Annual growth in construction had remained moderate over the past quarter (**Chart 1**). Housing completions had continued to grow, although some contacts had reported an easing of housing starts during the past six months. Social housebuilding had slowed, partly attributed to increased uncertainty around the sector. But commercial construction activity had continued to increase, with a focus on development within the major cities. University-related construction had remained buoyant, including student housing.

Chart 1 Activity

Three months on the same period a year earlier



Investment

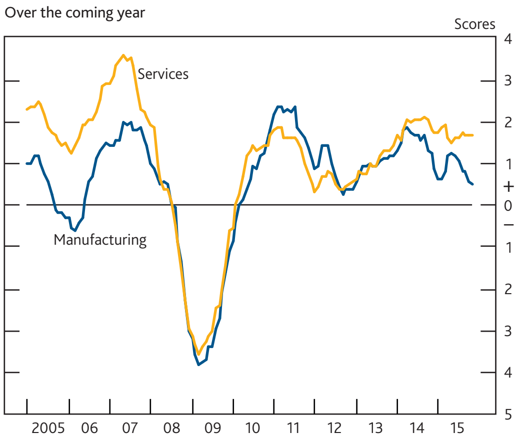
Investment intentions had eased in manufacturing, but remained firm among services companies, pointing to moderate growth overall (**Chart 2**). In manufacturing, intentions had been affected adversely by a weakening international outlook. But there remained areas of capital spending growth, including capacity expansion in the aerospace and automotive sectors. Some producers reported maintaining investment in research, new product development and efficiency gains, such as automation, as a response to highly competitive conditions. Service sector intentions remained comparatively stronger, often with a focus on IT spending to improve productivity, service levels and system resilience. Spending on transport facilities and premises expansion or refurbishment was also rising.

Box 1
Agency intelligence on drivers of high corporate holdings of cash

For some time, a common feature of Agents' discussions with business contacts has been their high levels of cash holdings, reflected also in strong corporate money growth data. Contacts have offered a wide range of reasons for recent high levels of corporate deposits. Those have included gently rising profitability for many firms, still-modest levels of investment, and for many — particularly among smaller companies — a persistent distrust of banks following their experience of the financial crisis. Some smaller businesses have also reported holding surplus cash due to their overdrafts having been replaced with invoice discounting facilities. At the other end of the corporate spectrum, some very large companies have reported that high levels of cash may act as an insurance against the possibility of illiquidity in capital markets, by providing companies with flexibility about the timing of corporate debt issuance: the benefits of that flexibility can potentially far outweigh the opportunity costs of holding cash.

When asked why they have chosen to hold deposits rather than other assets that might pay a higher return, companies have often cited long-term precautionary motives. Businesses report valuing the liquidity and security of cash, and the relative ease of managing any associated risk exposures (such as through exposure limits). In many cases, companies note that the financial crisis highlighted how firms fail when they run out of cash, and how, during periods of financial stress, credit availability can dry up, credit lines can be withdrawn or covenant terms become more strictly enforced. But businesses also report holding cash ready for opportunities for expansion, especially by company acquisition, as bank finance for such deals may not be sufficiently timely or may not be forthcoming.

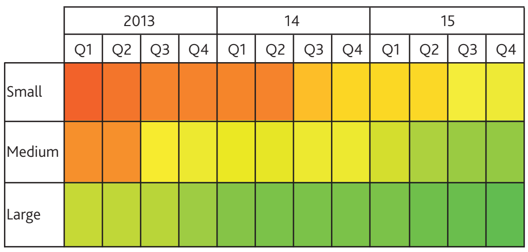
Chart 2 Investment intentions



Corporate financing conditions

Credit availability had increased a little further, but at a slower rate than earlier in the year (**Chart 3**). Strong competition to lend was reported by banks, reflected in lending rates and terms that borrowers often reported were attractive. However, a small number of larger businesses reported a recent increase in loan spreads — or expected an increase — which their lenders had attributed to higher regulatory and capital costs. There had been a slight easing in credit availability for asset-owning smaller businesses. However, some SMEs reported that their finance options were limited to invoice discounting, which could be costly. Overall, corporate loan demand had remained muted, reflected in high holdings of cash (Box 1). The availability of non-bank finance had increased further. There were reports of increasing private equity activity, including lending. Competition among asset-based lenders had increased and pricing had fallen. Crowd funding and peer-to-peer lending had also continued to grow, albeit from a low base as a share of total lending. The cost of debt raised in capital markets had remained low, but had increased slightly in recent months due to market volatility.

Chart 3 Heat map of credit availability relative to normal by size of business[(a)]



(a) This mapping is based on individual Agencies' national assessments of corporate credit availability, weighted by the gross value added of their regions or countries. 2015 Q4 uses Agents' latest assessment as of November. The greater the intensity of red, the tighter credit availability; the greater the intensity of green, the looser credit availability. Yellow indicates normal conditions. Includes bank and non-bank credit.

Property markets

Commercial real estate

Occupier demand for commercial property had continued to increase gradually. Demand growth was reported to be strongest for office space in London and the larger regional cities, and for good-quality industrial/warehouse space more generally. In some regional city centres, rental values had risen to levels that would justify new development, though contacts expected that supply would take some years to respond fully. In other occupier markets demand and rental values were generally increasing more slowly. Substantial inflows of overseas and UK investment into the sector were reported, including from sovereign wealth funds, private equity firms and institutional funds, with investor demand spreading across regions and sectors. That had contributed to increases in asset values, often beyond the rate of increase of rents. The main UK banks were reported to be reluctant to fund speculative development, but bank funding was generally reported to be available for other forms of commercial real estate investment, albeit at loan to value (LTV) ratios that remained below those available before the crisis.

Housing market

Housing market activity had remained relatively subdued, but generally above levels a year earlier. There was some evidence that secondary market supply had started to pick up in some areas. However, the availability of properties for sale had continued to constrain growth in activity in most parts of the United Kingdom, supporting price inflation. Activity in higher-price brackets had remained particularly weak. And some developers had noted a recent softening in demand for new-build housing, particularly from foreign investors in the London market. Private rental demand had continued to grow steadily, leading to some rental inflation. Demand among buy-to-let (BTL) investors to purchase properties had remained robust, reflected in strong growth in mortgage lending to the sector. Lenders, particularly those smaller in size, were responding to strong demand by increasing the range of BTL products available and lowering rates, although LTV ratios had tended to remain low by pre-crisis standards. Competition had remained intense in the owner-occupier mortgage market, with some increase in the availability of higher LTV lending.

Capacity utilisation

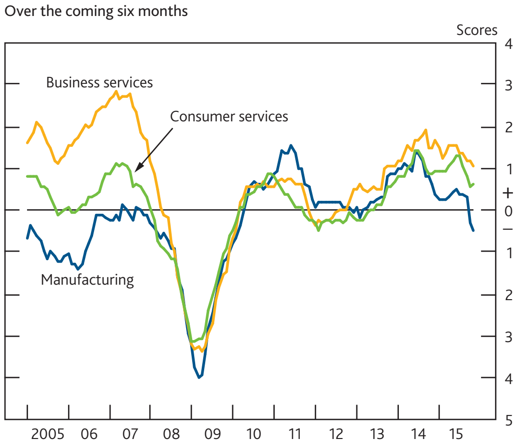
Over the quarter, capacity utilisation had fallen further below normal in manufacturing and risen further above normal in services. Slack in manufacturing had increased as a result of investment in productivity enhancements and the recent weakening in output growth, especially among exporters. By contrast, services capacity utilisation had risen alongside rising activity, with some capacity constraints reported. Those constraints were centred around areas experiencing skills shortages, such as IT, haulage and professional services. Occupancy of commercial property had increased overall, with warehousing space in increasingly short supply.

Employment and pay

Employment intentions had fallen on the quarter and were consistent with modest workforce growth (**Chart 4**). Productivity improvements were expected to make a stronger contribution to meeting future demand growth than in the recent past, as businesses sought to offset rising labour costs. Intentions had turned negative in the manufacturing sector, reflecting weaker activity in export markets, the steel industry and oil and gas sector, along with intense pressure to reduce costs within supermarket supply chains. The employment outlook remained strongest within business services, but some professional and IT companies that had increased staffing strongly over the past few years were becoming more circumspect about future hiring. For some contacts, moderating intentions also reflected skills shortages, which made it difficult to fill certain positions and, for a minority of contacts, was constraining output growth. Recruitment difficulties had remained above normal and, while not intensifying, had become slightly more widespread.

Chart 4 Employment intentions

Over the coming six months



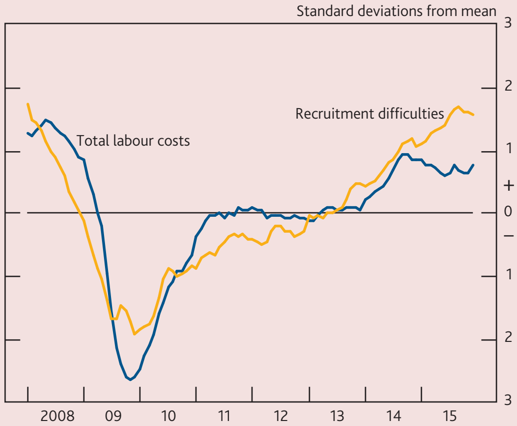
Growth in total labour costs had remained moderate, and lower than might be expected from companies' reports of recruitment difficulties (Box 2), with the majority of pay awards remaining in the 1%–3% range. Some easing in the momentum of pay growth had been reported, as low inflation had started to offset upward pressures on pay from recruitment difficulties. The outlook for wage growth had remained strongest in parts of the services sector where skills were reported to be tightest, such as professional services. Manufacturing labour cost growth was slower than for services, in part reflecting relatively weaker demand growth and strong competitive pressures. Contacts continued to express some concerns about second round effects on pay from the introduction of the National Living Wage, arising from pressure to

Box 2
Recent trends in Agents' company visit scores for pay and recruitment difficulties

Agents' scores for total labour cost growth have been relatively steady over the past year, having increased during 2014 alongside tightening recruitment conditions and the introduction of auto-enrolment to larger companies. As **Chart A** shows, that steady pattern of labour cost growth over the past year contrasts with a continued increase in recruitment difficulties, such that the current average labour costs growth score from company visits is lower than might be expected given the level of recruitment difficulties. That could indicate an upside risk to labour costs growth, if recruitment difficulties were to feed through to pay growth with a lag, perhaps as staff churn increases. But it could also indicate that some other factor is suppressing labour cost growth. In particular, weak inflation has been cited by Agents' contacts more frequently in recent months as a factor holding down pay awards. And in the manufacturing sector, Agents' contacts report that pay growth has also been negatively affected by weak demand growth and reduced overtime and shift work.

Monitoring pay growth will be an important part of the Agents' work over coming months, especially as many pay settlements are agreed around the turn of the year. Agents conduct a regular annual pay survey during December and January, the results of which will be published in the Agents' February *Summary* update.

Chart A Agents' company visit scores for labour costs and recruitment difficulties



maintain pay differentials. Those with large low-paid workforces planned to react in a range of different ways, often seeking to offset higher costs through efficiency or productivity gains.

Pricing

Supply chain pricing

Materials costs had remained substantially lower than a year earlier, largely reflecting the effect of weaker global demand conditions on a range of materials prices, including food, energy and metals. Construction materials price inflation had slowed to a modest rate. Prices of imported finished goods were also lower than a year earlier overall, although the pattern was uneven, reflecting the divergent effects of sterling's appreciation against the euro on one hand and depreciation against the US dollar on the other. In some cases, overcapacity in Chinese production had acted to offset upward pressures on import prices from the strength of the dollar and increases in labour costs.

Manufacturing output price inflation had become more negative as falls in material costs were increasingly passed on. Manufacturers reported difficulty in justifying output price increases given the weakness of non-labour input costs. As a result, increases in wage costs were often leading to a narrowing in margins for some, unless offsetting productivity gains could be generated. In contrast, business services price inflation and profitability had edged marginally higher in recent months, reflecting relatively buoyant demand conditions. Box 3 on page 6 presents the results of a recent Agents' survey on corporate pricing.

Consumer prices

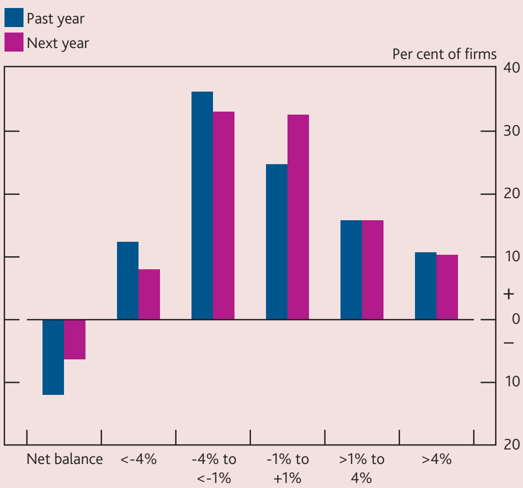
Annual consumer goods price inflation had remained negative, albeit mainly due to falls in prices earlier in the year. Retailers' expectations were for inflationary pressures to remain subdued in the near term, as some input cost reductions were still to work through to prices. Recent mild weather had left some contacts with excess stock of winter clothing and footwear, which they expected would be cleared through deeper-than-normal discounting during the upcoming sales season. Black Friday was expected again to be a major event, although some retailers were looking to be more targeted in promotions this year. Retail services price inflation remained modest and had edged lower as input cost falls were passed on, and as earlier falls in RPI inflation were reflected in some index-linked regulated services prices with a lag, such as social rents and utilities. However, buoyant demand growth was allowing margins to increase in some consumer services, most notably in rented private housing and the leisure sector, where spare capacity had been eroded.

Box 3
Agents' survey on corporate pricing

The Bank's Agents undertook a survey during October and November to investigate past and expected changes in domestic prices, the factors affecting pricing decisions and the frequency with which companies changed prices. Some 350 companies responded to the survey with a combined UK turnover of about £70 billion. The results, as presented here, were weighted by turnover and reweighted by sectoral shares of gross value added to adjust for differences in the composition of the survey compared with the economy as a whole.

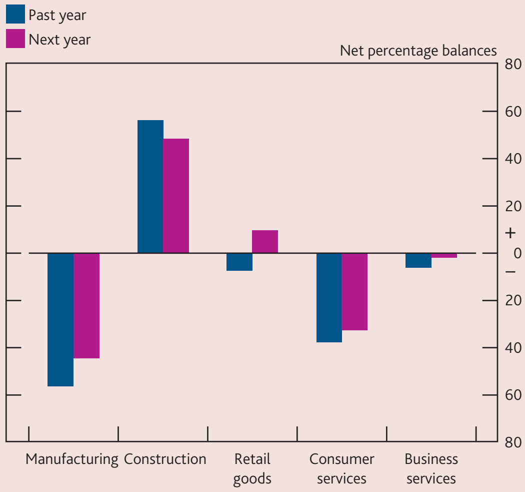
A modest net balance of respondents had seen prices fall over the past year (**Chart A**). Almost half of businesses surveyed had reduced their prices over the past year, while only a small minority of companies had raised prices significantly. Looking ahead a slightly smaller net balance expected a further fall in prices over the coming year, with almost half of respondents still expecting prices to fall by more than 1%. Again, relatively few businesses expected to be able to raise prices significantly.

Chart A Price changes over the past year and expected next year



Across sectors, only construction firms reported a positive balance of price changes over the past year; and expectations within the sector were for further price increases during the coming twelve months (**Chart B**). Manufacturers reported the most negative net balance for price changes during the past year, and expected further price declines. Expectations for services firms over the next year were more mixed, however, with a modest balance of retailers expecting an increase in prices, business services firms expecting prices to be little changed overall, and consumer services respondents expecting a further decline in prices.

Chart B Changes in prices by sector



The factors most frequently cited as driving prices lower over the past year were energy costs, competition from abroad, productivity and domestic competition. Those factors had more than offset upwards pressures from labour costs, planned changes in margins and UK input/finished goods costs (**Chart C**). The pattern of factors expected to influence prices over the next twelve months was broadly similar, but the balance of contacts expecting upward pressure from imported finished goods costs had turned slightly positive; downwards pressures from demand/excess capacity were expected to be smaller, and 'other' factors were no longer expected to drag on prices.

Chart C Factors influencing prices

Finally, the survey asked about the frequency with which companies changed prices. Some 40% of respondents reported changing their prices at least monthly, while just over 20% of companies changed their prices annually or more; and just over 20% changed their prices 'as the need arose'. The remaining firms reported changing their prices either quarterly or six-monthly.