BANK OF ENGLAND

Agents' summary of business conditions

February 2015

- Consumer demand had continued to grow at a moderate pace.
- Housing market activity had remained subdued relative to levels in 2014 H1.
- Investment intentions for the next twelve months were consistent with modest growth overall.
- Business services turnover growth had remained robust.
- Manufacturing output growth for the domestic market had eased further.
- Construction output growth had eased slightly, but had been robust overall.
- Corporate credit availability had improved slightly over recent months.
- Employment intentions had eased slightly for manufacturing and business services firms, but were consistent with modest headcount growth overall.
- Recruitment difficulties had changed little, at a level somewhat above normal.
- Capacity utilisation was at broadly normal levels in manufacturing, but slightly above normal for services.
- Growth in total labour costs per employee had been steady, although contacts reported increasing wage pressures in some subsectors with skills shortages.
- Materials costs and imported finished goods prices had remained lower than a year earlier.
- Output prices were broadly flat for manufacturers on a year earlier, although they had risen moderately for business services. Profitability growth had edged higher.
- Consumer price inflation had fallen further for goods. Moderate rates of inflation in services prices had continued.

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 December 2014 and late January 2015. 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

Retail sales values had continued to grow at a moderate pace during the past three months, although some contacts reported an easing in growth since November, when demand had been boosted by 'Black Friday'. Seasonal trading had been strongest in the non-food retail sector, where sales growth was reported to have been higher than a year earlier. However, sales values growth in the grocery sector had slowed further, in part reflecting further price discounting. Some retailers reported slightly weaker-than-expected levels of demand during their January Sales. Demand for consumer services was increasing more quickly than for goods. Annual growth of spending at pubs, restaurants, hotels and leisure attractions had picked up a little over Christmas. And the number of rail journeys and passengers at regional airports had seen robust growth in recent months. There were some reports that a revival in household real disposable incomes, in part reflecting falls in fuel prices, was starting to have a positive impact on consumer demand.

Housing market

Housing market activity had remained subdued in most regions compared with a year earlier. However, some early signs of a pickup in activity were reported, particularly in the new build sector, where some large house builders noted improved levels of reservations. In the secondary market, activity appeared to be relatively stronger in the market for lower value homes, reflecting demand among first-time buyers, downsizers and investors.

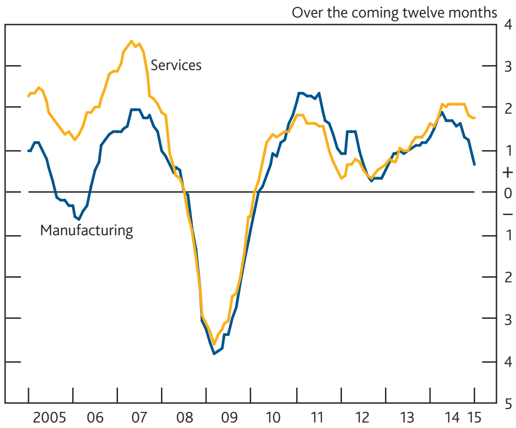
Business investment

Investment intentions in manufacturing had eased back further this month, but indicated a modest increase over the next twelve months (**Chart 1**). Some contacts had delayed investment programmes, often due to the weakness in overseas demand. Falls in oil prices had also led to a retrenchment in spending plans within the oil and gas sector. Intentions were relatively stronger in services, implying modest growth in capital spending. Two particular factors were often cited as drivers: catch-up spending following a period of underinvestment and plans for commercial property related investment, though some supermarkets had reduced their expansion plans. The forthcoming General Election had created a degree of uncertainty, but that was rarely reported to have affected investment spending.

Exports

Manufacturing export growth had steadied somewhat, albeit at a low rate, after recent falls. US demand had continued to strengthen. But growth in the euro area had slowed slightly, and export volumes to Russia had weakened, in part reflecting the effect of trade restrictions. Services export growth had remained stronger than for manufactured goods. Professional services companies had reported growth in a range of markets. Contacts in construction-related services had generally seen demand in the Middle East holding up well to date. Across manufacturing and services, suppliers to the oil and gas sector were expecting the fall in oil prices to depress their export activity over the next year.

Chart 1 Investment intentions



Output

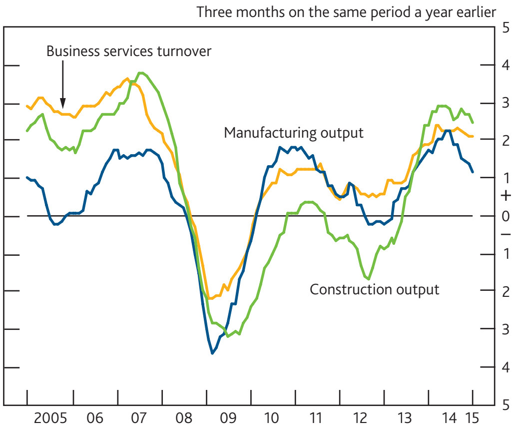
Business services

Growth in business services turnover had remained robust (**Chart 2**). Rising corporate finance, commercial real estate and M&A activity had acted as drivers of growth in law, accountancy and banking. Architects, surveyors and engineering consultants had seen increasing workloads from commercial property development and infrastructure projects. Haulage, warehousing, and courier services contacts reported increasing activity, as demand within retail and construction companies had continued to strengthen. Private sector demand for IT services had remained robust. Business discretionary spending on travel, conferencing and hospitality had risen. Publishing had remained weak, however, due to structural changes in the sector, with growth in digital sales insufficient to offset the continuing decline in demand for printed media. Service companies exposed to the oil industry expected a sharp fall in demand during 2015.

Manufacturing

Growth in manufacturing output for the domestic market had eased further (**Chart 2**). Companies in automotive-related supply chains reported continued robust growth in production. Manufacturers of construction products had also reported strong output growth. Household consumer goods producers had benefited from rising consumer confidence. The fall in oil prices had reduced new orders across oil and gas supply chains. Declines in food commodity prices over the past year had decreased demand for agricultural machinery.

Chart 2 Output growth



Construction

Construction output growth had eased slightly but remained robust (**Chart 2**). Construction growth had become more broad-based over the past year, as a slowing in house building growth had been largely offset by a recovery in commercial activity. Large house builders had continued to plan increases in output in 2015, although some smaller house builders reported that tight funding conditions and materials or skills shortages were constraining their activity. Commercial construction had continued to grow robustly, including some speculative development of warehousing and industrial units. Infrastructure investment had also risen.

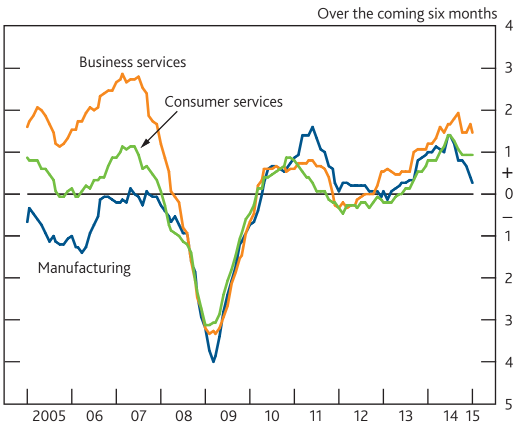
Credit conditions

Credit availability had increased slightly over recent months, although there remained a disparity between the experiences of large and some smaller firms. Intense competition among banks to lend to larger firms had led to significant reductions in finance costs for some contacts. Bank lending conditions had remained tighter than pre-crisis for many small and medium-sized companies, but were improving: some stronger businesses described conditions now as reasonably good. However, a distrust of banks among smaller companies had continued to bear down on their demand for bank credit. In the commercial real estate sector, banks were reported to be increasing the amount of funds available at higher loan to value ratios. More generally, a rise in the availability of funds from private equity investors was reported, as some had been able to sell earlier investments made before the financial crisis. Bad debts and arrears had remained contained, although some fears had been expressed that significant cuts in the oil and gas sector's cost base could lead to insolvencies within the supply chain.

Employment

Employment intentions over recent months had been consistent with easing growth (**Chart 3**). This had reflected a combination of factors, including: a slight easing in the demand outlook; a sense that many firms had reached appropriate employment levels following recruitment last year; and a focus on gains in efficiency or productivity. Manufacturing intentions were now broadly flat overall. Intentions in business services had eased a little, but remained consistent with moderate employment growth. A broad range of sectors were recruiting, with plans strongest among IT and some professional services firms. Modest headcount growth in consumer services had continued. Recruitment difficulties had remained at elevated levels. Skill shortages had remained most pronounced within IT, engineering, construction trades. There were reports of companies using migrant workers to fill vacancies in some higher-skilled occupations, as well as for less-skilled roles. More generally, staff attrition rates had continued to pick up from low levels.

Chart 3 Employment intentions



Capacity utilisation

Capacity utilisation had remained close to normal in manufacturing, but was slightly above normal in services. Within manufacturing, some companies had seen utilisation rates ease due to slowing demand or as earlier investment had increased physical capacity. But that had been broadly offset by tightening capacity elsewhere in the sector, such as for companies producing construction materials. Within services, hotel occupancy levels had been reported as strong, and some shortages of high-grade office space and warehousing were emerging. But reports of excess sales space within the retail sector had persisted. In terms of labour, there had been an increase in reports of skill shortages acting as a constraint within professional services. Across sectors, capacity utilisation was most intense in the construction sector.

Costs and prices

Labour costs

Growth in labour costs per employee had remained steady. The results of a pay survey (summarised in a box on pages 5) indicated a very slight increase in wage settlements in 2015. There remained a number of sectors where skills shortages had exerted more pressure on labour costs, often addressed through targeted awards or special payments with limited effect on average pay growth. Contacts typically regarded the recent decline in inflation as easing upwards pressures on pay growth. The increase in the National Minimum Wage in October had led to larger wage increases for some staff at the lower end of the pay scale.

Non-labour costs

A broad range of materials costs had fallen on a year earlier. However, most contacts had not yet benefited fully from the large reductions in oil prices, given extensive forward purchasing of oil. Users of oil-based intermediate materials were also yet to see major decreases in their costs. Shipping rates had fallen but this was largely attributed to overcapacity, rather than fuel costs. A range of non-oil input costs had declined, including silver, scrap metal, chemicals and cotton, as a result of lower global demand. Construction material costs, however, had continued to increase. There had been a further fall in the costs of imported finished goods, in part as forward contracts were renewed following sterling's appreciation since early 2013, but in some cases also due to recent falls in the value of the euro.

Output prices and margins

Manufacturing output price inflation had fallen, with prices now broadly flat on a year earlier (**Chart 4**). A combination of falling raw material costs and competitive markets had provided little scope for price increases for most companies. Suppliers to the large supermarkets had experienced continuing downward pressure on prices. Business services price inflation had edged lower, remaining modest (**Chart 4**). Professional services firms had continued to increase prices moderately, especially for more specialised services, as demand had improved and spare capacity had eroded. Commercial property rents had continued to rise as demand improved. But elsewhere in the sector, limited pricing power was reported. In haulage, lower fuel costs had led to price reductions due to fuel indexation clauses in contracts. Manufacturing profitability had edged up, as some companies had seen improvements to their margins from reductions in input costs. Service sector profitability growth had also increased overall, due to increasing business volumes, efficiency gains and some price increases.

Consumer prices

Consumer goods price inflation had been negative, although modest inflation in services prices had continued (**Chart 5**). Food and fuel prices had continued to fall. Looking ahead, contacts expected that price competition in the grocery sector would intensify further. Some further falls in grocery prices had been announced early in the New Year. In the non-food sector, discounting in the post-Christmas sales period had appeared little changed on a year earlier. Retail services price inflation had edged lower, remaining modest (**Chart 5**). A moderate recovery in discretionary spending had continued to support price rises for a range of leisure services. Private sector rents had increased a little. But inflation in regulated transport fares had declined following the earlier slowing of RPI inflation, and for some unregulated transport fares, there had been signs of lower fuel costs being passed through to the consumer. A number of utility companies had announced price reductions that would start to take effect in the near future.

Chart 4 Manufacturing and services output prices

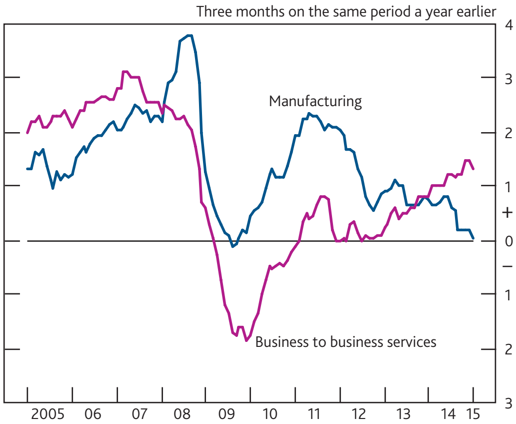
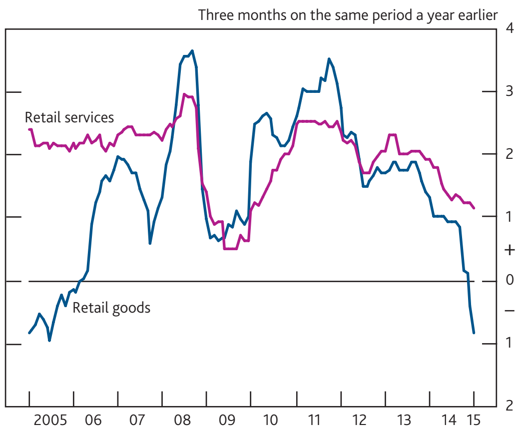


Chart 5 Retail goods and consumer services prices



Agents' survey on pay and labour costs

The Agents have conducted an annual pay survey since 1998, asking private-sector contacts about their expected pay settlements for the year ahead, and the key drivers of any changes to growth in total labour costs per employee. This year 436 firms responded, with a combined UK employment of 977,000 staff. The results of the survey have been weighted by employment.

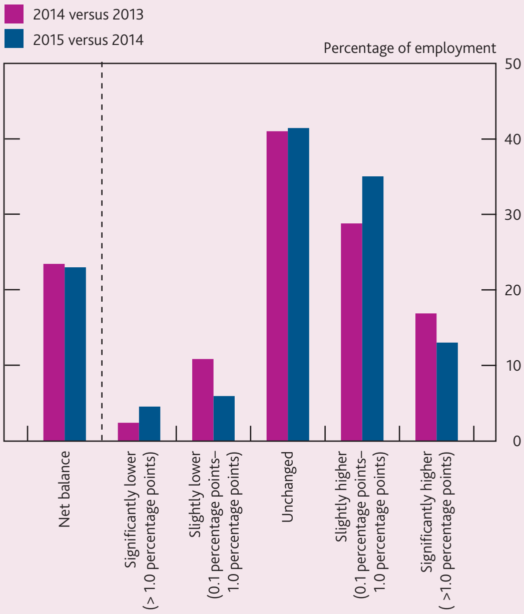
The average pay settlement was expected to increase slightly to 2.5% in 2015, from 2.4% in 2014 (**Chart A**). These figures remain well below pre-crisis growth rates, although there has been a very gradual drift upwards in settlements over the past few years. Looking across sectors, pay settlements in 2014 and those expected for 2015 were a little higher in construction than in other parts of the economy.

Chart A Pay settlements by sector

This year's survey, in common with recent years, saw a clear majority of expected settlements in the range 2% to 3%. Fewer firms were expecting to freeze pay in 2015 than in the previous year, and there were no reductions in pay reported for 2014 or expected for 2015. Around 9% of firms in the sample (covering 12% of employees), reported that collective wage bids had been made for 2015. A little over half of those bids were reported to have been higher in 2015 than in 2014.

A modest balance of respondents expected total labour costs per employee to increase more rapidly in the coming year than in the previous twelve months (**Chart B**). That balance suggests that the pickup in growth of total labour costs per employee in 2015 may be a little greater than that for settlements. Across sectors, expectations of increases in growth of labour costs per employee were strongest for construction.

Chart B Expected growth in total labour costs relative to the previous year



As in last year's survey, the factor most commonly cited as expected to increase growth in total labour costs per employee in the coming year was staff retention and recruitment (**Chart C**). As well as upward pressure from higher productivity growth, a number of respondents also cited a positive influence from the National Minimum Wage, or pressure to pay the Living Wage (captured within 'other' in **Chart C**). But there were some countervailing downward pressures, particularly from inflation expectations and from the ability to pass on cost increases in to price. These reflected the significant fall in inflation and reports from some contacts that competition in their markets made it difficult to raise prices, particularly in a low-inflation environment.

Chart C Influences on expected growth in total labour costs per employee in 2015 relative to 2014