BANK OF ENGLAND

Agents' summary of business conditions

2017 Q2

- Moderate underlying growth in activity had continued overall. Annual sales growth in volume terms had continued to slow. Export volume growth had continued to increase, supported by the lower sterling exchange rate and stronger world growth.
- Investment intentions had strengthened a little further, including investment in technology and to support increased export demand. However, heightened uncertainty remained a drag on some businesses' willingness to invest.
- The direct impact of the fall in sterling on cost inflation for manufacturers' raw materials had eased, but increased costs continued to pass through supply chains into retail prices.

Growth in **retail sales values** was broadly unchanged, and **consumer services** turnover growth continued to ease slightly. In light of the further increase in price inflation for retail goods, this suggested that annual sales growth in volume terms had continued to slow.

Business services turnover had continued to increase moderately. Contacts had reported robust growth for accountancy, legal, corporate finance and IT services.

Growth in **manufacturing** output had picked up, and the fall in sterling and a stronger world economy had led to a marked increase in **export volume growth**.

Construction output had shown continued modest growth.

Investment intentions had strengthened a little further, mostly reflecting planned investment in technology to improve efficiency. However, heightened uncertainty remained a drag on some businesses' willingness to invest.

Bank **credit availability** for corporates was generally accommodative. There had been continued growth in SMEs' and larger corporates' use of alternative sources of funding.

Occupier demand for **commercial real estate** had been broadly resilient, but with some pockets of weaker activity. Investor demand growth and transaction volumes had continued to recover.

Housing market activity had been subdued in most parts of the United Kingdom, as demand weakened relative to supply. The mortgage market had remained competitive among both established and new lenders.

Capacity utilisation had changed little, though there had been a small tightening in manufacturing.

Employment intentions indicated a modest increase in staffing over the coming six months. **Recruitment difficulties** had increased, and were moderately above normal. A survey highlighted tightened labour market conditions, in particular for key skills (see Box 2 on page 5).

Labour costs: Growth in **labour costs** per employee had remained subdued. Settlements continued to be clustered around 2% to 2.5%.

Price inflation for **materials costs** and **imported finished goods** was stable but remained elevated. Pass-through effects on material cost inflation may have passed their peak.

Manufacturing **output price inflation** had increased a little further, though contacts struggled to achieve full pass-through of input cost inflation. **Business services price inflation** had remained subdued.

Consumer goods price inflation had risen further as the fall in sterling passed through to retail prices. **Consumer services price inflation** had been steady.

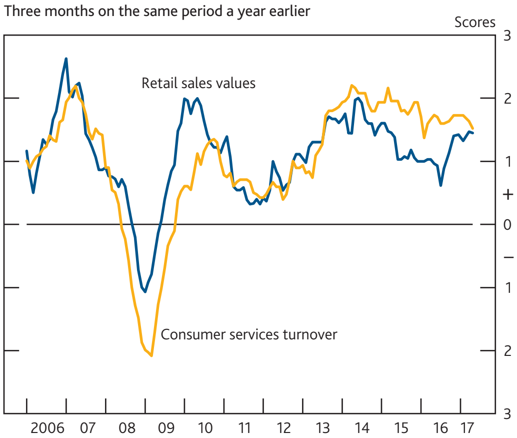
This publication is a summary of monthly reports compiled by the Bank of England's Agents between late February 2017 and late May 2017. It generally makes comparisons with activity and prices a year earlier. The report does not represent the Bank's own views, nor does it represent the views of any particular 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

Growth in retail sales values was broadly unchanged (**Chart 1**). In light of the further increase in price inflation for retail goods, this suggested that annual sales growth in volume terms had continued to slow. Higher price inflation in areas such as food had also squeezed consumers' ability to fund discretionary big-ticket purchases such as homeware.

Chart 1 Retail sales values and consumer services turnover

Three months on the same period a year earlier



Growth in consumer services spending had continued to ease slightly (**Chart 1**). This was largely attributed to 'belt-tightening' by consumers, with growth in spending on restaurants and leisure activities in particular slowing.

Business and financial services

Business services had continued to grow at a moderate pace (**Chart 2**), albeit activity had been patchy across sub-sectors. Generally strong transactional activity (including mergers and acquisitions) was driving growth for contacts in accountancy, legal and corporate finance. IT companies had reported robust demand for digital and cyber security services. Strong price competition had, however, continued to hold back turnover growth in some commoditised services (for example audit). And there were some indications of businesses reducing discretionary spending such as advertising and corporate hospitality. Services exports growth had continued at a steady pace, boosted by stronger underlying global demand and the fall in the exchange rate.

Production

There had been a further pickup in domestic manufacturing output growth (**Chart 3**). Growth was strongest for companies in the pharmaceutical, aerospace, automotive and construction-related sectors. A very modest recovery in output for those in the oil and gas supply chain was in train, on the back of a more stable outlook for the sector. Across different sectors a small number of contacts were benefiting from import substitution on the back of the depreciation in sterling.

Chart 2 Professional and financial services and other services turnover

Three months on the same period a year earlier

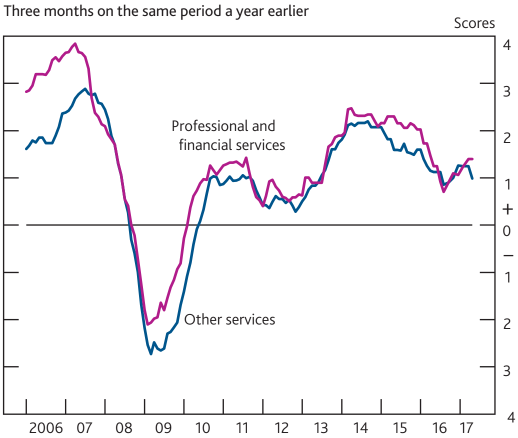
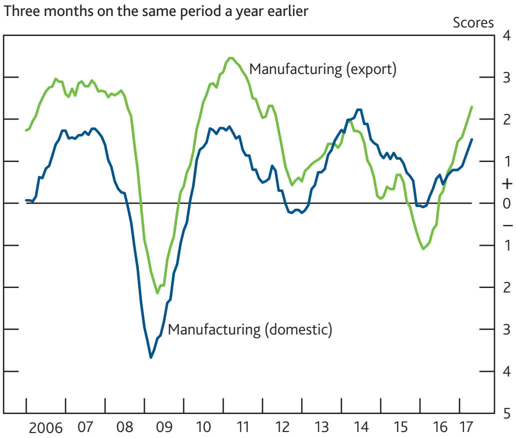


Chart 3 Manufacturing output — domestic and exports

Three months on the same period a year earlier



Goods export volume growth had increased further (**Chart 3**), with a broader range of sectors (including automotive and pharmaceuticals) reporting increasing export volumes than in previous periods. This increase had been supported by the fall in the exchange rate and by strengthened demand in key international markets.

Construction

Construction output had shown continued modest growth. Housebuilding had again made the most significant contribution to growth, including from the private rental sector and social housing. Some contacts reported supply constraints to future growth, including planning requirements and shortage of materials and skilled labour. Commercial development was strongest for industrial, logistics and some prime city office space, and comparatively less strong in retail. In line with previous reports, larger infrastructure projects were expected to provide strong support in the medium term.

Investment

Investment intentions had strengthened a little further (**Chart 4**). Investment in technology to drive efficiencies was prevalent across most sectors. And a few manufacturing exporters were expanding capacity on the back of improving

Box 1
Recent developments in UK car sales

One recent area of focus for the Agents has been developments in car sales; this box provides a brief overview of key developments.

New car sales have fluctuated in recent months: sales eased over 2016, then spiked higher in 2017 Q1 — the most commonly cited factor was consumers bringing forward purchases ahead of Vehicle Excise Duty tax changes. Sales have fallen subsequently. Looking through those short-run effects, contacts have revised down their previous projections for 2017, given reports that UK demand was weakening. Contacts reported a range of potential headwinds, including the slowdown in real pay growth, upward pressure on new car prices arising from sterling's depreciation and, for high-volume manufacturers, weaker second-hand car residual values, which had raised the costs of depreciation and so car finance. Demand for premium cars had remained relatively more buoyant than for higher-volume manufacturers.

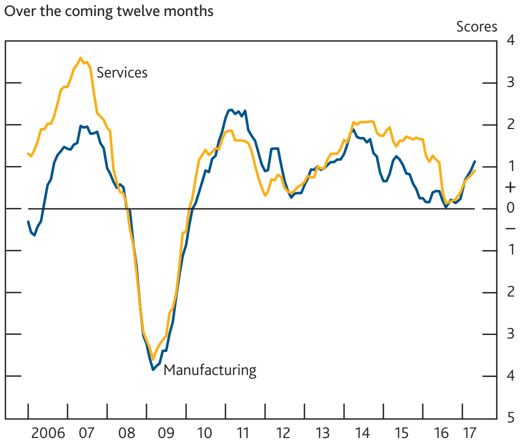
In terms of pricing, the UK market for car sales was reported to be highly competitive, and so manufacturers had not sought to pass through the effect of sterling's depreciation fully into final car prices. Instead, producers had typically made a series of smaller increases, estimated to total around 4% to 5% over the past twelve months. Manufacturers' profitability on UK car sales had fallen, and further gradual price rises were expected over the next few years as they sought to rebuild margins. In contrast, profitability on global sales had increased alongside a stronger world economy.

Increases in the sterling cost of new cars and decreases in the expected future residual values of many used cars had put some upward pressure on monthly finance payments on Personal Contract Purchase (PCP) plans (where consumers pay a deposit and make monthly finance payments for a fixed period, and have the option to buy the car outright at the end of that period). Car companies had sought to offset this in a number of ways, including increasing the length of PCP contracts. In addition, there had been an increase in the availability of Personal Contract Hire plans (long-term rental agreements where the customer does not have the option to buy the car), which tend to have slightly lower monthly payments.

demand. In services, there were several reports of business services companies investing in modernising offices, in part to aid recruitment and retention of staff. Spending had also remained robust within leisure industries. Conversely, some contacts remained cautious around investment, particularly firms heavily exposed to domestic consumer demand or trade with the European Union.

Chart 4 Investment intentions

Over the coming twelve months



Corporate financing conditions

Credit conditions had remained accommodative overall — competition between lenders on price and covenants for large firms had been intense. However, some smaller companies reported greater difficulty in gaining access to banks' relationship managers in recent months. Over the past quarter, there had been some reports of banks increasing interest rates on loans to sectors they perceived to be more vulnerable, such as retail, construction and hospitality.

For non-bank finance, provision of asset finance, crowd-funding and peer-to-peer lending for SMEs had continued to increase, and larger corporates had been able to access long-term debt funding from pension funds and insurance companies. There had also been continuing growth in funding from venture capital, business angels, high-net-worth individuals and private equity investors. Some contacts expressed concern around the prospects for replacing European Investment Bank funding following the United Kingdom's departure from the European Union.

On the demand side, growth in credit demand had remained steady but muted, reflecting some firms' low appetite for gearing.

Property markets

Commercial real estate

Contacts reported a mixed picture on occupier demand for UK commercial property, with rental values increasing further for warehouses, but falling for some retail space. Investor demand growth and sales transaction volumes had continued to recover, partly reflecting increased appetite among foreign investors following the fall in the exchange rate. Conversely, some contacts reported that a lack of visibility around the United Kingdom's future trading arrangements was weighing on investor appetite in the short term. Investor demand was shifting away from London towards other major UK cities, reflecting a search for yield.

Housing market

Activity in the housing market had been subdued in most parts of the United Kingdom, in line with previous updates. Demand had weakened recently relative to supply, bringing the market closer to balance. House builders remained positive and continued to increase output, though some contacts indicated that they may reassess development plans if weakness in the wider market persisted. The prime London market remained depressed, and there were signs that weaker sentiment was spreading to surrounding areas.

The mortgage market remained competitive among both established and new lenders, with high overall availability and low lending rates. More products were available at higher loan-to-value ratios, but availability of lending remained constrained for borrowers with impaired credit histories. Mortgage lending for buy to let had remained subdued, partly reflecting recent taxation and policy changes. Pressure on margins was forcing many small lenders to focus more on niche segments of the market such as shared ownership, older borrowers and self-build. Arrears and repossessions remained very low.

Capacity utilisation

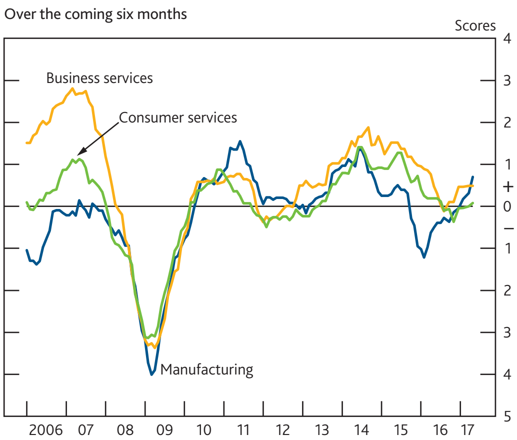
Capacity utilisation had changed little. There had been a small tightening in manufacturing, with exporters, the automotive supply chain and producers of construction-related products continuing to report the most material constraints. Generally though, capacity was not constraining growth.

In services, the picture was mixed. Utilisation of fixed assets (such as office, warehousing and distribution space) was highest in business services, and some capacity shortages were reported. Some IT and professional services firms also reported skills shortages. Conversely, in consumer services, the growth in hotel and restaurant capacity was outpacing the growth in demand, and there also remained an excess of in-store retail space.

Employment and pay

Employment intention scores (**Chart 5**) indicated a modest increase in headcount. Employment intentions among manufacturers had edged up further, reflecting strengthening output growth among exporters in particular — though firms were primarily pursuing productivity improvements and efficiency gains to meet expected demand growth, to a greater extent than expanding headcount. In consumer services, firms' hiring to support new premises was broadly offset by rationalisation to mitigate higher labour costs associated with the National Living Wage, in line with previous updates.

Chart 5 Employment intentions



A number of firms across sectors were taking on more apprentices and trainees to address current or future recruitment difficulties. In some cases this was encouraged by the Apprenticeship Levy.

Recruitment difficulties had picked up slightly since the start of the year as the labour market continued to tighten (see Box 2 on page 5). Skills shortages were most common in construction, IT, engineering, professional services and health care, and in a few cases this was constraining employment growth.

There was little evidence of greater numbers of existing EU migrants leaving the United Kingdom, however there were more reports of a reduction in inflows of new labour from continental Europe. Contacts believed that this reflected uncertainty about their status following the United Kingdom's departure from the European Union, and the negative impact of the lower exchange rate.

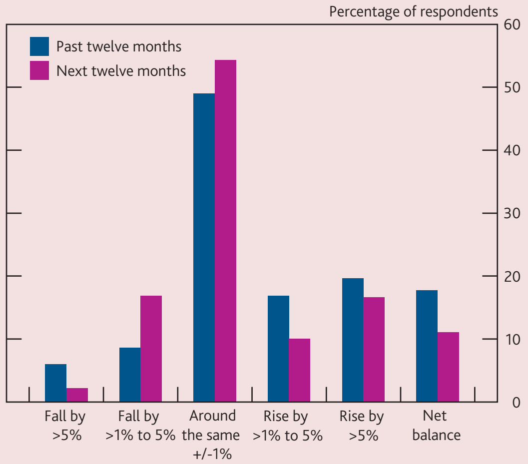
Growth in total labour costs had remained subdued across sectors, despite the tightening labour market. The majority of pay settlements remained clustered around 2% to 2.5%. Pay growth had edged up slightly in manufacturing, due to higher overtime payments and productivity bonuses in response to robust output growth, especially for exporters.

Box 2
Survey: Labour market tightness

During April and May, the Bank's Agents undertook a survey of business contacts to gauge whether labour markets were tightening, and to identify the tactical responses businesses were making to any staffing challenges. Over 400 companies responded to the survey.

Nearly 40% of businesses surveyed had seen employment rise over the past twelve months, while only 15% had reduced employment (**Chart A**). A smaller but still positive net balance of companies expected to increase staff numbers over the next twelve months. Across sectors, reports of growth in headcount were most common among construction and business services contacts and least common among consumer services firms.

Chart A Change in employment over the past year and next year[(a)]

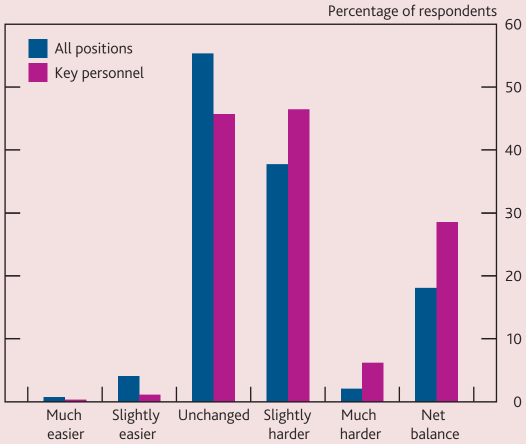


(a) Results are weighted by employment within respondents' sector and by sectoral shares of national employment.

Survey responses indicate increasing recruitment and retention difficulties — most acutely for key skills, but with increased challenges for all positions (**Chart B**).

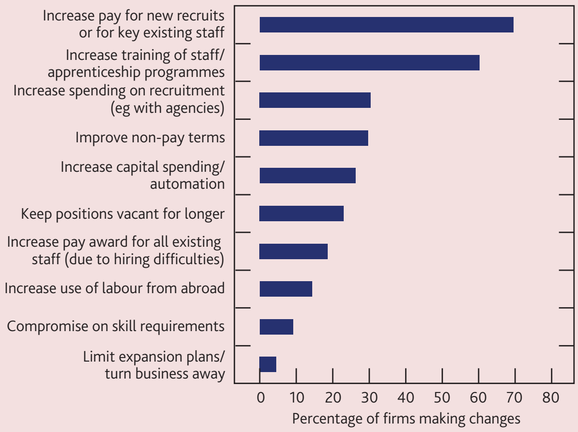
58% of respondents said they made significant use of non-UK EU national employees. For those firms, responses showed that availability of these employees had tightened on balance over the past twelve months. However, it did not appear to have done so sufficiently to change these respondents' views of overall labour market tightness: responses to questions on overall labour market tightness were similar whether respondents made significant use of non-UK EU nationals or not.

Chart B Change in recruitment and retention difficulties over the past twelve months



Respondents were also asked whether they had made changes as a result of any recruitment/retention challenges they faced. A small majority had made changes; of those, the most common response was to increase the pay offered to new recruits or to key existing personnel (**Chart C**). Such responses were common across all sectors, and were most frequently cited in construction. By contrast, broad-based increases in pay were rarely applied as a response to labour market tightness.

Chart C Changes made as a result of recruitment/retention challenges — by those making any changes



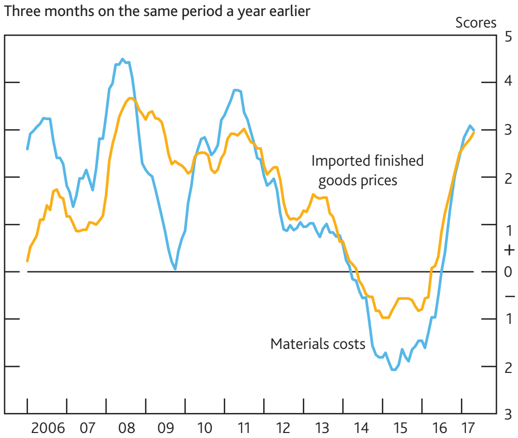
Pricing

Supply chain pricing

Inflation of raw materials costs (**Chart 6**) had stabilised. Pass-through of the effects of previous sterling depreciation to cost inflation for manufacturers' raw materials appeared to have passed its peak, but the costs of construction materials were reportedly still rising. Manufacturers had reported further cost increases as suppliers of intermediate goods, including packaging, passed through their own cost inflation.

Chart 6 Material costs and imported finished goods prices

Three months on the same period a year earlier



Manufacturers' output price inflation had picked up slightly. In many cases, though, contacts had continued to struggle to achieve full pass-through of input cost inflation, particularly where their customers were larger retailers with significant purchasing power. This was squeezing profit margins on domestic sales. Growth in business to business prices remained subdued.

Consumer prices

Inflation in retail goods prices had picked up further, as the depreciation of sterling continued to pass through to retail prices. Patterns of pass-through had been mixed; in groceries this had begun to pick up but had been slower than expected due to competition and compressed margins along the entire supply chain. Prices for imported clothing had been subject to small increases, with prices expected to continue increasing until well into next year. List prices for new cars were rising in small increments. Inflation in retail services prices had been steady. The announced price rises in gas and electricity were starting to affect household bills.