BANK OF ENGLAND

Agents' summary of business conditions

and results from the Decision Maker Panel

2017 Q4

- Recruitment difficulties were a growing concern for businesses as labour shortages had become more generalised across sectors and skill levels.
- Despite this, pay growth had only increased a little, reflecting greater focus on non-pay benefits, a limited number of pay reviews in Q4, and rising input costs. Staff retention and recruitment, and to a lesser degree, inflation, were expected to push pay settlements moderately higher in 2018.
- Consumption growth had eased slightly, reflecting squeezed real incomes and possibly some anticipation of Black Friday. Purchases of big ticket items had eased, and mild weather earlier in the period had weighed on clothing sales.

Retail sales values growth had slowed, reflecting squeezed real incomes and possibly some deferral of spending ahead of Black Friday. **Consumer services** turnover growth had been maintained at a steady pace, but ancillary spending had started to soften.

Business services turnover growth remained moderate as pockets of more cautious demand were offset by strength in IT and advisory work.

Domestic **manufacturing** output had continued to grow relatively strongly; export volumes had strengthened, supported by an improving global economic outlook.

Construction output growth had eased. Increased risk aversion in the private sector, reflecting greater uncertainty, and delays to major projects had slowed activity across commercial and infrastructure projects.

Investment intentions had remained consistent with modest growth.

Credit availability for corporates generally remained good although banks' risk appetite towards consumer-facing businesses had fallen slightly. **Demand for finance** continued to grow alongside activity but appetite for increased gearing remained muted.

Domestic and overseas investor demand for UK **commercial real estate** had stabilised as sentiment continued to recover from its Summer 2016 low.

Housing market activity had moderated in Q4 after a post-summer pickup. Demand remained weaker in the secondary market and in London, notably for the most expensive properties. Demand for new housing showed signs of softening nationally.

Overall **capacity utilisation** was broadly at normal rates, with only a slight skew towards greater than normal spare capacity.

Employment intentions continued to point towards modest headcount growth. **Recruitment difficulties** continued to intensify, becoming more broadly based across sectors and skill levels.

Pay growth had risen slightly. A significant number of contacts expected pay awards to increase towards 2½%–3½% over the next year, from 2%–3% in 2017. That uplift showed some signs of coming through for the minority making decisions in late 2017.

Input cost inflation had persisted due to higher global market prices for materials and ingredients. Sterling depreciation continued to contribute to high **imported finished goods** price inflation albeit down from rates seen in 2016 H2 and 2017 H1.

Manufacturers had been able to increase **domestic output prices** modestly, particularly in food processing, but price increases had typically been insufficient to restore **margins** in domestic business. Business services margins remained under pressure.

Consumer goods price inflation had edged up, driven by pass-through of higher input costs, for example in food and drink. **Consumer services price inflation** was steady.

Results from the Decision Maker Panel suggested that companies expected some weakening in sales and employment growth over the next year. Brexit was expected to reduce sales in 2020, but was considered unlikely to influence wage growth.

This publication includes a summary of economic reports compiled by the Bank of England's Agents between late August 2017 and late November 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/about/people/agents.

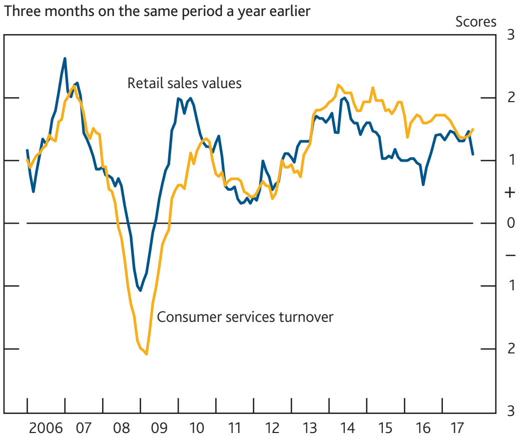
This publication also includes a summary of information gathered by the Bank's recently established Decision Maker Panel. Further background is provided in Box 2 on pages 7–8.

Consumer services and retail sales

Agents completed the majority of their intelligence gathering prior to Black Friday. Retail sales values growth (**Chart 1**) had slowed ahead of the Black Friday sales. Several Agencies reported that consumers may have delayed spending on consumer durables in order to take advantage of discounts during the Black Friday week. Mild weather had also weighed on demand for winter clothing. Replacement cycles had lengthened for big-ticket items (such as fitted kitchens and cars), suggesting that the squeeze on household real incomes continued. Car manufacturers had significantly reduced sales targets for next year, in the expectation that current economic growth rates would continue in 2018. Nominal demand growth for consumer services had remained steady. Tourism and leisure demand had remained strong, but ancillary spending had started to soften, and expectations for 2018 had weakened slightly. Consumer credit remained readily available at relatively low cost, but demand for such credit had weakened a little, in part reflecting lower demand for new cars and associated finance.

Chart 1 Retail sales values and consumer services turnover

Three months on the same period a year earlier



Business and financial services

Business services turnover growth had remained moderate overall. There was some evidence that corporates had exercised greater caution in their spending on marketing, travel and hospitality, in response to cost pressures and a more challenging business environment. Some firms linked to the commercial real estate sector, such as property consultants and architects, also reported a softening in demand. However, demand for a variety of IT services remained robust, partly to adopt new technology but also to drive efficiency gains. And some transport and logistics services firms had benefited from increased UK exports. Finance and insurance companies had reported modest growth in activity, while advisory work for accountants and lawyers had been strong.

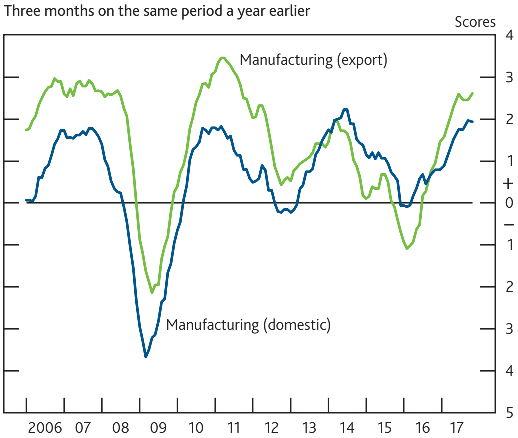
Services exports values growth had remained steady, helped by the past fall in the sterling exchange rate. Overseas tourism visitor numbers and related spending had risen strongly since sterling had begun falling, although annual growth rates had probably peaked. Demand from overseas students for higher education in the United Kingdom had also started to slow. Professional services firms across law, accountancy and consultancy reported robust demand for advice related to acquisition of UK assets, or to the establishment of UK operations by EU clients to retain market access. Overseas activity had edged up from a low base for domestic oil and gas companies.

Production

Domestic manufacturing output (**Chart 2**) had continued to grow relatively strongly. The past fall in sterling had helped manufacturers facing overseas competition to grow domestic market share, and to raise output for those in the supply chain of exporters. Although still limited, an increasing number of producers had also gained from some reshoring of activity, for example in the food and construction material sectors. Strength in construction sector activity had been supporting growth in output of building materials and components, but was expected to ease as construction activity started to moderate. Capital equipment manufacturers and supply chains had benefited from increased demand from the aerospace, nuclear, renewables and defence sectors, and there was continued growth in chemicals and pharmaceuticals. Food and drink sector volumes had continued to increase solidly, although non-food consumer-facing manufacturers had been affected by weaker household spending. Suppliers to the oil and gas sector continued to report moderately improved demand, but many had also diversified to seek growth.

Chart 2 Domestic manufacturing output and manufacturing exports

Three months on the same period a year earlier



Growth in goods exports had strengthened further to a robust pace. An improving global economic outlook continued to support UK exports, notably in Europe, but also in the United States and Far East. Existing exporters had also become more willing to step into new markets such as

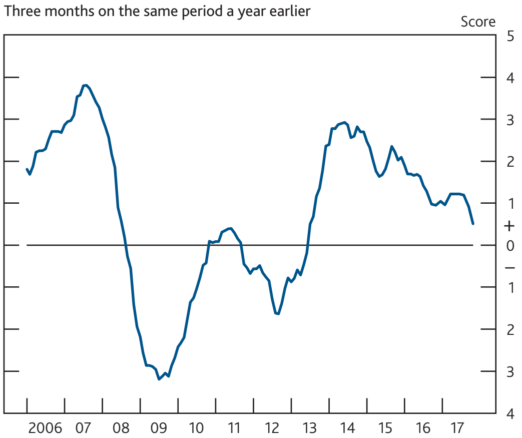
Australia and India. Export demand strength was relatively widespread across sectors such as construction materials, automotive and chemicals. But some exporters were taking the benefit of sterling's depreciation in higher profit margins, rather than cutting foreign currency prices to generate volume growth. And there were fewer examples of domestically focused businesses considering exports for the first time than might have been expected, given the fall in sterling. In addition, some EU clients had started to switch from UK to EU suppliers where contract expiry dates spanned 2019 and beyond.

Construction

Construction output growth had slowed recently (**Chart 3**). Housebuilding remained the strongest sector but growth rates had eased, reflecting continuing constraints such as planning, land availability and skills. Increased risk aversion in the private sector, reflecting greater uncertainty, and delays to major projects had weighed on activity across commercial and infrastructure projects. Slowing demand and escalating costs were raising pressure on margins, and there was some concern about near-term prospects for the sector.

Chart 3 Construction output

Three months on the same period a year earlier



Investment

Investment intentions remained modest. Some manufacturers were deferring or scaling back investment plans due to uncertainty about future trading arrangements with the European Union, and a minority of contacts were diverting some investment overseas. Some companies had strengthened their investment plans due to increased product demand, but for others capital spending had risen due to higher import costs for plant and materials. Investment in service sectors remained steady. Some investment had focused on maintaining the customer experience to remain competitive. But elsewhere, for example in car dealerships, investment was being scaled back due to the anticipation of lower demand.

Corporate financing conditions

Banks continued to report slower growth in net business lending in line with economic activity. Lending was mostly to fund working capital and acquisitions rather than capacity expansion. But many firms remained reluctant to increase gearing, preferring to use cash flow. Competition among the banks for good quality credits remained intense and price driven, with limited changes to terms. Banks' risk appetite for lending to the consumer-facing sector had fallen slightly. Risk appetite remained limited for commercial property lending for new development, although overseas funds were willing to lend for UK property developments. Asset-backed finance remained readily available at competitive rates.

Property markets

Commercial real estate

Domestic and foreign investor demand for UK commercial real estate had stabilised, as sentiment recovered from its Summer 2016 low. In aggregate, there was modest excess investor demand, and values had increased slightly. This was underpinned by continued high occupancy rates and flat to modestly rising rents, but the outlook appeared fragile. UK investor and occupier demand for logistic space remained strong nationally, reflecting the shift towards e-commerce. But more broadly contacts reported a weakening in confidence and delays in decisions by most prospective tenants, notably in retail where some stores had been closed. In the office sector, growth in demand remained steady. This was set against a backdrop of scant new prime office stock across all major UK cities, supporting valuations and rents. In London, there continued to be modest excess supply: investor sentiment had marginally weakened and occupier demand remained subdued. On the occupier side, some contacts suggested that London was in the early stages of a downturn.

Housing market

Housing market activity had moderated in Q4 after a post-summer pickup. Demand remained weaker in the secondary than primary market, though modest price inflation persisted in some areas due to weak supply. The London market remained weak; stretched affordability was leading many would-be purchasers to rent. Prices of the most expensive properties were being reduced significantly in order to sell stock that had been on the market for some time. New-build sales remained strong nationally, underpinned by the Help to Buy scheme, but there had also been some signs of a softening in demand for new houses, as evidenced by greater use of incentives. The rental market had remained steady; rents had grown modestly, partly due to a marginal reduction in supply as some smaller landlords continued to exit.

Residential mortgage availability had remained reasonable, and keen competition for the strongest credits was expected to keep pricing low. There had been an increase in mortgages with terms over 30 years to enable applicants to meet affordability requirements. Few contacts anticipated much impact on mortgage demand from the increase in Bank Rate. Lenders typically reported strong demand, especially for fixed-rate products, much of it driven by remortgaging as borrowers had sought to lock-in low rates in anticipation of further interest rate rises.

Capacity utilisation

Capacity utilisation was broadly around normal, with a slight skew towards greater than normal spare capacity, other than in the construction sector, where contacts reported some tightness in capacity. Labour availability was cited as the most likely factor that would inhibit contacts' ability to meet growth, as covered in the Agents' survey in Box 1 on page 5.

Employment and pay

Employment intentions pointed towards modest headcount growth, reflecting higher activity in manufacturing (including exports) and business services. Marginally negative intentions within consumer services indicated a rationalisation of labour in retail in response to the impact of the National Living Wage on labour costs, and a continued shift towards online sales. In the majority of cases, employee numbers were growing more slowly than output as rising costs brought the need for productivity improvements into greater focus. For a small but growing number of contacts, headcount growth had become constrained by skill shortages.

Recruitment difficulties had continued to intensify (**Chart 4**), becoming more broadly based across sectors and skill levels. And while less skilled posts were generally easier to fill than skilled ones, this too had tightened for some contacts, notably those that relied heavily on seasonal workers (for example in horticulture and agriculture), mostly from the European Union. Such individuals had become less inclined to travel to the United Kingdom due to Brexit uncertainty and the negative impact of sterling's depreciation on pay when translated into their home currency.

There had been limited upward movement in pay settlements (**Chart 5**). But a significant number of contacts expected pay awards to edge up a little towards 2½%–3½% over the next year, from 2%–3% in 2017. That uplift showed some signs of coming through for the minority making decisions in late 2017. The National Living Wage continued to exert upward pressure on labour costs in consumer services. And, although there were few inflation-linked pay rises in place outside unionised workforces, CPI was cited more often by contacts as a

Chart 4 Recruitment difficulties

In the past three months, 'relative to normal'

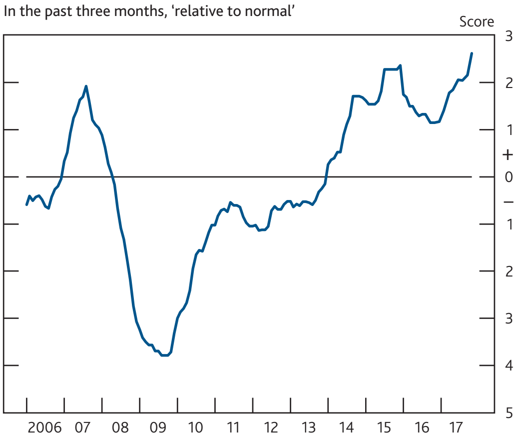
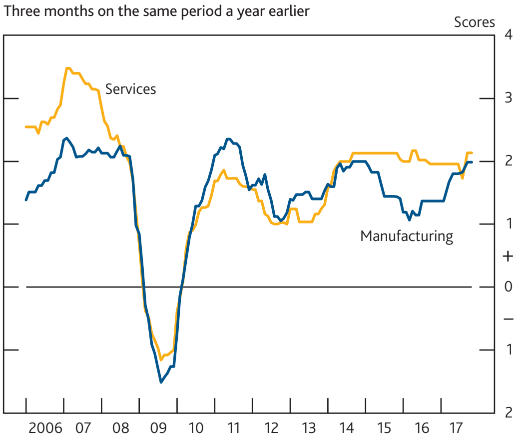


Chart 5 Total labour costs per employee

Three months on the same period a year earlier



potential source of upward pay pressure. There had been a small number of reports of companies increasing EU workers' wages partly to offset the impact of weaker sterling on repatriated pay, but contacts were more likely to have enhanced non-pay benefits, such as subsidised accommodation.

Pricing

Supply chain pricing

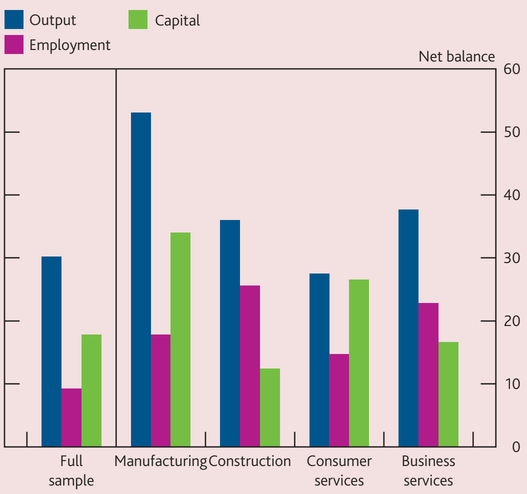
Input cost increases had persisted due to higher global market prices for materials and ingredients. Sterling depreciation had continued to contribute to high imported finished goods price inflation albeit down from rates seen in 2016 H2 and 2017 H1. Manufacturers had generally been able to increase domestic output prices modestly, particularly in food processing, but price increases had typically been insufficient to restore margins in domestic business. Some manufacturing exporters selling in foreign currency denominated prices had achieved a margin gain due to the weaker sterling exchange rate. Business services pricing had continued to increase modestly overall, constrained by competitive markets. And business services margins had remained under pressure as a result both of higher

Box 1
Survey: capacity for growth

The Agents surveyed business contacts about their capacity for growth now and over the next twelve months. The survey asked four questions: 'how fast did contacts expect their output, headcount and physical capacity to grow?'; 'what did this mean for productivity?'; 'how much spare capacity did contacts have if demand growth were to exceed assumptions?'; and 'what were the main factors constraining output?'. A total of 362 businesses responded to the survey, accounting for just over 372,000 UK employees. The survey results were weighted by employment unless otherwise stated below.

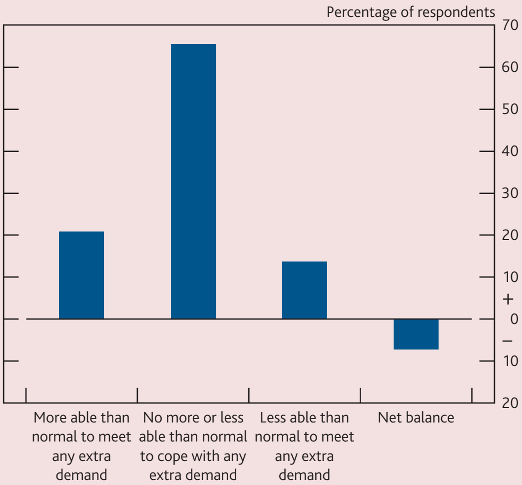
Overall, firms' responses were skewed towards expectations for output growth (**Chart A** blue bars). All sectors expected output to grow over the next twelve months, with the fastest growth expected in the manufacturing sector. Contacts expected to grow their output without a proportionate increase in headcount, suggesting that they were factoring in some future growth in productivity. The majority of contacts had also seen some growth in productivity over the past twelve months, and more than suggested by the official data.

Chart A Expected output, employment and capital growth over the next twelve months (sector balances unweighted)



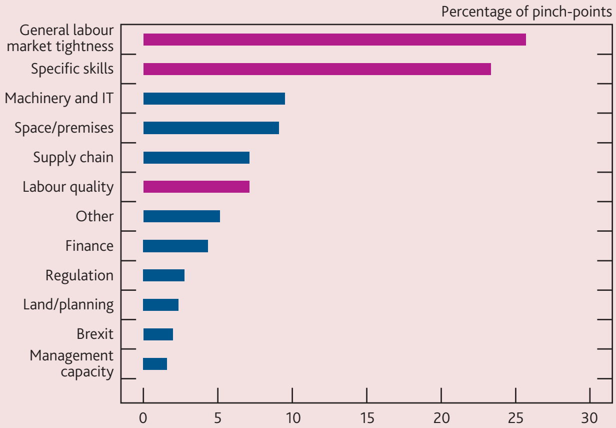
In order to identify capacity excess or shortages, the Agents asked contacts about their ability to service demand were output to grow faster than expected. The bulk of respondents (around two thirds) described their capacity to meet unanticipated demand as 'normal' (**Chart B**). Contacts reporting capacity excesses and shortfalls were approximately in balance, with only a slight skew towards greater than normal spare capacity. This was true of all sectors barring the construction sector, where there was less spare capacity than normal.

Chart B Capacity for above-budget growth



Although the survey did not flag significant capacity constraints in aggregate, it did highlight labour availability as the most likely pinch-point were contacts to need to add resources. **Chart C** shows the pattern of free-text responses to the question 'What would be the pinch-point, if any?'. 40% of respondents had no concerns to cite. But the remainder appeared materially more concerned about labour market issues (magenta bars) than other possible pinch-points (blue bars). That is consistent with broader intelligence on recruitment difficulties — set out in the main text. A number of contacts mentioned Brexit as a factor likely to constrain output in the future due to its effect on further labour market tightness and headwind for physical capacity investment.

Chart C Potential pinch-points identified by respondents(a)



(a) Chart shows the pattern of responses for the 60% of respondents who identified one or more production constraints.

salaries to retain and recruit skilled professionals, plus the additional costs of National Living Wage related increases in outsourced services such as cleaning and security.

Consumer prices

Agents' scores for consumer goods price inflation had edged up, driven by pass-through of higher input costs, for example in food and drink. Continuing pass-through of sterling depreciation was expected to cause suppliers to raise prices again in 2018. In some product markets, including groceries, higher commodity costs were the reason for some recent price rises. In the car market, used car values were expected to fall owing to an emerging excess of supply. Black Friday had remained a key feature of the retail calendar; this year retailers had sought to lengthen the Black Friday period to a week or more, but early indications suggested that retailers had sought to protect margin by focusing discounts on specific stock lines. Consumer services price inflation had remained steady. Pass-through of higher input and labour costs (led by rises in the National Living Wage) was reflected in prices increasing typically by 2%–3%.

Box 2
Results from the Decision Maker Panel

Overview

To help understand the implications of the United Kingdom's withdrawal from the European Union, the Bank established the Decision Maker Panel (DMP) in partnership with Stanford University and the University of Nottingham.(1) The panel comprises a large number of Chief Financial Officers (CFOs), who can provide direct insight into businesses' expectations. The DMP complements the broader intelligence gathered from the Bank's Agents' contacts.

At the time of the November DMP survey, the panel contained around 2,500 executives, from small, medium and large UK companies operating in a broad range of industries. Typically 50%–60% of panel members respond to each monthly survey. The panel is designed to be representative of the UK business population, excluding a small number of sectors such as finance.

Since the launch in August 2016, panel members have been regularly asked about their employment, investment, prices and sales. Decision makers are asked to provide five scenarios for each variable: from the worst case to the best case, and to specify how likely they think each scenario is.(2) From this, it is possible to assess businesses' expectations and measure uncertainty. Participants are also asked special questions, which so far have mostly related to Brexit. Aggregate-level data from the DMP are available on the Bank's website and are updated on a quarterly basis.(3) This box summarises the latest results.

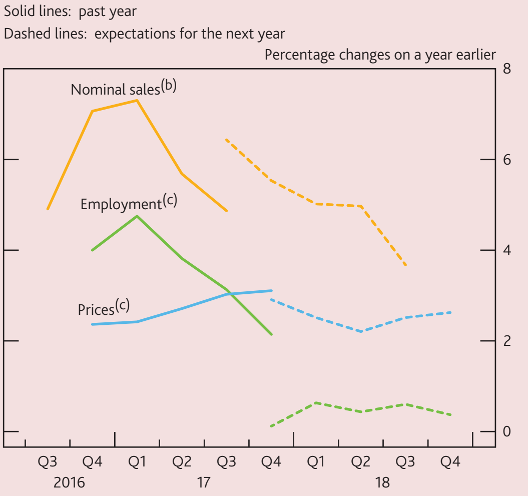
Business expectations

Chart A summarises panel members' expectations of key variables (dashed lines) and actual values (solid lines). This shows that CFOs continue to expect some weakening in sales growth over the next year. Panel members expect annual sales growth to slow to 3.7% by 2018 Q3 after nominal sales growth of 5.7% and 4.9% over the year to 2017 Q2 and Q3 respectively. Actual sales growth over the year to 2017 Q3 was lower than expectations reported in 2016 Q3 (as shown by the dashed orange line on **Chart A**, which is above the solid orange line).

Employment growth has slowed over recent quarters too. However, it remained positive at around 2% for the year to 2017 Q4 and was higher than expected a year ago (as shown by the solid green line versus the dashed green line on **Chart A**). But over the next year, the pace of employment growth is expected to remain lower than its present value.

DMP members reported that annual price inflation rose to 3.1% in 2017 Q4 (as shown by the solid blue line on **Chart A**).

Chart A Realised and expected growth in employment, nominal sales and prices(a)



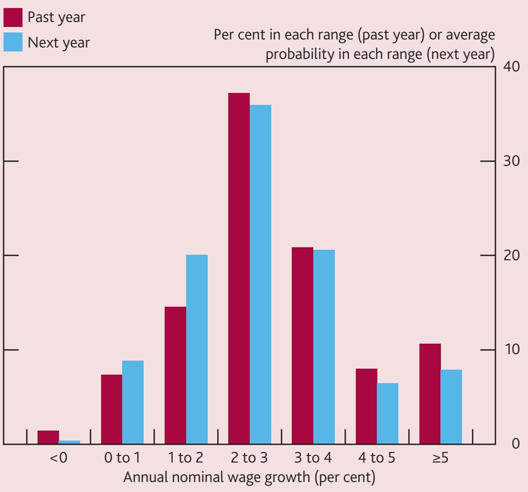
Sources: DMP and Bank calculations.

(a) Questions about employment and prices refer to latest month. Questions about sales refer to the last complete quarter.
(b) Data for year to 2017 Q3 and expectations for year to 2018 Q3 are based on data collected in November only.
(c) Data for year to 2017 Q4 and expectations for year to 2018 Q4 are based on data collected in November only.

That was close to what was expected by panel members a year ago. Over the year to 2018 Q4, price inflation is expected to slow modestly to 2.6%.

Between August and October 2017, panel members were asked about wage growth for the first time.(4) **Chart B** shows that,

Chart B Distribution of nominal wage growth over the past year and expectations for next year(a)



Sources: DMP and Bank calculations.

(a) Data were collected between August and October and refer to those months.

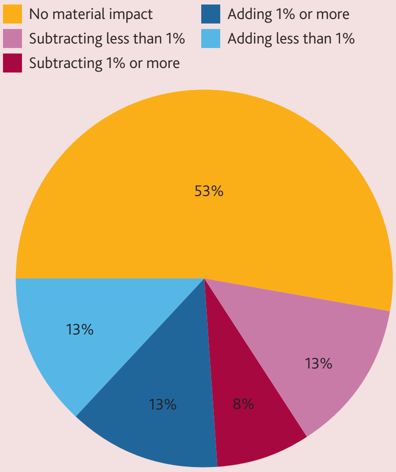
(1) This project is supported by the Economic and Social Research Council grant number ES/P010385/1.
(2) For details on the methodology, see www.bankofengland.co.uk/quarterly-bulletin/2017/tracking-the-views-of-british-businesses-evidence-from-the-dmp. All results are weighted.
(3) For aggregate data and details on questions asked to panel members, see www.bankofengland.co.uk/-/media/boe/files/statistics/research-datasets/dmp-results-december-2017.xlsx.
(4) Questions about wages are only expected to be included in the survey on an occasional basis and not in every quarter.

on average, respondents expected wages in their business to grow by 2.5% in the next twelve months, similar to the 2.6% reported for the past year. The distribution of expected wage growth was also similar to that for the past year (**Chart B**). However, intelligence gathered by the Agency network since these wage questions were asked in the DMP has begun to provide evidence of some limited upward movement in pay awards (as discussed in the main Agents' summary).

Role of Brexit

Brexit could be one of the factors influencing wage growth. To investigate this, panel members were asked to estimate how they think EU withdrawal is likely to affect wages in their business over the next year. On average, respondents did not see Brexit as an important factor influencing wages. Just over half of panel members thought that Brexit would have no material impact (**Chart C**). Among the remainder there was a relatively even split between those firms thinking that Brexit would add or detract from wages. Additional comments provided suggest that the most common reason for a positive effect was wages having to keep up with the higher cost of living. A negative effect was linked with the higher cost of imported raw materials squeezing profits and reducing the funds available for pay increases.

Chart C Expected impact of Brexit on wages over the next year[(a)]

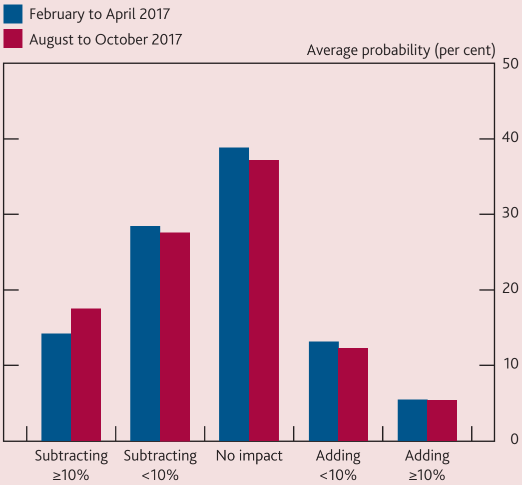


Sources: DMP and Bank calculations.

(a) Data were collected between August and October. Question: 'Could you say how the UK's decision to vote 'leave' in the EU referendum is likely to influence your average wage growth per employee over the next year?'.

Between August and October, companies were also asked how they expect Brexit to eventually impact on their sales in 2020. The average probability attached to Brexit reducing sales was 45% (sum of the first two left-hand bars in **Chart D**), compared to 18% for a positive effect (sum of the last two right-hand bars). Overall the distribution was largely unchanged from when the same question was asked six months earlier, although there was a slight increase in the probability attached to a large negative effect.

Chart D Expected impact of Brexit on sales in 2020[(a)]

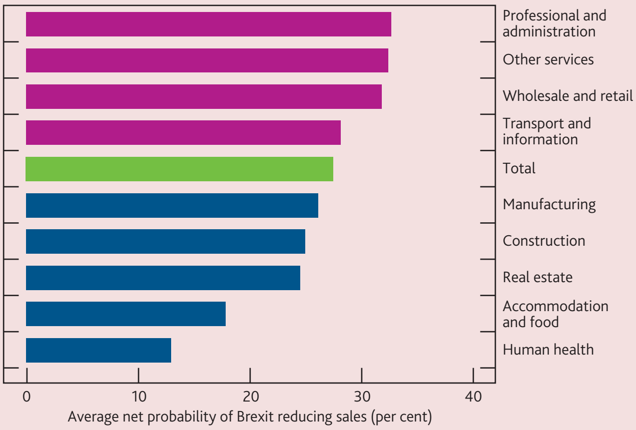


Sources: DMP and Bank calculations.

(a) Data collected between August and October. Question: 'The Prime Minister has said that the UK government does 'not seek membership of the Single Market. Instead we seek the greatest possible access to it through a new, comprehensive, bold and ambitious Free Trade Agreement'. How likely do you think it is that the eventual agreement will have the following effects, compared to what would have been the case had the UK remained a member of the EU?'.

Views on the eventual impact of Brexit on sales vary by industry (**Chart E**). The average probability of Brexit reducing sales in 2020 was highest in professional and administrative services, other services and wholesale and retail. It was lowest in human health and accommodation and food. The probability of Brexit reducing sales was also higher than average for firms who export to the European Union.

Chart E Expected impact of Brexit on sales in 2020 by industry[(a)]



Sources: DMP and Bank calculations.

(a) Net probability of Brexit reducing sales is defined as the probability of Brexit reducing sales less the probability of Brexit increasing sales. Data were collected between August and October. Question is the same as reported in the footnote to **Chart D**.