BANK OF ENGLAND

Agents' summary of business conditions

February 2014

- Growth in retail sales values in the past three months on a year earlier had been little changed, though consumer services turnover growth had edged higher.
- Housing market activity had continued to strengthen across the country.
- Investment intentions were strengthening gradually.
- Annual growth in business services turnover had been little changed.
- Manufacturing output growth for the domestic market had risen further, while growth in manufactured exports values had remained steady.
- Construction growth had increased a little further, following a sharp pickup through 2013.
- Credit availability had continued to improve gradually across the corporate sector, including for smaller companies.
- Employment intentions had increased a little, indicating expectations of modest headcount growth across the economy over the next six months. Recruitment difficulties had ticked up and were marginally above normal.
- Capacity utilisation had edged higher in manufacturing on the month and, overall, was close to normal levels.
- Growth in labour costs per employee had edged higher, but remained moderate.
- Inflation in materials costs and imported finished goods prices had fallen in recent months.
- Output price inflation had been little changed, remaining subdued. Profitability had continued to improve across manufacturing and services, though remained below normal.
- Consumer price inflation had eased slightly further.

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 2013 and late January 2014. It provides information on the state of business conditions from companies across all sectors of the economy. The report does not represent the Bank's own views, nor does it represent the views of any particular company or region. The Bank's Monetary Policy Committee uses the intelligence provided by the Agents, in conjunction with information from other sources, to assist its understanding and assessment of current economic conditions. A copy of this publication can be found at: **www.bankofengland.co.uk/publications/Pages/agentssummary/default.aspx.**

The Bank of England has Agencies for Central Southern England, the East Midlands, Greater London, the North East, the North West, Northern Ireland, Scotland, the South East & East Anglia, the South West, Wales, the West Midlands & Oxfordshire, and Yorkshire & the Humber.

The Bank's assessment of current monetary and economic conditions, and the outlook for inflation, are contained in the *Inflation Report*, obtained from: **www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx.**

Demand

Consumption

Growth in retail sales values in the past three months on a year earlier had been little changed. Following a slow start to December, retail sales growth had strengthened significantly in the second half of the month, with consumers reported to have delayed spending in expectation of discounting in the immediate run-up to Christmas. Sales through 'click and collect' had grown strongly, to some extent at the expense of other types of transactions. There were continued reports of rising demand for household durables, partly linked to rising housing market activity. New car sales growth was reported to have remained buoyant, though the pace of growth was seen by some contacts to be easing. More generally, the majority of retail contacts anticipated modest sales growth in the coming months, given perceptions of continuing tightness in many consumers' disposable incomes. Growth in consumer services turnover had edged up further. Reports from providers of leisure services had been more consistently positive over the festive period than for retailers, with hotels, restaurants and coffee shops reporting an increase in sales growth. Some recovery in growth in non-leisure services, such as car servicing was also reported. Consumer services contacts expected continued moderate growth during the year ahead, given for example the pattern of forward booking seen by hoteliers and travel agents.

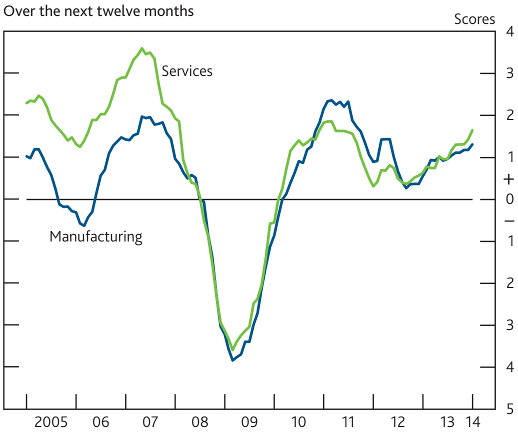
Housing market

Housing market activity had continued to strengthen across the country, as confidence and mortgage availability improved. Sales of both new and existing homes were well above the levels of a year earlier, though remained generally below pre-recession levels. Growth in turnover among housing-related services, such as estate agency and conveyancing, had increased accordingly. Estate agents increasingly reported shortages of properties available for sale, as instructions to sell failed to keep pace with buyer enquiries. As a result, the gap between asking and selling prices was reported to be closing, though house price inflation outside London was reported to have remained moderate. Some estate agents expected an increase in instructions from vendors to come as confidence in realising 'target' sale prices rose.

Business investment

Investment intentions had continued to strengthen gradually, pointing to a modest recovery in investment growth over the next twelve months (**Chart 1**). Contacts remained focused on investment to improve efficiency, particularly through updating IT systems and implementing energy saving technology. But a growing number reported plans to increase capacity, in both manufacturing and services, as firms became more confident about the medium-term outlook for demand. Consistent with that, there were increasing reports of investment in the refurbishment or building of new commercial property. Continued robust investment spending was reported in North Sea oil and gas extraction.

Chart 1 Investment intentions



Exports

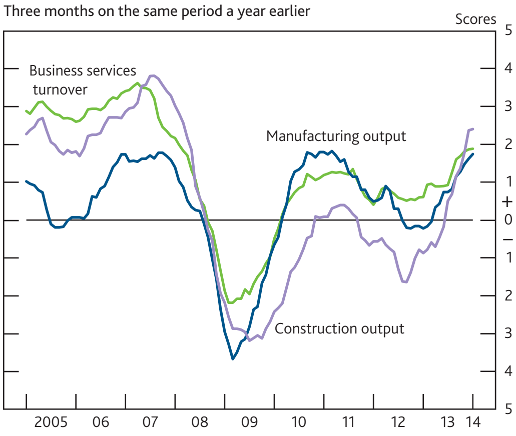
Manufacturing export growth was reported to be steady and broadly based across subsectors. Robust growth was often reported to the United States and the Middle East, alongside continued reports of gradual market share gains in some emerging economies. But euro-area demand was reported to be broadly flat. The recent appreciation of sterling was reported to have had little effect as yet on export volumes. In the services sector, there were reports of continuing export sales growth among professional service providers such as legal, architecture and accountancy firms. That partly reflected rising investment from overseas in both UK commercial property and company acquisitions. Engineering and construction consultancy companies also reported growing exports, in particular to the Middle East and emerging economies.

Output

Business services

Annual growth in business services turnover had been little changed, having increased through 2013 (**Chart 2**). In professional and financial services, accountancy and legal firms had benefited from a continuing pickup in mergers and acquisitions, and initial public offering activity. A range of property-related service companies reported growing turnover arising from increasing activity in property markets — both residential and commercial. And a related increase in lending had also boosted output in some parts of the financial sector. Continued growth in recruitment, advertising and consultancy was reported as clients' confidence strengthened. In other business services, IT services growth had remained robust as firms replaced ageing systems and invested in cloud computing, big data, digital marketing and cyber security. Wholesale, transport and logistics firms reported further

Chart 2 Manufacturing, business services and construction output



modest increases in activity, particularly for companies supporting housebuilding. There were signs of recovery in corporate spending on training, conferences and events, though activity had remained restrained relative to the pre-crisis period.

Manufacturing

Output growth for the domestic market had risen further across a broad range of subsectors. Growth in automotive, engineering and energy-related supply chains had continued to be robust, although there were reports that the rate of growth in aerospace supply chains might be easing as a weakening in spending on military aviation started to feed through. Annual growth in construction materials output had picked up as production schedules were maintained over the winter and as some mothballed capacity had been bought back on stream. Printing output, however, had remained in decline.

Construction

Construction growth had increased a little further, following a sharp pickup through 2013 (**Chart 2**). Housebuilding had remained the major driving force behind growth in the sector, though a lack of development land, local planning delays, poor weather and difficulties in obtaining building materials were acting to limit the pace of output growth. Outside housing, there were a growing number of reports of an increase in commercial activity. This was largely focused on pre-let or owner-occupied industrial development, large infrastructure projects and some public sector work, especially in education. Speculative office development outside London had remained very subdued, however.

Credit conditions

Credit availability had continued to improve gradually across the corporate sector, including for smaller companies. Credit was often reported to be readily available for large companies and at a cost that was low by historical standards, given conditions in capital and bank credit markets. Some small companies continued to report the opposite case, especially where those companies had low levels of assets or some impairment of their trading record. But contacts generally reported that competition to lend was increasing, with growing numbers being offered finance or changing banking relationships recently, and with 'challenger banks' and non-bank finance providers gradually gaining market share. Some contacts noted that the number of sectors to which banks were reluctant to lend was gradually decreasing, though companies in property development, construction and hospitality sectors often continued to report that their access to bank finance was patchy. Demand for credit was reported to be starting to increase, including from smaller companies. For large companies, however, that demand was often being filled by capital market finance or private placements where the maturities of funds available were longer.

Employment

Employment intentions had edged up a little further, indicating expectations of modest headcount growth across the economy over the next six months. Contacts' employment was often rising incrementally alongside gentle increases in their productivity. The main driver of employment growth was increased economic activity, but there were also growing reports of firms recruiting key skills ahead of need, in response to a pickup in attrition, and/or of hiring more trainees to address skill shortages, both of which were likely to act as a drag on productivity in the near term. Recruitment difficulties had ticked up a little further and were marginally above normal. While it had remained generally easier than normal to recruit unskilled and semi-skilled workers, this was being more than offset by a broadening of skill shortages beyond IT and engineering, to include construction and related services, a range of senior management positions, and qualified professional services staff.

Capacity utilisation

Capacity utilisation had edged higher in manufacturing on the month and, overall, was close to normal levels (**Chart 3**). Utilisation of staff was often reported to be higher than for plant and equipment, contributing to rising employment intentions. In services, growth in employment had enabled professional and financial services companies to meet increased demand, so that capacity utilisation had been little changed on the month. In contrast, manufacturers had been more content to meet rising demand by using existing resources more intensively. In house building, reports of constraints in construction products and labour continued, though materials shortages had eased a little as some mothballed capacity had been gradually brought back on stream. In contrast, many consumer services firms reported ample spare capacity.

Chart 3 Capacity Utilisation

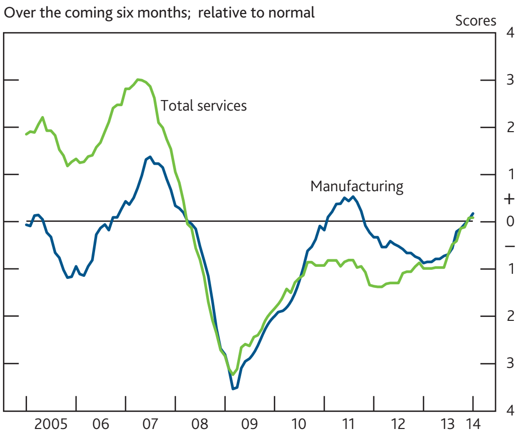
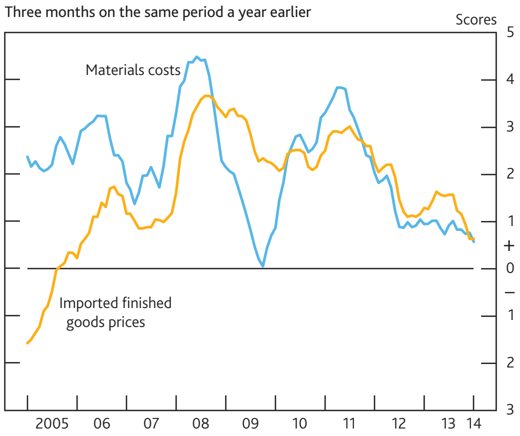


Chart 4 Cost of raw materials and imported finished goods



Costs and prices

Labour costs

Growth in labour costs per employee had edged higher, though remained moderate. While the majority of settlements had remained around 2%–3%, the central tendency had moved up a little within that range and the number of pay freezes had fallen back to the lowest level seen in recent years. In general, pay increases were reported to be closely aligned to developments in companies' profitability. However, in some areas where there were some present or emerging skills shortages, there were rising numbers of reports of higher, targeted pay increases to retain or attract key staff. Auto-enrolment pensions were contributing to upwards pressure on labour costs for some businesses, with only a minority intending to offset that effect through lower wage growth. A box on page 5 summarises the results of the Agents' annual survey on pay and labour costs.

Non-labour costs

Materials cost inflation had fallen further (**Chart 4**). Most companies reported that the principal cost components of their business had been flat or falling over recent months. The major exceptions to this pattern were rising cost inflation for some building aggregates and continued increases — albeit sometimes below expectations — in the cost of energy. Imported goods cost inflation had fallen in recent months, in part reflecting downwards pressure on the pricing of goods from weak demand in the euro area. Contacts expected that sterling's recent appreciation would put some further downward pressure on import prices through the year, as annual contracts were repriced.

Output prices and margins

Output price inflation had been little changed, remaining subdued. Manufacturers and services providers continued to report difficulty in raising prices, given strong competitive pressures. But price inflation for house building products were rising, reflecting the strength of demand. Profitability had continued to improve across manufacturing and services, in part as stronger output growth had lowered unit costs and allowed companies to shift away from lower margin work. For some manufacturers in particular, weakening materials price inflation, alongside efforts to raise efficiency, had also boosted profitability. However, margins in both sectors remained below long-term averages.

Consumer prices

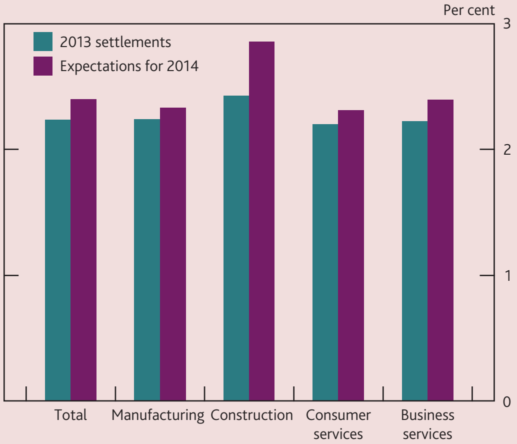
Consumer price inflation had eased slightly further. That had reflected lower goods price inflation, in part as food price inflation had fallen back following better domestic harvests and lower global prices for basic agricultural goods. More generally, lower commodity prices and sterling's recent appreciation were expected to bear down on goods price inflation over coming months. Expectations of inflationary pressure from energy prices had also abated recently. In some leisure services, strengthening demand growth had allowed for a modest acceleration of prices. But inflation in some administered services prices indexed to the retail prices index (RPI), such as in public transport, had started to ease back as earlier falls in RPI inflation fed through. Rail fare inflation had also been lowered by a reduction in the cap on average regulated fare increases from 1% above the rate of RPI inflation to match that rate instead. Insurance premia were often reported to be falling, though some upwards pressure on premia for household insurance was expected following recent flooding. In general, contacts reported that squeezed disposable incomes continued to restrain inflationary pressure.

Agents' survey on pay and labour costs

The Agents have conducted an annual pay survey since 1998, asking contacts in the private sector 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 449 firms responded, with a combined UK employment of 986,000 staff. The results of the survey have been weighted by employment.

The average pay settlement was expected to increase slightly to 2.4% in 2014, from 2.2% in 2013 (**Chart A**). These figures remain well below pre-crisis growth rates and suggest that total pay growth is not expected to pick up significantly this year. Looking across sectors, pay settlements in 2013 were a little higher in construction than in other parts of the economy, and this differential was expected to widen a little further in 2014.

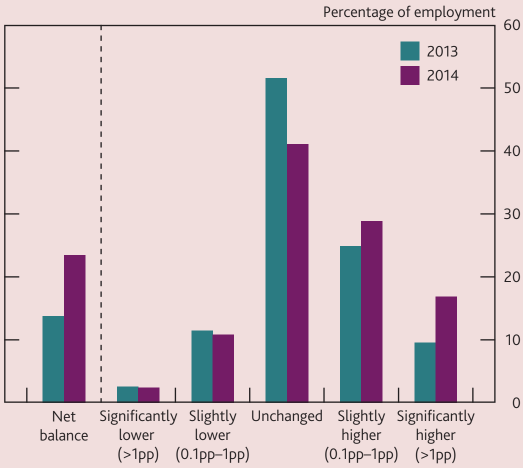
Chart A Pay settlements by sector



This year's survey, as for last year, saw a strong concentration of expected settlements of between 2% and 3%, with this range capturing the expected 2014 settlement for nearly 80% of employees in the sample. Fewer firms were expecting to freeze pay in 2014 than in the previous year and, if expectations were realised, the proportion of companies freezing pay would be the lowest since the start of the financial crisis. Around 10% of firms in the sample (covering 5% of employees), reported collective wage bids for 2014, with no sign of a significant increase in those bids relative to 2013.

The net balance of respondents expecting total labour costs per employee to increase more rapidly in the coming year than in the previous twelve months was a little higher than in last year's survey, but remained modest (**Chart B**). Across sectors, expectations of changes in total labour costs per employee were stronger for construction and business services than they were for manufacturing. Expectations for changes in labour cost growth were weakest for consumer services, though still consistent with a slight pickup.

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



Respondents identified the need to retain key skills and recruit staff as the most significant factor expected to increase growth in total labour costs per employee (**Chart C**). Pressure on real pay levels, including to 'catch up', was also a significant factor this year. Although employer pension contributions continued to increase total labour cost growth, it was a less significant factor than last year. That might partly reflect that the largest firms had adopted auto-enrolment — and so incorporated any associated increase in pension costs — during the previous year. Consistent with the fall in consumer price inflation seen during 2013, inflation expectations were the most significant downward influence on expected growth in total labour costs per employee in 2014.

Chart C Influences on expected growth in total labour costs per employee in 2014 relative to 2013