BANK OF ENGLAND

Agents' summary of business conditions

2016 Q4

- Activity growth had edged up, but businesses remained cautious about prospects. The fall in sterling since June had led to higher goods export volumes. Consumer demand had been boosted by rising tourist spending.
- Contacts expected consumer spending to slow next year as higher inflation squeezed consumers' spending power. Firms' intentions pointed to only small increases in investment over the coming twelve months. Many companies were choosing to hold a larger amount of cash given high levels of uncertainty.
- Input cost inflation had picked up sharply. That was expected to start affecting consumer prices more noticeably in the New Year. Wage growth had remained stable, but some contacts expected upward pressures, including from higher inflation next year.

Consumer spending growth had remained resilient. Growth in retail sales values had picked up, in part as tourist spending had risen. There were expectations of slowing demand growth next year as higher inflation squeezed spending power.

Business services turnover growth had picked up, following some weakness in the summer. But contacts remained cautious about business prospects.

Growth in **manufacturing** output remained modest but had risen. That was partly due to increased production in export supply chains. Some customers had switched to domestic suppliers from foreign ones following the fall in sterling.

Construction output growth was modest and had eased during recent months.

Investment intentions pointed to only small increases in spending over the coming year. Many companies were choosing to hold more cash instead, given high uncertainty. A box on page 3 looks at a new measure of uncertainty from Agency intelligence.

Bank **credit availability** had remained stable and generally exceeded companies' demand for loans. Peer-to-peer lending had continued to grow. A box on page 5 introduces a new set of Agents' scores for corporate credit availability.

Investor demand in **commercial real estate** had edged higher from a low base. However, there were signs that occupier demand had started to soften in London.

Housing market activity had recovered, but remained weak in central London. Strong competition was reported in mortgage lending.

Capacity utilisation had risen slightly in manufacturing and remained stable in services.

Employment intentions pointed to little change in staff levels over the next six months. Recruitment difficulties had eased alongside lower hiring activity.

Growth in **labour costs** per employee had been steady. Most pay awards were in the 1% to 3% range. Some contacts expected upward pressure next year, including from higher inflation.

Materials costs and **imported finished goods** price inflation had risen sharply. The recent fall in the exchange rate had started to feed through to higher sterling prices.

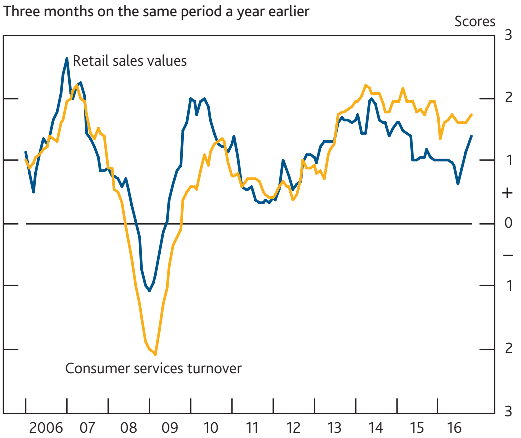
Manufacturing **output price inflation** had also risen. Business services price inflation had remained modestly positive overall. A box on page 7 presents the results of an Agents' survey on pricing.

Consumer price inflation had picked up. Strong competition among grocery retailers had restrained the pass-through of higher import costs. But prices were expected to rise more noticeably in the New Year.

Consumer services and retail sales

Growth in retail sales values had picked up (**Chart 1**). Some households were thought to have brought forward purchases of larger items such as furniture and electrical goods in the expectation that prices would rise next year. Retail spending by foreign tourists had risen, as UK retail prices had fallen in foreign currency terms due to sterling's deprecation. Their spending on hotels, meals out and visitor attractions was also higher. Increased 'staycationing' was also supporting consumer services growth, which had remained resilient. Contacts expected consumer demand to slow next year as higher inflation squeezed spending power.

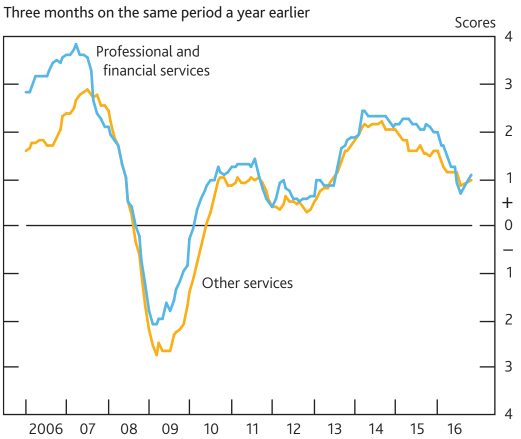
Chart 1 Retail sales values and consumer services turnover



Business and financial services

Business services turnover growth had increased during the autumn, following some weakness in the summer (**Chart 2**). Professional services contacts reported that mergers and acquisitions and foreign direct investment activity had picked up. But both remained weaker than before the referendum. Demand growth for IT services had been supported by firms' continuing efforts to raise productivity and reduce vulnerability to cyber attacks. Recruitment agency activity had recovered, except for positions in finance. Advertising, media and PR activity growth had been softer than a year earlier. Some architects and surveyors reported slower turnover growth as commercial construction activity growth had weakened. However, some companies reported improving prospects for work overseas. Some professional and financial services companies were considering establishing European offices to service continental clients locally. Those offices would replace exports from the United Kingdom.

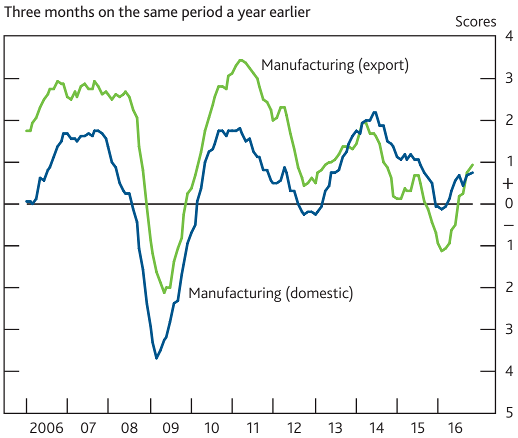
Chart 2 Professional and financial services and other services turnover



Production

Manufacturing output growth had risen but remained modest (**Chart 3**). Some contacts had seen a pickup in orders after a period of destocking among customers following the EU vote. Sterling's fall had boosted volumes in export supply chains. It had also, to a lesser extent, led some companies to switch from foreign suppliers to domestic ones. Consumer goods producers and those supplying house builders and public infrastructure projects reported robust demand. Capital goods production was sluggish. That was due to some delays in investment decisions among customers and weak profitability in the steel and oil and gas sectors. Growth in goods export volumes had continued to pick up but remained modest, with some firms focusing on increasing margins instead. But some firms reported gains in market share overseas. That was mainly the case for products where demand was price-sensitive, not tied to fixed long-term contracts, or where goods had low import content (so that cost pressures were less affected by sterling's fall and firms were more able to reduce foreign currency prices).

Chart 3 Manufacturing output — domestic and exports



Construction

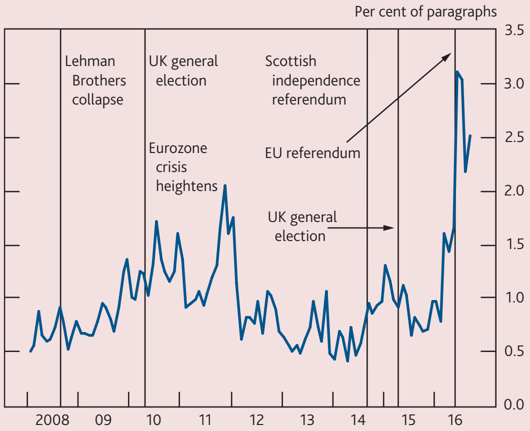
Construction output growth was modest and had eased over the past three months. Housebuilding was relatively more resilient than commercial building or local authority funded work. Materials shortages and recruitment difficulties had eased over the year. Planning processes continued to be cited as a constraint on output growth. Announcements in the

Box 1
Gauging uncertainty from Agents' company visit reports

The degree of economic uncertainty is a key issue at present, as highlighted in the Bank's latest *Inflation Report*.(1) This box looks at how often 'uncertainty' — and similar terms — have been used in Agents' company visit reports to provide a new measure of business uncertainty.

Chart A shows a time series of the share of paragraphs in Agents' company visit records that contain the words uncertainty, uncertainties or uncertain, up to the end of 2016 Q3. Those references picked up sharply in the run-up to the EU referendum. They then stayed at elevated levels over the third quarter. That could reflect Agents simply asking companies more often about their uncertainty. But an analysis of the paragraphs containing uncertainty words indicates that positive terms such as 'increased' or 'more' were used twice as often as negative terms such as 'no' or 'reduced'. That suggests a genuine increase in business uncertainty.

Chart A Proportion of paragraphs in Agency visit write-ups referencing 'uncertain', 'uncertainty' or 'uncertainties'



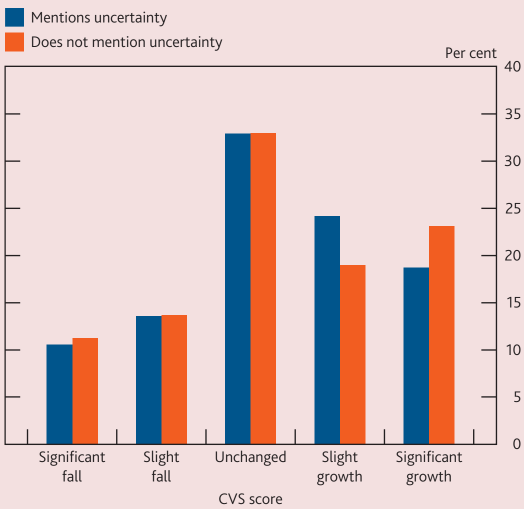
A wordcloud of terms appearing most often in the paragraphs including uncertainty terms provides further insights (**Figure A**). The cloud indicates that referendum is the most frequently appearing word. This is in line with contacts' reports that the United Kingdom's future relationship with the EU is the main source of uncertainty at present. 'More' is the second most frequent term. The word 'investment' appears more often than 'staffing'. That is perhaps because investment spending can be more affected by uncertainty than staffing, as it can be harder to reverse.

The analysis can be extended using Agents' company visit scores. **Chart B** shows the distribution of scores for expected

Figure A Words appearing most commonly in the same paragraph as 'uncertain', 'uncertainty' or 'uncertainties' — for visits undertaken during 2016 Q2 and Q3

investment spending both for those companies mentioning uncertainty during visits and those that don't — as reflected in Agents' meeting records. Contacts that mention uncertainty are less likely to report notable growth in investment plans than those who do not. Otherwise the distributions of scores are fairly similar. On its own, that suggests uncertainty has, at least so far, had a relatively limited impact on investment intentions. However, Agents scores for investment intentions have softened since the referendum. They currently point to only small increases in spending for the coming year. A recent Agents' survey indicated that uncertainty was the largest single drag on companies' investment plans in the year ahead.

Chart B Expected investment score: for firms discussing uncertainty or not: 2016 Q2 and Q3



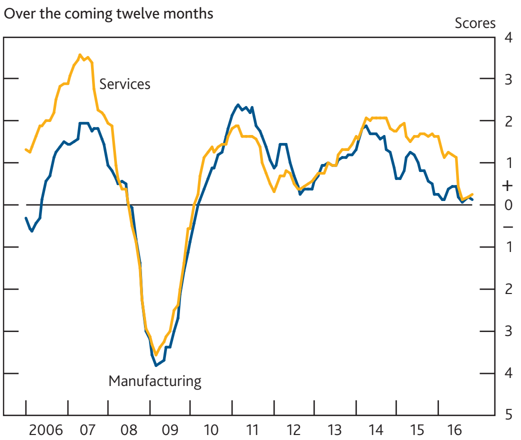
(1) For example, see the measures of uncertainty in Chart 2.4, page 16, of the November *Inflation Report*.

Autumn Statement of increased public sector spending on infrastructure and housing had boosted sentiment about future activity.

Investment

Investment intentions were consistent with small increases in spending over the coming year (**Chart 4**). Many firms were looking to hold more cash in the face of uncertainty, rather than raise spending. Increased costs for imported capital equipment were starting to deter some capital spending. But there were also examples of spending being brought forward ahead of expected price rises. Some manufacturing exporters were continuing to invest to meet any rise in demand due to the fall in sterling. Service sector intentions were slightly positive. IT spending continued to grow where there were clear benefits to productivity or due to cyber security needs. Investment in distribution and logistics remained resilient, aimed at raising efficiency in supply chains. But a range of service sector firms reported tightening their capital spending budgets for 2017.

Chart 4 Investment intentions



Corporate financing conditions

Bank credit availability had changed little since the EU referendum. There was strong appetite to lend to companies with strong balance sheets. But there appeared to be little appetite to lend for speculative property development. The cost of debt for small house builders and commercial property developers had risen. Loan to value ratios available for property loans had fallen. Some lenders were also reported to be more cautious about exposure to hospitality and leisure sectors, and to some wholesale and importing firms, due to rising costs. But overall, banks' appetite to lend had remained greater than firms' desire to borrow. Demand for credit was reported to be subdued. In part, this reflected subdued investment plans. In some cases, especially among smaller companies, firms were choosing to finance spending internally rather than by borrowing. Demand for asset finance had weakened during the year. That was partly due to a weaker appetite to borrow for plant and machinery investment. Demand for refinance facilities had risen due to falls in the cost of credit. For larger companies, subdued demand for bank credit partly reflected the even lower rates available from capital markets.

Availability of non-bank finance had remained strong. In capital markets, some firms were looking to refinance early to take advantage of low bond yields. Peer-to-peer lending had continued to grow as a funding source. The British Business Bank was reported to be becoming more active in lending. There were some concerns about how current EU funded schemes would be replaced in future.

Property markets

Commercial real estate

Investor demand for UK commercial property had edged higher from a low base, following sharp falls after the EU referendum. Capital values were generally reported to be stabilising or increasing modestly. Occupier demand had shown some signs of softening in London. Vacancy rates there had ticked up from low levels and the rate of rental growth was easing. Elsewhere in the United Kingdom, occupier demand had been steadier and rents had remained flat or risen modestly.

Housing market

Activity in the housing market had recovered following a period of weakness after the EU referendum. Purchases had remained concentrated in lower-price brackets and in the new-build market. But transactions were muted for property values above £1 million. That was adversely affecting volumes in prime London property in particular. The fall in sterling had increased overseas interest in London property. But that was yet to convert into increased transactions. Investment activity in the buy-to-let market overall had recovered a little, though some smaller landlords had exited the market by selling their properties. Low numbers of properties available for sale were supporting modest price inflation overall, although high-value house prices were falling in central London. Strong competition was reported between mortgage lenders. Most lending to first-time buyers was reported to be at loan to value ratios below 90%. These buyers were often using large deposits from savings made over many years, or had help from older relatives.

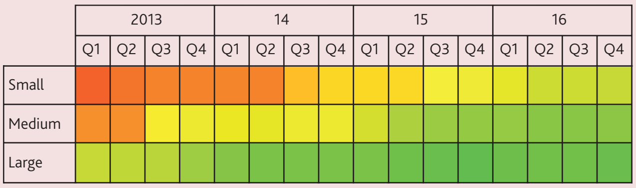
Capacity utilisation

Capacity utilisation in manufacturing had edged higher, although it was a little lower than normal. Automotive, food and some construction related manufacturing companies reported less slack due to increasing output. Services

Box 2
Agents' scores for corporate credit availability

Over the past year the Agents have published a heatmap of corporate credit availability in the Agents' summary. From now on, the Agents will supplement that by publishing their underlying scores for corporate credit availability. This is part of their regular scoring of the economy.(1) These scores are the Agents' assessment of corporate credit availability for small, medium and large-sized firms. They cover bank and non-bank credit, including for example bond finance and peer-to-peer lending. The scores are for availability relative to normal, on a scale of -5 to +5. A score of 0 would indicate normal credit conditions with +/-5 representing extremely high or low availability, respectively. These scores are embodied in **Chart A**, the Agents' heatmap of corporate credit availability.

Chart A Agent's assessment of corporate credit availability[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. 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.

Currently, the scores show that credit availability is well above normal for large and medium-sized businesses, and more modestly so for small businesses.(2)

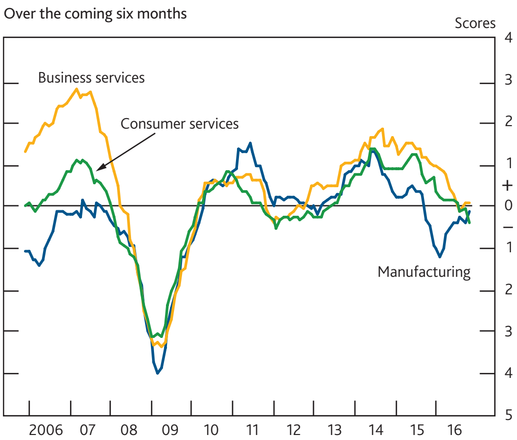
(1) The Agents' scores are available at www.bankofengland.co.uk/publications/Pages/agentssummary/default.aspx.
(2) Small businesses defined as those with fewer than 50 employees, medium businesses between 50 and 250, and large over 250.

utilisation remained close to normal. Passenger transport companies, notably air and rail, reported increased capacity pressures. Utilisation had also risen in warehousing and logistics. New capacity had been created in the hotel and restaurant sectors.

Employment and pay

Staffing intentions indicated little change in job numbers over the next six months (**Chart 5**). The outlook for manufacturing jobs had improved slightly due to a pickup in export sales. But plans in consumer services suggested falls in staff numbers. Companies were looking to offset costs from the National Living Wage (NLW) and rising import costs. There was little net job creation in business services. That was largely due to uncertainty about future demand prospects.

Chart 5 Employment intentions



Recruitment difficulties remained slightly above normal but had become less widespread. That partly reflected the softening outlook for hiring. Acute skills shortages had remained in a few sectors, such as construction, IT, engineering and professional services. Contacts in those sectors were often relying on overseas labour to fill gaps. There were occasional reports of workers from other parts of the EU becoming more reticent about moving to the United Kingdom since the referendum.

Growth in total labour costs had remained moderate. Most pay awards were in the 1%–3% range. Some contacts were worried that rising inflation may cause some upward pressure on pay growth in 2017. Contacts also noted legislative increases in labour costs from the Apprenticeship Levy, NLW and pensions auto-enrolment.

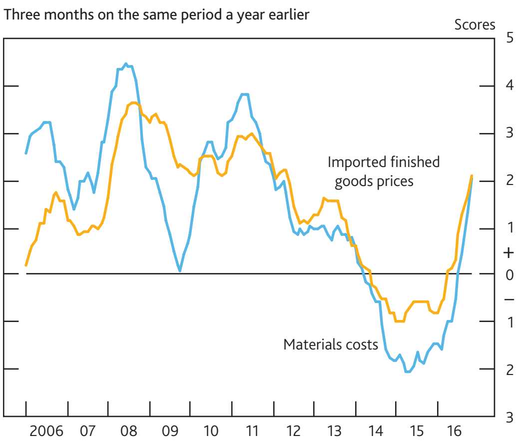
Pricing

Supply chain pricing
Non-labour input cost pressures were reported to be increasing due to the fall in sterling since the EU vote (**Chart 6**). Global commodity prices had also risen. Further increases in input costs were expected to come through in early 2017. Some importers had put pressure on overseas suppliers to offset some of sterling's impact on costs by lowering their foreign currency prices, with varying degrees of success. Manufacturing output price inflation had picked up notably as costs increases started to be passed through. Business services price inflation had remained moderate. A box on page 7 provides a summary of an Agent's survey of pricing.

Consumer prices
Consumer price inflation had increased overall, but remained modest. Food price deflation had eased slightly. Grocery retailers reported that strong competition had held back price increases. They were reluctant to raise prices before the start of 2017. For non-food retailers, most Black Friday promotions

had been lengthier than previously. But that had been coupled with less dramatic price cuts. Within consumer services, inflation remained modest and little changed. Buoyant demand had supported moderate increases in restaurant prices and hotel room rates.

Chart 6 Material costs and imported finished goods prices

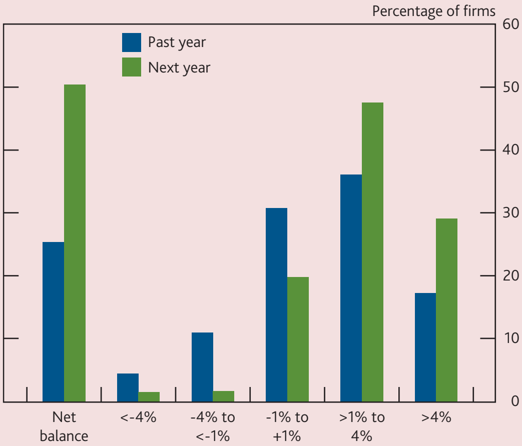


Box 3
Agents' survey on corporate pricing

The Bank's Agents ran a survey in October and November to investigate changes in domestic prices and the factors affecting pricing decisions in the year ahead. They also asked about contacts' expectations of pass-through from sterling's depreciation to prices, compared with the fall in sterling in 2007–08. Around 350 companies responded with a combined UK turnover of about £75 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 net balance of respondents had seen prices increase over the past year (**Chart A**). Over half of businesses surveyed had increased their prices over the past year, while relatively few companies had reduced prices. Over the coming year, a significantly larger net balance of companies expected increases in prices, with nearly 80% of respondents expecting prices to rise by more than 1%.

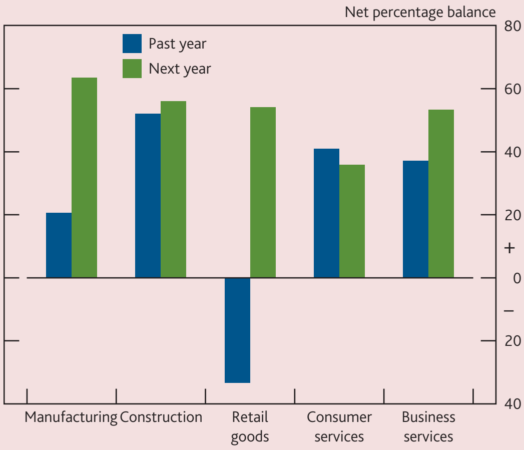
Chart A Price changes over the past year and next year



Across sectors, only goods retailers reported a negative balance of price change over the past year (**Chart B**). Over the coming twelve months, retail goods prices were expected to rise. Average prices were expected to increase across all sectors of the economy. Manufacturing companies reported the most positive net balance for price expectations.

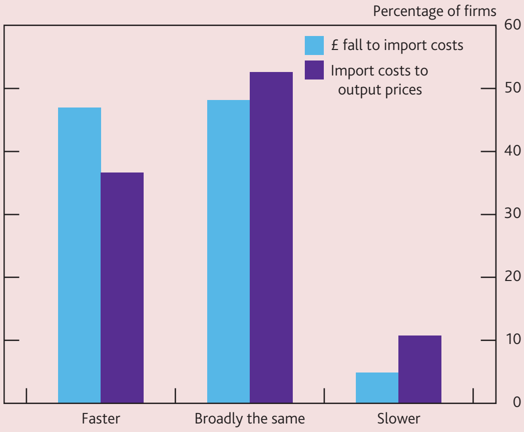
The factors most often cited as driving prices higher over the next year were, in descending order: imported inputs and finished goods costs, labour costs, UK input and finished goods costs, and energy costs. Downward price pressures were reported to be coming from overseas and domestic competition and productivity.

Chart B Changes in prices by sector



The survey asked about the effects of sterling's decline on costs and prices. Around half of respondents expected that the speed of pass-through to import costs, and from import costs to output prices, would be broadly the same as that seen in 2007–08 (**Chart C**). In both cases though, a net balance of respondents expected the speed of pass-through to be faster this time than during that earlier episode.

Chart C Expected speed of pass-through of the fall in sterling to import costs and from import costs to output prices compared to the 2007–08 sterling depreciation



A majority of respondents expected the total size of pass-through of the fall in sterling to output and retail prices to be broadly comparable to that of 2007–08. However, a modest net balance of some 10% of companies expected pass-through to be greater overall. The vast majority of those responding expected that pass-through to their output or retail prices would be completed within twelve months.