BANK OF ENGLAND

Agents' summary of business conditions

2016 Q2

- The annual rate of activity growth had remained moderate. Turnover growth had eased further in the business services sector, partly reflecting some delays in clients' decision-making ahead of the EU referendum, but it had picked up in consumer services. The annual rate of decline in manufacturing output had waned.
- Bank credit availability had stabilised, after a prolonged period of easing, remaining above normal for most contacts. Capital market issuance and corporate finance activity had slowed recently. Peer-to-peer lending had continued to expand.
- Employment growth and recruitment difficulties had eased, partly reflecting slower demand growth among business services companies. But total labour costs per employee had edged higher due to the introduction of the National Living Wage. Inflation had remained subdued.

Consumer spending growth had remained resilient. Growth in spending on consumer services had risen, remaining stronger than for retail goods.

Business services turnover growth had slowed. The flow of new work for professional and financial services in particular had moderated, with some clients delaying major business decisions ahead of the EU referendum period.

Growth in **manufacturing** output for the domestic market had increased a little, with volumes marginally higher than year earlier. The pace of contraction in manufactured export volumes had eased, in part reflecting the recent depreciation of sterling.

Construction output growth had been stable, with reports of moderate rates of expansion across commercial, infrastructure and private housing construction.

Investment intentions for the year ahead were little changed and pointed to modest growth in investment. There were some reports of delays in decision-taking on corporate spending until after the EU referendum.

Bank **credit availability** had remained stable, after a long period of easing. Capital market issuance had slowed, alongside other corporate finance activity, with investor appetite reported to have been negatively affected by uncertainty around the EU referendum. The availability of other sources of non-bank finance had continued to expand. A box on page 4 looks at recent developments in peer to peer lending.

Occupier demand for **commercial real estate** had remained robust. Investor demand for London property had slowed. Elsewhere, investor demand had held up better, though some slowing of decision-making was reported.

Housing market activity had fallen back in April and May, following heightened transaction numbers in Q1.

Capacity utilisation was slightly above normal in services and below normal in the manufacturing sector.

Services **employment growth** had slowed, largely reflecting an easing of demand growth in business services, but manufacturing intentions had become less negative. A box on page 3 presents the results of a survey on employment and productivity prospects. **Recruitment difficulties** had eased, though remained moderately above normal.

Growth in **labour costs** per employee had edged higher, largely reflecting the introduction of the National Living Wage in April.

The annual rate of decline of **materials costs** had eased as some commodity prices had risen in recent months, and as the recent exchange rate depreciation had increased imported materials prices. Imported finished goods prices were little changed on a year ago, having risen in recent months as falls in sterling were passed through.

Manufacturing **output prices** had fallen on a year earlier, though the rate of decline had slowed. Business services price inflation had remained modestly positive overall.

Consumer price inflation had edged higher and was modestly negative for goods and positive for services.

This publication is a summary of monthly reports compiled by the Bank of England's Agents between late February 2016 and late May 2016. 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

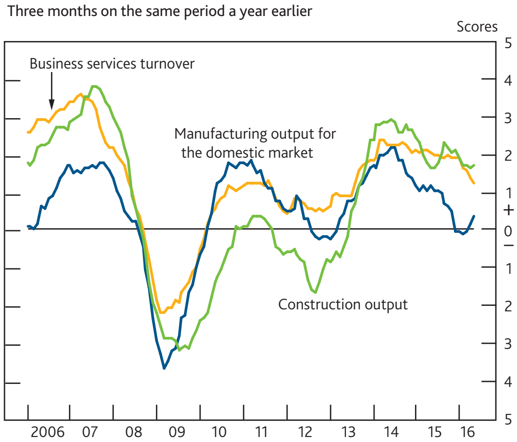
Annual growth of consumer spending had remained resilient. Retail sales values growth had changed little over the quarter. Demand growth for larger-value items such as furniture and white goods had been robust, but growth had weakened for clothing and footwear. Growth in new car sales had softened. Consumer services turnover growth had picked up over the past three months. UK holiday companies and visitor attractions reported increasing domestic tourism, in part reflecting perceptions of heightened threats of terrorism overseas and the depreciation of sterling, which had increased the cost of holidaying abroad. Demand growth was reported to be strong at restaurants and coffee bars. Growth in consumer credit had remained robust, driven by low interest rates, interest-free periods on lending and confidence about personal financial prospects.

Business and financial services

Growth in business services turnover had slowed further (**Chart 1**). The flow of new work for professional and financial services firms had weakened, with some clients delaying major business decisions during the pre-referendum period. That was reflected in a slowing of M&A, IPO, and commercial real estate investment activity. However, demand growth for corporate services including accommodation, conferencing and exhibitions had risen, suggesting that underlying business confidence was still positive. Some IT businesses reported strong growth as customers continued to build online and mobile sales platforms or improve cyber security and data analytics.

Chart 1 Activity

Three months on the same period a year earlier



Production

Growth in manufacturing output for the domestic market had increased a little, with volumes marginally higher than a year earlier (**Chart 1**). Growth in aerospace and automotive sector output had continued. Demand for construction products and equipment had risen. Output of medical products and pharmaceuticals had continued to expand. But sales of capital goods, especially those within the oil and gas supply chain, had fallen. The pace of contraction in manufactured export volumes had eased, in part reflecting the recent depreciation of sterling. Rising euro-area demand was reported for a range of products. But Chinese demand for luxury consumer goods and some industrial goods had softened.

Construction

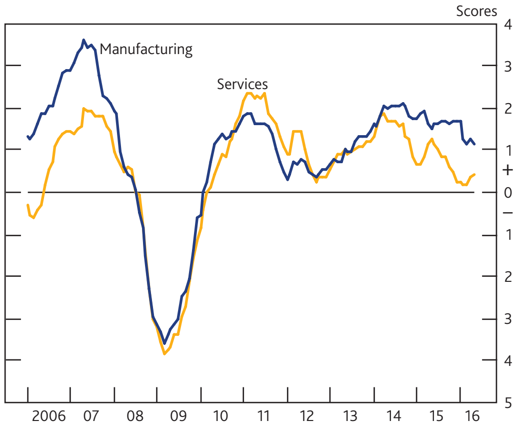
Growth in construction output had been stable. Growth in construction of new industrial property and educational facilities and prime office space had remained solid. Demand for the refurbishment of commercial space had increased further. Infrastructure work, for example in transport and telecommunications, had risen steadily. Output of new homes had risen, but some social housing projects had been put on hold, reflecting regulatory changes to housing associations' rents.

Investment

There had been some reports of delays in decision-taking on corporate spending until after the EU referendum. However, investment intentions for the year ahead were little changed overall, consistent with modest growth (**Chart 2**). Manufacturing investment intentions were generally weaker than for services firms, reflecting relative demand conditions. For some manufacturing firms, sterling's depreciation had increased the cost of capital goods, reducing the attractiveness of investment. Some subsectors, however, were expanding capacity, including both automotive and construction goods. In the service sector, capital expenditure was often aimed at reducing the labour intensity of production. Within consumer services, resilient demand growth was reported to be driving expansion and refurbishment spending in leisure services, retail and higher education.

Chart 2 Investment

Over the coming twelve months



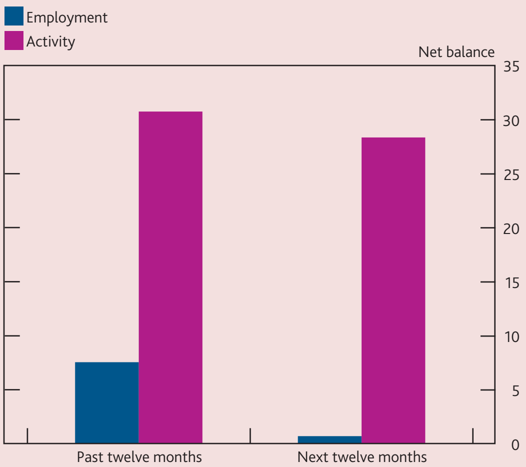
Box 1

Agents' survey on employment intentions and productivity

The Agents conducted a survey to ask business contacts about the change in employment and activity over the last twelve months, and their expectations and plans for the twelve months ahead. The survey also asked how factors were affecting employment plans. In addition, firms were asked to indicate how other factors were affecting productivity and if there were any significant restraints on businesses' ability to raise productivity. Over 400 businesses responded to the survey, with total employment of nearly 700,000 staff. The results were weighted by employment.

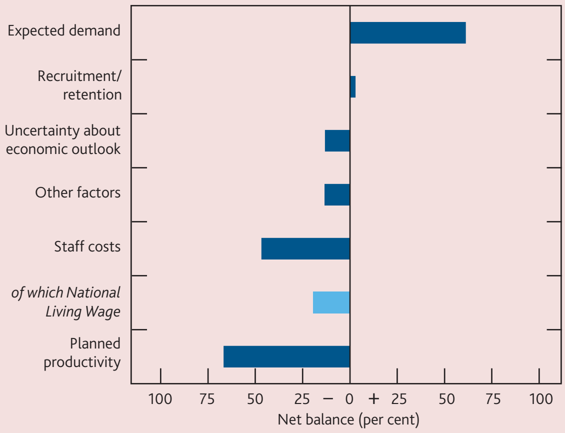
The survey results showed that over the past twelve months employment had increased modestly and by less than activity (**Chart A**). This suggests that, for the survey sample, productivity had risen somewhat over the past twelve months. Expectations for employment and activity over the next twelve months were both expected to be slower than over the last twelve months, but more so for employment than for activity. This would be consistent with expectations for slightly stronger growth in productivity in the year ahead.

Chart A Change in employment and activity, past twelve months and expectations for next twelve months



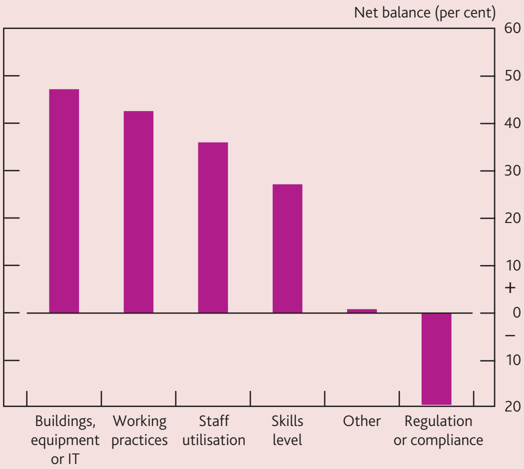
Looking at how changes in the economic environment were affecting employment plans for the next twelve months, the only significant reason given to increase employment was higher demand (**Chart B**). Heightened uncertainty about the economic outlook had a mildly depressing effect on employment plans, with a greater negative impact from both staff costs and opportunities to increase productivity. The National Living Wage was cited by only some of those concerned by staff costs — mainly consumer services and manufacturing respondents.

Chart B Factors affecting employment plans for the next twelve months



Among changes expected to influence productivity growth over the next twelve months, businesses planned a range of activities to boost productivity in the next twelve months (**Chart C**); including the improvement of both physical capital and labour efficiency. A balance of respondents expected that regulation and compliance would lower productivity growth, particularly for business services respondents.

Chart C Factors affecting productivity growth in the next twelve months



In terms of constraints on businesses' ability to raise productivity, access to skills was a commonly-reported concern. Consistent with the findings shown in **Chart C**, respondents also indicated that regulation was a barrier to improving productivity, including 'red tape' and delays in the planning system for property and construction businesses. Some respondents reported a need to maintain minimum staffing levels or to hoard labour where skills were in short supply.

Box 2
Recent trends in peer-to-peer lending

Agents had focused on gathering intelligence on peer-to-peer (P2P) lending recently, to gauge how the use of this form of finance was developing among corporate borrowers. That intelligence suggested that growth in P2P lending had continued to be strong throughout 2015 and into 2016.

The supply of P2P funds was supported by an inflow of institutional money into the sector, which had allowed P2P lenders to offer larger loans. That had made P2P a more attractive option for a wider range of borrowers and for property investors in particular: property-related lending had accounted for a large part of the recent growth in lending for some P2P platforms. More generally, the number of P2P lending platforms had continued to grow and the range of financing options had increased, including for working capital, such as certain types of invoice finance. There were reports of a pipeline of plans to introduce new P2P lending platforms. Overall, contacts saw P2P lending as providing a useful and growing source of finance to smaller businesses. But some were cautious about its rapid expansion, noting a risk that, given the complexity of the sector, difficulties at any individual P2P lender could lead to reputational risks for the sector more widely.

Contacts reported that the main driver of demand for P2P loans was a continued perception of a lack of access to bank funding on terms that some, often smaller, borrowers were comfortable with. In practice, P2P lending was most popular with start-ups and micro firms not able to access bank finance; or more generally among borrowers for projects that might be outside banks' lending criteria. In some of those latter cases, banks were reported to be referring clients to P2P lenders as a supplementary source of funds. But in most cases, borrowers were reported to be approaching P2P lenders directly.

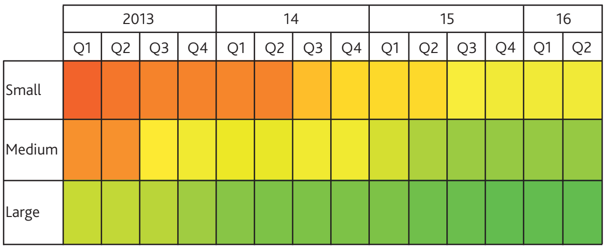
Although growth of P2P lending had been rapid, that was from a low base and some contacts noted factors constraining businesses' use of P2P lending platforms. For example, P2P lending was said to not yet meet the full range of borrowers' funding needs. Some contacts noted that the range and complexity of funding options was confusing to potential borrowers, and there were some concerns about the extent to which P2P platforms would exercise forebearance in the event of short-term repayment difficulties. And some businesses were reported to be reluctant to make the public disclosures required to attract funds. More generally, contacts noted that competition from other traditional forms of lending had increased over the past year, as the availability of those funds increased.

Corporate financing conditions

Bank credit availability had stabilised after a prolonged period of easing, remaining above normal for most corporate borrowers (**Chart 3**). Lending spreads were thought to have reached a trough, although some contacts reported that non-price terms had continued to improve. Competition had remained particularly strong in the invoice discounting market and for lending secured on property. But loan-to-value ratios had remained below those available during the pre-crisis period. Demand for bank lending had eased in recent months. More generally, companies continued to be cautious about increasing their gearing levels. Challenger banks continued to increase their lending to smaller companies.

Capital market issuance had appeared to have slowed recently, with reports that uncertainty around the EU referendum had negatively affected investor appetite. Availability of some other forms of non-bank finance had continued to expand. For example, increased institutional investment had allowed peer to peer lenders to finance larger deals (see Box 2 for more detail on recent trends in peer to peer lending). Asset financing had remained readily available at very competitive — and falling — rates.

Chart 3 Heatmap of credit conditions relative to normal by size of business[(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. 2016 Q2 uses Agents' latest assessment as of May. 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.

Property markets

Commercial real estate

Occupier demand for UK commercial real estate had remained robust, most notably for warehouses but also for prime office and retail space in both London and the major UK cities. Rents had risen but, London apart, they had often not reached levels sufficient to spur new speculative development. Where such development was taking place, it was generally funded by overseas investors or property funds, rather than by bank lending. Investor appetite for London property had slowed, with expectations for prime properties' asset values having moderated. In other regions, although contacts reported some slowing in decision-taking, investor appetite had generally held up better, both from overseas and domestic investors.

Housing market

Housing market activity had fallen back in April and May, following heightened transaction numbers in Q1 as buy-to-let investors had brought forward purchases ahead of the introduction of a rise in stamp duty on additional properties in April. Underlying activity in the owner-occupier market was little changed, although there were some reports of a softening, especially in higher price brackets.(1) Demand for new-build properties had remained robust. Shortages in the availability of properties for sale had persisted in the secondary market. Mortgage rates had edged lower overall and there were signs that availability had increased further, including for self-employed and older borrowers.

Capacity Utilisation

Capacity utilisation was slightly above normal in services and below normal in manufacturing. In manufacturing that reflected subdued levels of activity. Among business services companies, utilisation of staff had remained above normal, and skilled labour availability was reported to be fairly tight, especially in IT. Logistics businesses reported being increasingly short of warehouse space. But some slack had opened up in a number of legal, financial and advisory businesses, as demand growth had eased. Among consumer services contacts, resilient demand growth was keeping capacity utilisation above normal levels, with little slack reported in the air and rail industries in particular. In construction, the availability of skilled labour remained an impediment to growth although recruitment difficulties had eased recently.

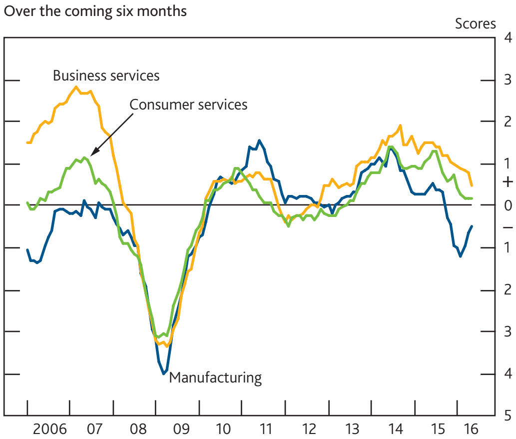
Employment and pay

Services employment intentions had eased, but manufacturing intentions had become less negative (**Chart 4**). Business services contacts' employment plans had moderated, reflecting weakening output growth and a renewed focus on productivity gains to mitigate skills shortages. Employment intentions in consumer services were consistent with little change in staffing levels, with the introduction of the National Living Wage (NLW) weighing on recruitment plans for some contacts. Manufacturing employment intentions had increased slightly, but were still consistent with reductions in staffing overall, particularly among commodity-processers such as steel producers.

Recruitment difficulties had eased in recent months, though were still moderately higher than normal. The share of companies reporting severe hiring difficulties had fallen back

Chart 4 Employment intentions

Over the coming six months



markedly since 2015 Q3. That easing largely reflected a slowing of employment growth and an improved flow of qualified staff — attributed to past investment in training. Reduced employment in the oil and gas sector had increased the availability of skilled engineers, but some specific technical, professional and managerial skills had remained in short supply.

Growth in total labour costs per employee had edged higher in services and remained little changed in manufacturing. The former mostly reflected the introduction of the NLW. Measures taken by contacts to ameliorate the impact of the NLW on margins had varied. For example, some contacts were reviewing wage differentials and bonus and commission payments to limit the potential impact on total labour costs. But in some cases, the NLW had been extended to employees under the age of 25 who were not legally required to be paid the higher rate. The majority of pay awards remained in a range between 1%–3%, with upward momentum restrained by the persistence of low inflation. Manufacturers reported subdued pay pressures, reflecting the recent weakness of output.

Pricing

Supply chain pricing

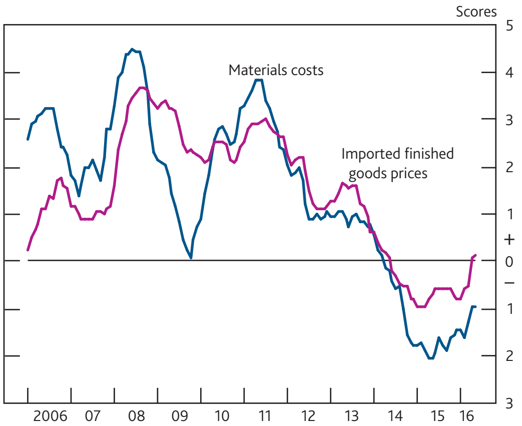
Materials costs had risen recently, but remained slightly lower than a year earlier. Recent increases had reflected a combination of global commodity price rises and the weakening of sterling since the start of the year. Imported finished goods prices had also increased as the impact of sterling's fall had started to be passed through to customers. Nonetheless, prices were flat on a year earlier (**Chart 5**).

As higher non-labour input costs started to be passed on, the annual rate of decline in manufacturing output prices had

(1) See the box on page 2 of the *Agents' Summary of Business Conditions, May 2016 Update* for more details on contacts' views of housing market prospects, available at www.bankofengland.co.uk/publications/Pages/agentssummary/2016/may.aspx.

Chart 5 Raw materials and imported finished goods

Three months on the same period a year earlier



eased. Business services price inflation had remained modestly positive, albeit with substantial variation in contacts' ability to raise prices. For example, IT outsourcing and insurance prices had continue to fall, whereas commercial property rents had risen alongside higher occupancy, and some professional services firms reported improved pricing power for specialist services.

Consumer prices

Consumer price inflation had edged higher and was modestly negative for goods and positive for services (**Chart 6**). Annual grocery price declines had persisted, reflecting strong competition in the sector, although the pace of decline had eased slightly over the quarter. Some retailers thought that clothing prices could weaken in the near term, due to disappointing sales of seasonal lines and a build-up in stocks. However, prices were expected to strengthen further ahead due to the recent decline in sterling against the dollar. There were tentative signs that an increased supply of used cars had started to reduce prices. Consumer services price inflation had edged higher. Sustained demand growth had increased the pricing power of some providers, particularly in the leisure and private rented housing sectors. And some firms had started to pass through higher wage costs of the NLW into prices, although most expected that to be a gradual process.

Chart 6 Retail goods and consumer services prices

Three months on the same period a year earlier