BANK OF ENGLAND

Agents' summary of business conditions

and results from the Decision Maker Panel Survey

2018 Q2

- Retail sales growth had ticked up over the past month, boosted by stronger sales of seasonal clothing and footwear; growth in consumer services had slowed.
- Growth in domestic manufacturing output had edged up; growth in export output had eased slightly but remained robust.

There had been a tick up in **retail sales growth**, helped by stronger sales of seasonal clothing and footwear. However, this was not sufficient to fully make up for sales lost due to the adverse weather in Q1. There was ongoing weak demand for new cars, white goods and homewares. Growth in **consumer services** slowed, particularly in travel and tourism. Contacts attributed cautious consumer sentiment to squeezed real incomes, higher pensions auto-enrolment contributions and political uncertainty.

Business services turnover had grown relatively solidly, with fee growth driven by Mergers & Acquisition (M&A) activity by overseas buyers. Preparations for Brexit and activity relating to insolvency, restructuring and company voluntary arrangements, as well as regulatory changes such as GDPR and IFRS9 had also supported activity.

Services exports values had grown at a moderate pace, with strength among professional services firms, engineering, IT and pharmaceuticals research and development.

Growth in domestic **manufacturing output** edged up, with some manufacturers benefiting from suppliers looking to source more goods from the UK. Growth in **export manufacturing output** eased slightly but remained firm. The slight slowdown reflected a modest easing in global demand for some products such as UK-produced vehicles, and materials for processing destined for China.

Construction output remained little changed on a year ago, and contacts were cautious about the short-term outlook.

Investment intentions remained modestly positive among manufacturers and in business services. Some manufacturers were investing in capacity in order to meet export demand, others in automation to overcome labour shortages or in diversification to insure against weak consumer activity and competition.

Corporate **demand for credit** remained subdued. Bank credit continued to be readily available for medium and large companies, and firms with strong balance sheets. However, bank **credit availability** was still tightening for consumer-facing, construction and property development firms, and trade credit insurance for these firms had also tightened. Moreover, small firms reported increasing difficulty accessing traditional bank finance.

There was modest excess demand among investors for **commercial real estate**. In London, high values had dampened demand from domestic buyers, but the weak exchange rate supported demand from overseas. In other parts of the UK, valuations had risen for good quality assets in prime locations. Nonetheless, there were some signs of investors becoming more cautious.

In the **housing market**, supply and demand were broadly in balance across the whole market, with excess supply more prevalent in the south, while excess demand was more evident in parts of the north. **Mortgage availability** was generally regarded as favourable for borrowers, reflecting strong competition in the market, though a few contacts noted that affordability assessments had tightened somewhat.

Capacity constraints in manufacturing remained tighter than normal, notably for exporters. In services, capacity utilisation was around normal overall, reflecting tight capacity in business services and excess capacity in consumer-facing sectors.

Employment intentions in consumer services had weakened further, indicating contracting headcount. Intentions in business services and manufacturing remained consistent with modest employment growth. Planned productivity improvements through automation were expected to constrain headcount growth. **Recruitment difficulties** remained elevated and widespread across sectors and job roles. Pay settlements had generally been a little higher this year.

Materials costs inflation was steady. Pass-through of the past depreciation of sterling to the cost of imported goods had abated, but there had been quite significant increases in some material costs, particularly construction materials, metals and oil-derived products. Nonetheless, **profit margins** in manufacturing were stable and export margins remained attractive.

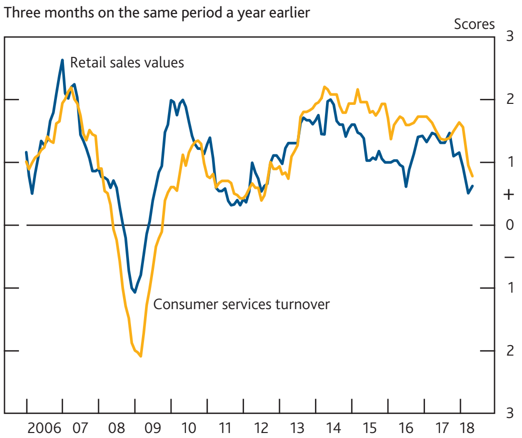
Consumer goods price inflation had eased, reflecting the diminishing effect of the past fall in sterling, and widespread competitive pressures.

This publication includes a summary of economic reports compiled by the Bank of England's Agents between late March and late May 2018. It generally makes comparisons with activity and prices a year earlier. The report does not represent the Bank's own views, nor does it represent the views of any particular company or region. More information on the Bank's Agencies can be found at www.bankofengland.co.uk/publications/Pages/agentssummary/default.aspx.

Consumer services and retail sales

Growth in consumer services turnover had softened a little further (**Chart 1**), reflecting slower growth in discretionary spending on smaller-ticket leisure services (travel and tourism, hotel bookings, etc). However, forward bookings for summer holidays had held up well. By contrast, there had been a tick up in retail sales growth, assisted by stronger sales of seasonal clothing and footwear. Growth in demand for consumer goods had not recovered sufficiently to make up for sales lost due to the adverse weather in Q1, however, and there was ongoing weak demand for new cars, white goods and homewares. Contacts attributed more cautious consumer sentiment to squeezed real incomes, higher pensions auto-enrolment contributions and political uncertainty. Third-sector contacts suggested that delays in benefit payments and benefits sanctions were increasing the pressure on low-income households.

Chart 1 Retail sales values and consumer services turnover



The Agents conducted a survey of consumer demand (see Box 1). Overall, the results indicated that there had been a significant drop in sales volumes in Q1 due to the adverse weather, with lost sales likely to be only partially recovered in subsequent quarters. However, improvements in consumers' real disposable incomes and in confidence were both expected to boost volume growth in the year ahead, in contrast to the survey results from 2017.

Business and financial services

Business services turnover had been growing relatively solidly and more strongly than most other sectors. This was despite some hesitancy around client investment decisions that contacts reported had been driven by political uncertainty.

For professional services firms, Mergers and Acquisition (M&A) activity from overseas buyers, Brexit preparations, and insolvency and restructuring activity had driven fee growth. Regulatory changes such as GDPR and IFRS9 had also supported activity. In addition, demand for recruitment services had been helped by a tight labour market. Law firms reported some domestic growth, though this remained slower than overseas work.

Financial services firms remained under pressure to improve shareholder returns, for example by exiting low-margin lending. Competitive pressures were considered particularly strong in UK retail lending markets, and in global wholesale markets. Developments in technology continued to enable greater competition in some sectors. Growth was weak in the UK retail market for financial services, but the UK asset management industry was able to grow, benefiting from the rise in global savings.

In other business services, turnover growth had been strongest in IT businesses, followed by logistics and haulage. Retail-focused wholesalers and distributors had suffered from the knock-on impact of weaker consumer activity.

Services exports values had continued to grow at a moderate pace. Appetite from overseas investors looking to purchase UK businesses continued to boost exports growth among professional services firms. Demand for specialist services such as engineering, IT and research and development in pharmaceuticals was also strong. The past depreciation of sterling appeared to continue to support inward tourism from abroad and related spending, although contacts suggested that over the past year terrorism concerns had reduced tourism in London.

Production

Growth in domestic manufacturing output edged up. Growth remained stronger for those in export supply chains, though domestic-faced manufacturers benefited from suppliers looking to source more goods from the UK. Consumer goods manufacturers reported that weaker consumer confidence had dampened demand for big-ticket items. In the food and drink sector, output had been growing modestly, although retailers were paring back on some product ranges. Construction products suppliers were still benefiting from growth in housebuilding, but activity had been more muted in other parts of the sector. Automotive manufacturing and its domestic supply chain was subdued as a result of lower demand for cars and commercial vehicles, especially diesel models. Higher oil prices were supporting growth in the production of capital equipment and components for the oil and gas sector.

Growth in export volumes of manufactured goods had eased slightly (**Chart 2**), but remained firm and outpaced growth for the domestic market. The slight slowdown mainly reflected a modest easing in global demand for some products such as UK-produced vehicles, and materials for processing destined for China. Volumes continued to be supported by the past depreciation of sterling, although somewhat less so than

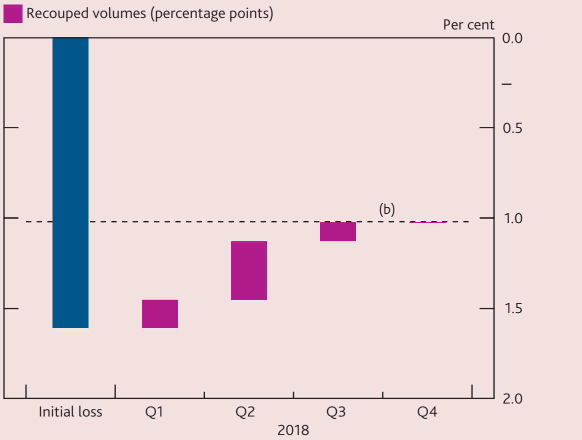
Box 1
Survey: consumer demand

The Agents surveyed business contacts about how consumer demand had been affected by bad weather in recent months, and how sales volumes had changed in the past 12 months and were expected to evolve over the next 12 months. Contacts were also asked how different factors would affect sales volume growth in the coming 12 months, and how prices would change in that period. Around 230 companies responded. Results were weighted by turnover; one large response was reduced in weight to match its market share of the relevant sub-sector.

The survey showed that, in the past three months, sales volumes had dropped by around 1½% due to bad weather.

Sales weakness was spread across goods and services and suppliers. Contacts expected that just over a third of these lost sales would eventually be recouped, with 80% of that by Q2 (**Chart A**). Consumer service providers were less confident than goods retailers that they would recoup lost sales.

Chart A Impact of bad weather on past three months' sales volumes,[(a)] and subsequent recovery by quarter

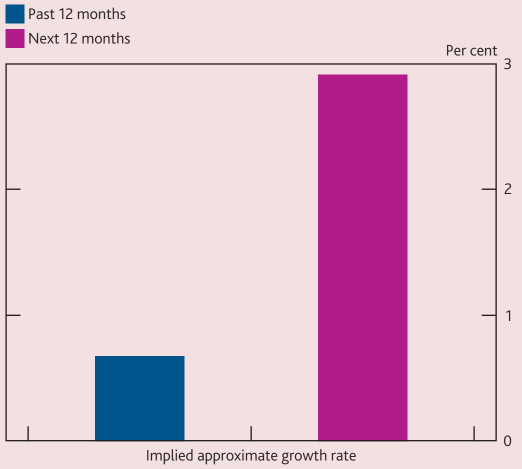


(a) The initial lost sales volumes estimate is based on broad response buckets rather than point estimates. In calculating the overall impact, a judgement was applied to the results for one bucket, as written responses had suggested the impact was towards the smaller end of the range for that bucket.
(b) The dotted line denotes the lost sales that retailers expected eventually to be recouped.

The survey showed that sales volumes growth over the past 12 months was modest at around ½% (**Chart B**). Consumer service providers and online retailers registered the strongest growth, offset by weakness in traditional bricks and mortar retailers and goods wholesalers. Contacts expected volumes growth to pick up to around 3% in the year ahead, with all sectors expecting to grow.

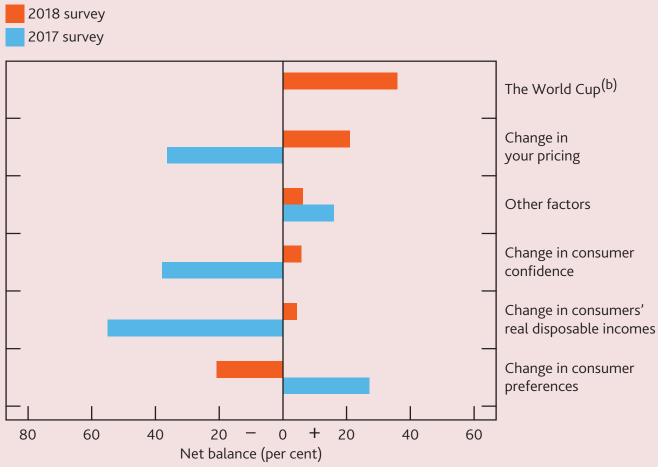
Among the factors likely to affect consumer sales volumes over the next 12 months (**Chart C**), the World Cup was expected to give a positive sales boost, for example in sales of

Chart B Estimates of sales volumes growth[(a)]



(a) Implied growth rates are calculated from broad response buckets, rather than point estimates of growth, so are broad approximations only.

Chart C Factors affecting sales volumes over next 12 months — 2018 and 2017 survey results[(a)]



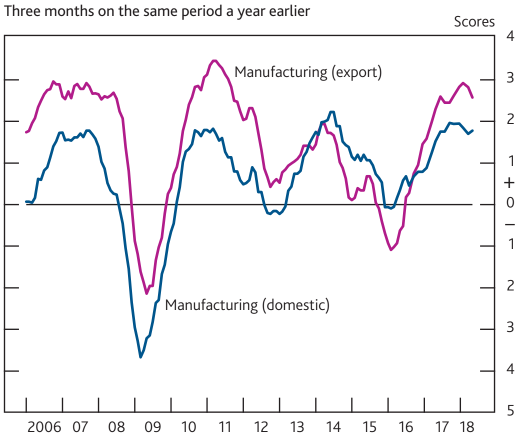
(a) Last year's survey was conducted in January and February 2017.
(b) Not relevant in 2017.

electronics and alcoholic drinks. Changes to consumer confidence and consumers' real disposable incomes were expected to make a small positive contribution to demand, in contrast to last year's survey where they were significant drags on demand growth.

We asked firms how they expected unit prices to change over the coming 12 months. Inflation expectations for the next 12 months averaged 1.5% across our sample. By sector, consumer service providers expected the highest inflation at just over 2%, with more modest expectations by goods retailers as the effects of sterling's past depreciation continue to fade.

previously. Nevertheless, most exporters continued to report strong volume growth to major markets such as the EU and US, notably in pharmaceuticals, food, drink and textiles. Brexit was causing exporters and clients to examine their supply chains due to potential tariff and non-tariff barriers, and there were growing concerns about global trade protectionism.

Chart 2 Manufacturing output



Construction

Activity in construction remained little changed on a year ago and contacts were cautious about the short-term outlook. Although the level of activity had recovered from the effects of adverse weather in Q1, in many cases lost activity had not been fully made up because of capacity constraints within the sector. As a result some completion times had been delayed. Housebuilding remained the strongest part of the sector, but growth had slowed and contacts were finding it harder to sell new houses than last year. Elsewhere, there was some weakness in infrastructure, where there was not enough new work to offset completing projects, and in retail where store expansion had been significantly curtailed. However, there was stronger activity in warehousing and logistics.

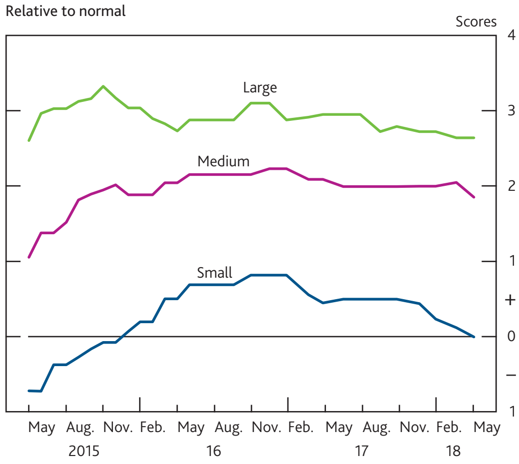
Investment

Investment intentions remained modestly positive among manufacturers and in business services. Some manufacturers were investing in capacity in order to meet export demand, others in automation to overcome labour shortages or in diversification to insure against weak consumer activity and competition. However, intentions among consumer-facing businesses had been depressed by concerns about soft consumer activity and tight margins. Brexit uncertainty was weighing down discretionary or expansionary investment for some medium to larger-sized businesses, or those with a greater international focus. SMEs and domestic-facing businesses were more likely to maintain a business as usual approach to investment as potential Brexit effects remained unclear.

Corporate financing conditions

Corporate demand for credit remained subdued. Bank credit (**Chart 3**) continued to be readily available for medium and large companies, and firms with strong balance sheets. Growing competition among non-bank lenders was leading to looser price and non-price conditions for larger companies.

Chart 3 Credit availability



However, bank credit availability was still tightening for consumer-facing, construction and development firms, and the availability of trade credit insurance for such firms had also reduced. Moreover, small firms reported increasing difficulty accessing traditional bank finance.

Suppliers to consumer-facing businesses had reported an increased incidence of bad debts, and contacts expected continued retail and restaurant company voluntary arrangements (CVAs) and administrations as rising costs and over-supply put pressure on balance sheets.

Property markets

Commercial real estate

There was modest excess demand among investors for commercial real estate. In London, high valuations had dampened demand from domestic buyers, but the past fall in the exchange rate had supported demand from overseas. In other parts of the UK, valuations had risen for good quality assets in prime locations, which offered better yields than in London. Nonetheless, there were some signs that investors were becoming more cautious. Local authorities were buying less than last year. There was little appetite among investors for retail assets, amid concerns that valuations may come under pressure. There was strong occupier demand for industrial and warehouse premises and city centre offices, where availability was relatively low and rents were rising, albeit not sufficiently to stimulate a significant rise in new building. Vacancy rates continued to rise in the retail sector and contacts reported that CVAs were being used by a number of large tenants to push through rent reductions or accelerate store closures.

Housing market

In the housing market, supply and demand were broadly in balance across the whole market, with excess supply more prevalent in southern regions, while excess demand was more evident in parts of the north. The secondary market remained much weaker than the new-build market, which had been supported by the Help to Buy scheme. Nonetheless, there were some reports that new-build properties were taking longer to sell than a year ago and required greater use of incentives. Overall, contacts expected activity to remain subdued, and house price inflation was expected to remain modest. Mortgage availability was generally regarded as favourable for borrowers, reflecting strong competition in the market, though a few contacts noted that affordability assessments had tightened somewhat.

Capacity utilisation

Capacity constraints in manufacturing remained tighter than normal, especially for exporters. The impact of suppliers looking to source more goods from the UK was increasing capacity constraints for some domestically focused producers. Slower demand had eased capacity constraints for producers of construction materials.

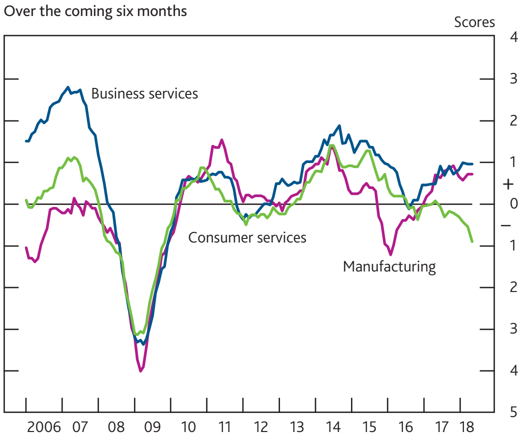
In services, capacity utilisation was around normal overall, reflecting tight capacity in business services and excess capacity in consumer-facing sectors. Business-facing contacts in sectors such as professional services, warehousing and distribution reported above-normal capacity constraints, mostly reflecting limited availability of skilled labour. Fixed asset utilisation was expected to ease with continued investment in warehousing and distribution. Higher capacity constraints among business-facing services was offset by a growing excess capacity in retail, while capacity utilisation in hotels and other consumer services businesses had eased somewhat.

Employment and pay

Employment intentions in consumer-facing sectors had weakened further, indicating contracting headcount (**Chart 4**). This primarily reflected job cuts in retail on the back of store closures and rationalisation of management and support roles, as well as closures in parts of the hospitality sector. Intentions in business services and manufacturing remained consistent with modest employment growth. Planned productivity improvements through automation were expected to constrain headcount growth.

Chart 4 Employment intentions

Over the coming six months



Recruitment difficulties remained elevated and were widespread across sectors and job roles. There were a growing number of reports of vacancies taking longer to fill and, in a small number of cases, labour shortages were constraining headcount growth. This was particularly the case where skill shortages were most acute, eg construction trades, drivers, specialist engineering and IT. A continued slowing in the inward flow of EU migrants for lower skilled and/or seasonal work was reported to be acting as a constraint in sectors such agriculture and food, hospitality and warehousing. Employee churn remained manageable for most contacts, due to a combination of companies making counter-offers to retain key skills, and reduced employee turnover in some sectors, such as retail and construction.

Pay settlements were generally a little higher this year compared with 2017, averaging 2½%–3½%. That was attributed to a combination of a tighter labour market and recent above-target CPI inflation. The National Living Wage was the main factor driving stronger pay growth in consumer services and a few other sectors that employ a high proportion of low-paid workers. But the impact on average wage bills was often limited by making lower or no awards to more senior staff. There were continued reports of companies awarding bigger pay increases to address skill shortages, but these were normally targeted at relatively small numbers of key employees. Total labour costs growth had risen for some contacts due to the increase in employers' pensions auto-enrolment contributions.

Pricing

Supply chain pricing

Materials costs inflation was steady overall (**Chart 5**). Pass-through of the past depreciation of sterling to the cost of imported goods had abated, so imported finished goods prices inflation had continued to moderate. However, there had been quite significant increases in some material costs, particularly construction materials, metals and oil-derived products.

Chart 5 Raw materials costs and imported finished goods prices

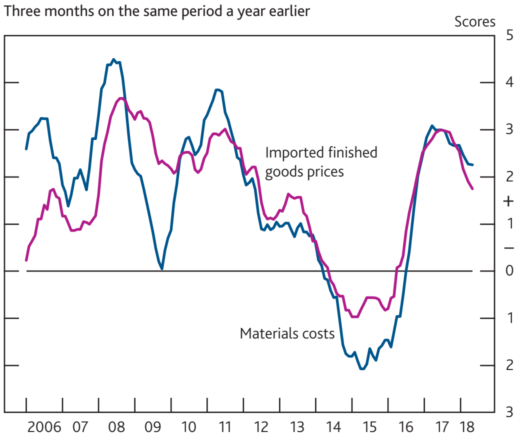
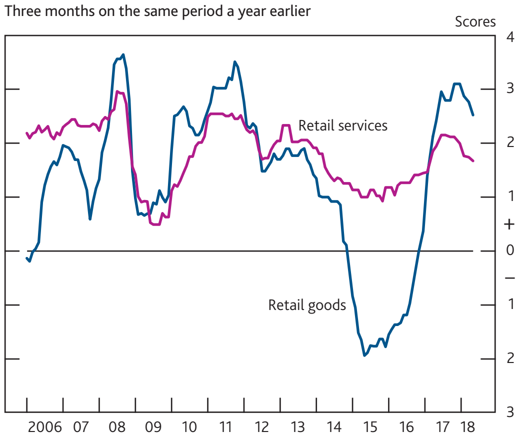


Chart 6 Consumer goods and services prices



Output price inflation eased slightly for manufactured products, but was significantly higher for construction products. Business services providers continued to achieve modest annual fee increases for bespoke or specialised services but were less able to raise fees for commoditised services. Profit margins in manufacturing remained stable as import cost inflation abated, and export margins remained attractive. Margins on services, by contrast, remained squeezed as higher costs of specialist labour in professional services and entry level labour in consumer services could not be fully passed through.

Consumer prices

Consumer goods price inflation had eased (**Chart 6**), reflecting the diminishing effect of the past fall in sterling and widespread competitive pressures. In the grocery sector, price growth was expected to be materially lower in 2018 than in 2017. Car list prices had risen due to the lagged pass-through of sterling's depreciation. Consumer services inflation remained steady, although inflation among hotels and restaurants, which have expanded capacity considerably in recent years was slowing. Meanwhile, energy, utility and fuel prices had been increasing recently.

Box 2
Results from the Decision Maker Panel survey

Overview

Together with academics from Stanford University and the University of Nottingham, the Bank has developed the Decision Maker Panel (DMP) survey to help monitor recent developments in the UK economy and to track businesses' expectations and the uncertainty surrounding them.(1) The DMP is particularly valuable in helping to assess the implications for UK businesses ahead of the United Kingdom's withdrawal from the European Union. The more quantitative responses from the DMP survey complement the more qualitative intelligence gathered from Bank Agents' contacts.

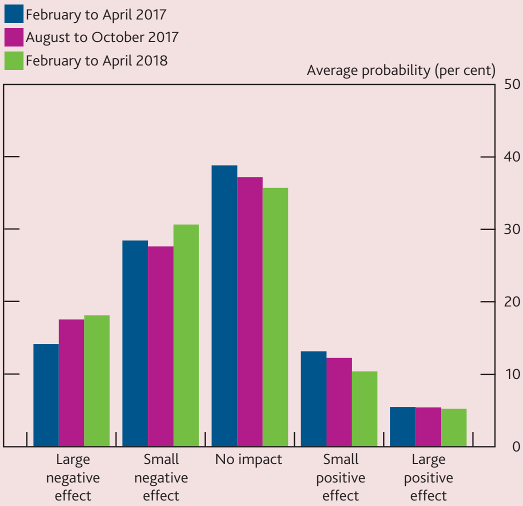
The panel comprises Chief Financial Officers (CFOs) from small, medium and large UK companies operating in a broad range of industries and is designed to be representative of the population of UK businesses.(2) The panel is continuing to expand; at the time of the April DMP survey around 4,000 members had agreed to be part of the panel, of which 1,000 had been added over the preceding three months. The response rate has been between 40% and 50% in recent surveys. Aggregate-level data from the DMP survey are available on the Bank's website.(3)(4) This box summarises the latest findings.

Latest views on Brexit

One of the key purposes of the DMP is to track how businesses' attitudes to Brexit are evolving. Between February and April 2018, panel members were asked to assign probabilities to potential impacts that the eventual Brexit deal may have on their sales, relative to what would have been the case if the United Kingdom had remained a member of the European Union. On average, companies attached higher probabilities to negative impacts than to positive ones (**Chart A**). An estimate of the expected eventual change in sales due to Brexit can be calculated for each respondent by multiplying some simple mid-points for the five response categories shown on **Chart A** by the probabilities assigned to them.(5) The average eventual change in sales was negative and stood at around -3%. Using the same methodology would suggest that the most pessimistic 10% of businesses expected a reduction in sales of more than 10% due to Brexit, while the most optimistic 10% of respondents expected a boost of 1% or more.

Relative to a year earlier, in the most recent surveys businesses attached slightly higher average probabilities to Brexit eventually reducing sales and slightly lower average probabilities to Brexit improving sales (**Chart A**). As a result, using the same approach as above to quantify the importance of Brexit for sales implies that the expected eventual negative impact of Brexit on sales has risen from just over 2% to 3%.

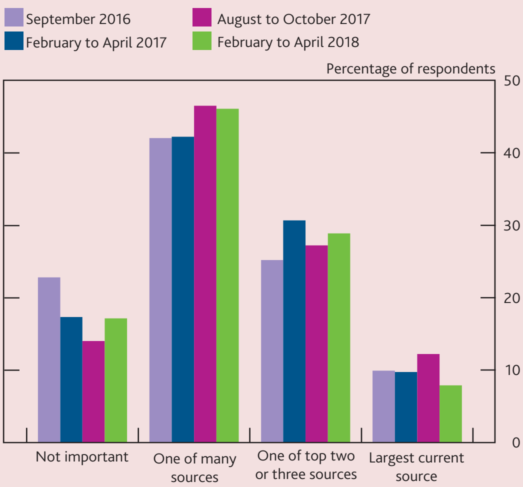
Chart A Expected eventual impact of Brexit on sales(a)



Sources: DMP and Bank calculations.

(a) 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?'. A large effect corresponds to changing sales at home and abroad by 10% or more, a small effect is defined as less than 10%.

Chart B Brexit as a source of uncertainty(a)



Sources: DMP and Bank calculations.

(a) Question: 'How much has the result of the EU referendum affected the level of uncertainty affecting your business?'.

In addition to lowering future sales, Brexit is also an important source of uncertainty for a number of businesses. In the most recent surveys, 37% of panel members thought that Brexit was currently in the top three sources of uncertainty for the business that they represent (**Chart B**). Relative to a year

(1) This project is supported by the Economic and Social Research Council (grant number ES/P010385/1).
(2) When it was launched the DMP initially excluded a small number of sectors, such as agriculture, mining and finance. Those sectors are excluded from the results reported in this box, but the survey is now being expanded to cover these industries and they will be included in future reports as soon as sufficiently large samples have been built up.
(3) For details on the methodology please see www.bankofengland.co.uk/publications/Pages/quarterlybulletin/2017/q2/a3.aspx.
(4) Aggregate data and details on questions are available on the Bank of England website: www.bankofengland.co.uk/-/media/boe/files/statistics/research-datasets/dmp-results-june-2018.xlsx. All results are weighted.
(5) Values of ±15% are used for large positive/negative effect and ±5% for a small positive/negative effect. Zero is used for no impact.

earlier, slightly fewer firms saw Brexit as an important source of uncertainty, although these changes have been modest, and overall, substantial uncertainty persists.

The impact of Brexit on investment

Brexit is also affecting businesses' current decisions. As discussed in the February *Inflation Report*, evidence from the DMP implies that Brexit has held back investment growth since the referendum.(6) This section updates that analysis.

Data from the DMP survey can provide more quantitative evidence on how investment has been affected by Brexit than is available from other surveys. This is done by comparing relative differences in nominal investment growth for businesses with different exposure to Brexit, based on responses to the questions described in the section above. This allows for effects through two channels: (i) businesses lowering investment because they expect lower future sales due to Brexit; and (ii) businesses investing less because Brexit has increased uncertainty.

In the year following the Brexit referendum, four-quarter investment growth is estimated to have been materially lower for businesses who expect Brexit to eventually reduce their sales than for those who expect either no impact on future sales or a positive effect (**Chart C**). Similarly, investment was also reported to have been lower over this period for businesses who viewed Brexit as being in their top three sources of uncertainty than for companies who saw Brexit uncertainty as less important (**Chart D**). A simple regression analysis of these data, taking account of both effects together, implies that Brexit is likely to have lowered aggregate nominal investment growth by 3–4 percentage points in the year to 2017 H1.

Unlike the previous period, in 2017 H2 there were no significant differences in investment growth between businesses with different degrees of exposure to Brexit on either definition (**Charts C** and **D**). This is likely to be related to the fact that growth in 2017 H2 is a comparison of investment levels in two post-referendum periods, while four-quarter growth over the preceding year was a comparison of a post-referendum period with a pre-referendum period. As businesses with greater exposure to Brexit in 2017 H2 did not experience higher investment growth, this implies that the Brexit effect on the level of investment has not yet unwound, although the results suggest that the impact has not got larger either.

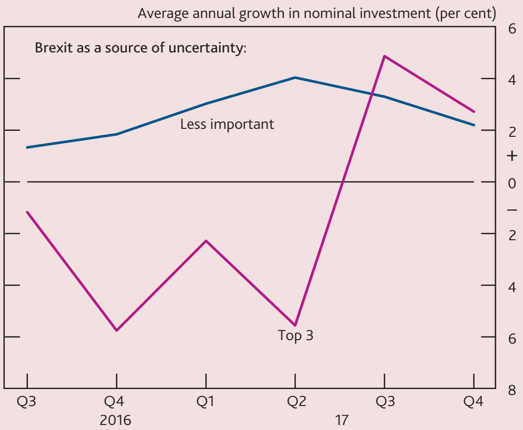
This analysis of the effects of Brexit on investment assumes that more exposed firms would have otherwise behaved like companies with limited exposure to Brexit. Moreover, the approach only captures exchange rate effects on nominal investment to the extent they are correlated with expected Brexit effects on future sales or uncertainty. It will not capture any additional effects on real investment from the price of imported investment goods having increased for all firms, which may encourage businesses to buy less of them. This would be likely to increase the size of the impact of Brexit on real investment. The impact may also be larger, if a weaker economy leads to further second-round reductions on investment.

Chart C Investment growth over the past year by expected eventual change in sales due to Brexit(a)

Sources: DMP and Bank calculations.

(a) Investment growth is calculated using Davis, Haltiwanger and Schuh (DHS) growth rates. This is the change between two periods, divided by the average of those two periods. The expected eventual change in sales due to Brexit is calculated for each business using responses to the question reported in **Chart A** and by multiplying them by some simple mid-points for the five response categories. Values of ± 15% are used for large positive/negative effect and ± 5% for small positive/negative effect. This question is only asked every six months. Response from the closest corresponding survey is used. Negative change in sales is defined as -0.5% or lower, while little or positive change as -0.5% or higher.

Chart D Investment growth over the past year by importance of Brexit as a source of uncertainty(a)



Sources: DMP and Bank calculations.

(a) Investment growth is calculated using DHS growth rates, as defined in the footnote to **Chart C**. Whether Brexit is in the top three source of uncertainty for a business is calculated using responses to the question reported in **Chart B**. This question is only asked every six months. Response from the closest corresponding survey is used.

(6) See the box on page 17: www.bankofengland.co.uk/-/media/boe/files/inflation-report/2018/february/inflation-report-february-2018.pdf.