Economic Review

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Summary

This month's Economic Review article looks at three aspects of the UK economy as described by the latest official statistics. First, preliminary estimates of Gross Domestic Product show that the economy expanded by 0.8 per cent in the third quarter of the year. Growth was broad-based across the main sectors of the economy, with construction output recording a particularly strong increase for the second quarter in a row. Second, total employment increased by 178,000 in the three months June–August 2010. Most of the increase was accounted for by male employment and by part-time employment. Employment rates for the under 25 age group though remain low, having fallen significantly during the recession. Total hours worked increased in this same three-month period, but most of the increase was attributed to an increase in average hours worked rather than employment. Ahead of the Spending Review there was a decline in vacancies, with the largest falls in the predominantly public services industries. However, redundancies remained at normal rates. Third and finally, some financial statistics relating to UK households and corporations are analysed. The housing market weakened in the third quarter as average prices fell and numbers of mortgage approvals remained at low levels. Households and firms have continued to pay-down debts. Households have continued to show little appetite for relatively expensive consumer credit, and private non-financial corporations have continued to build cash surpluses as a result of low investment intentions and the uncertain economic outlook.

UK economy grows by 0.8 per cent in the third quarter of 2010

Preliminary estimates show that Gross Domestic Product (GDP) increased by 0.8 per cent in the third quarter of the year. Output has now expanded for four successive quarters and is 2.8 per cent higher than in the same quarter in 2009 (**Figure 1a**). Growth though did slow from the second quarter when output had rebounded strongly from the weaker first quarter – which was affected by adverse weather conditions and the rise in Value Added Tax (VAT) in January.

Figure 1b shows the contributions to growth in the latest two quarters. There was a marked increase in construction output in the second quarter (up 9.5 per cent), and although growth slowed in the latest quarter, the 4 per cent increase in output contributed 0.25 percentage points to

Figure 1a GDP growth

Percentages

Source: GDP Preliminary estimate

Figure 1b Contributions to GDP growth by industry

Percentages

Quarter on quarter

Source: GDP Preliminary estimate

total growth. Construction output has now increased by 13.8 per cent in the last six months and is almost back to pre-recession levels.

Business survey data also pointed to a rise in construction output since the start of the year but are less optimistic about the future. The latest Purchasing Managers Index (PMI) provided further evidence that the recovery in UK construction output peaked in the summer. The survey showed that output has expanded for eight successive months, but growth had slowed to its lowest rate in October. The Royal Institute of Chartered Surveyors' (RICS) *Construction Market Survey* reported that surveyors are more pessimistic about workloads over the next 12 months as the Building Schools for the Future (BSF) program is scaled back and due to uncertainty over the impact of public spending cuts. The Bank of England's Regional Agents noted that public sector construction work had started to edge downwards and that continuing credit restrictions are limiting growth.

Output of the services industries, which accounts for around three-quarters of total value-added in the UK, has grown by 0.6 per cent in each of the last two quarters contributing 0.45 percentage points to overall growth. Between the second and third quarters, there was a slight change in the pattern of services growth, as business services and finance growth slowed whilst transport storage and communications grew faster. Growth in the distribution, hotels and restaurants and the government and other services sectors was broadly unchanged.

The services PMI for October registered an eighteenth successive monthly increase in activity, however the rate of growth has slowed from the start of the year and is now below the fourteen-year survey average. Those sectors most dependent on discretionary demand like hotels and catering and personal services are the least confident about the future due to the possible impact of public spending cuts on disposable incomes.

Despite the slowdown in the most recent published quarter, business services and finance has been the main driver of service sector growth since the recovery started in 2009 Q3. Over the last four quarters this sector has grown by around 3 per cent and has accounted for over half (1.2 percentage points) of the 2.1 per cent increase in total services output over this period.

The *Financial Services Survey* administered by the Confederation of British Industry (CBI) and PricewaterhouseCoopers (PwC) reported the strongest increase in business volumes since 2007 in the third quarter of the year. Furthermore, as this was broad-based across most sectors and across both retail and commercial customers it is an encouraging indicator of the overall strength of the recovery. However, all sectors are more cautious about future growth prospects. Uncertainty over the impact of fiscal tightening has increased concerns for future demand levels. The financial services industry is also preparing itself for an exceptional range of new regulatory initiatives with all survey respondents expecting compliance expenditure to increase over the next 12 months.

Manufacturing output expanded by 1.0 per cent in the third quarter, and has now expanded by 5.2 per cent since the trough in 2009 Q3. Given that a relatively large proportion of manufacturing output is traded, it is little surprise that this has coincided with recovery in the global economy and world trade over the last year. The latest *World Economic Outlook* published by the International Monetary Fund noted that the fastest growing countries so far in 2010 were those with a relatively high proportion of manufacturing in GDP, particularly emerging market economies.

Recent growth in manufacturing output around the world has been driven by a move to restocking as businesses, now more optimistic about future demand, seek to replenish stocks of raw materials, intermediate and finished goods that were run down quickly during the recession. As production processes are increasingly organised around global supply chains, reflecting the growing importance of multinational corporations, the move to restocking has gone hand-in-hand with an increase in the international trade of manufactures, especially for intermediate goods.

Other data sources show a similar story. The CBI *Industrial Trends Survey* in October reported a moderate increase in production in the third quarter following strong growth in the second when there had been exceptionally strong stockbuilding. The July 2010 survey had reported the fastest rate of stockbuilding since 1977. Export orders are expected to remain robust, but the October survey notes that a further fading of stockbuilding is considered inevitable. The Manufacturing PMI registered a seventeenth consecutive monthly rise in output in October, mainly attributed to the intermediate goods sector, although the index also showed a fall in the rate of growth relative to the record balances earlier in the year. Purchases of raw materials and other intermediate goods have picked up sharply. October marked the thirteenth successive monthly increase in purchases with stocks rising for the first time since November 2007 as manufacturers act to guard against raw material shortages, supplier delivery delays and expected future price increases. Stocks of finished goods have fallen for the thirtieth successive month, but the speed of de-stocking has continued to slow from the beginning of the year.

The Bank of England's Regional Agents also highlighted the important influence of 'export-led supply chain' demand. But on a more cautionary note, there were growing concerns about the potential impact of government spending cuts, especially in industries supplying the defence and construction sectors.

Employment up by 178,000 in the three months June–August 2010

UK employment levels have grown strongly since the spring as the recovery in output feeds through to the labour market. In the three-months March–May 2010 total employment was 137,000 higher than in the previous three-month period. In June–August 2010 total employment increased by a further 178,000 and is now almost quarter of a million (241,000) higher than in the same period in 2009 (**Figure 2**). As a result, the headline employment rate has improved to 70.7 per cent, 0.4 percentage points higher than in December–February 2010. However, employment still remains below pre-recession rates, which peaked at 73.0 per cent in March–May 2008.

Given that the increase in the household population (over 16 years old) has been fairly stable at about 400,000 per year, the rise in employment has resulted in a lower increase in the numbers of inactive and a fall in the total unemployed. In June–August 2010 total unemployment was 23,000 lower than in the same three months of 2009. The headline unemployment rate of 7.7 per cent in June–August 2010 is now the lowest for over a year (since spring 2009).

Figure 2 Labour market summary

Thousands

Change, three months on same three months one year ago

Source: Labour Force Survey

Figures 3a and 3b show recent changes in employment by sex and age respectively. In the latest three months, total UK employment has increased by 0.6 per cent, which was predominately driven by male employment which grew by 0.9 per cent compared to 0.3 per cent for women. This continues the pattern seen in the previous three-month period, when male employment growth also outstripped female employment growth. As a result, out of the total employment increase of 315,000 since December–February 2010, the majority (247,000) has been accounted for by men.

However, as Figure 3a shows, faster growth in male employment during 2010 followed significantly larger falls during the recession. Between March–May 2008 and December–February 2010, total employment fell by 721,000 (-2.4 per cent), of which 602,000 (-3.8 per cent) was attributed to male employment and 118,000 (-0.9 per cent) to female employment.

Therefore, despite recent stronger growth, male employment is still further below its pre-recession level (-2.2 per cent) than female employment (-0.4 per cent). This partly reflects the pattern of male and female employment across industries, and the differential impact of the recession and recovery on employment across those industries. The concentration of male employment is relatively high in the manufacturing and construction sectors where output fell significantly during the recession, but has since rebounded faster than the rest of the economy. Female employment,

Figure 3a Employment growth: by sex

Percentages

Three months on same three months one year ago

Source: Labour Force Survey

Figure 3b Change in employment: by age

Thousands

Source: Labour Force Survey

on the other hand, is more concentrated in the public services, particularly education and health, where output movements have been less cyclical and employment is relatively more stable.

Changes in employment during the up and down phases of the economic cycle have also been unevenly distributed over the age profile of the workforce (see Figure 3b). The fall in total employment of 721,000 between March–May 2008 and December to February 2010 was especially skewed towards the younger cohorts. Employment of the under–25s fell by 688,000 whilst that of the over–50s actually increased by 112,000.

Falling employment among the younger generations is particularly prominent in terms of employment rates. The employment rate of 16–64 years fell by 2.7 percentage points, compared to 9.5 percentage points for the 16–17 years and 6.5 percentage points for the 18–24 years. The subsequent improvement in the labour market and total employment since spring 2010 has not significantly reversed these falls with youth employment remaining considerably below pre–recession levels and rates.

Total employment of those aged 50–64 increased by 81,000 since March–May 2008. But given the larger rise in the household population of this age group, there was a fall in the employment rate of 0.6 percentage points. Over the same period, total employment of those aged above 65 has increased by 186,000, meaning that the current employment rate of 8.6 per cent is 1.3 percentage points higher than before the recession. This suggests that the impact of the recession on older workers has been relatively mild. Older workers, especially those beyond state retirement age, may be better placed to take advantage of the growth in part–time and temporary opportunities. Those who have been in employment the longest will typically cost more to make redundant. In addition, the Financial Reporting Standards (FRS) 17, concerning the treatment of company pension fund positions on balance sheets, may have reduced the incentive to use early retirement as an alternative to redundancy.

Employment of 25–34 year olds fell modestly in the downturn and has subsequently increased to stand 76,000 higher. Employment of 35–49 year olds fell significantly during the recession, and has shown a further slight fall since then and is now 314,000 lower. However, when looking at employment rates the pattern is reversed. The current employment rate of 25–34 year olds is 78.7 per cent, 3.1 percentage points lower than in March–May 2008. However, for the 35–49 year old age category, the current employment rate of 81.1 per cent is only 1.7 percentage points lower. This reflects changes in the underlying household populations with stronger growth in numbers of 25–34 years olds than in 35–49 year olds.

Increases in part–time and self–employment

An interesting feature of the labour market over the last year has been the rise in numbers of self–employed. Although changes in total employment are dominated by employees, which typically account for 9 out of 10 people in employment (see **Figure 4a**), self–employment has contributed around a third of the increase in the last six months (99,000 out of 315,000 in employment since December–February 2010). Furthermore, during the recession, whilst total employees fell sharply (–739,000), total self–employment actually increased (+40,000) over the same period. Increases in numbers of small and medium enterprises also suggests that many UK workers have reacted to

Figure 4a Changes in employment by full-time, part-time and others¹

Percentages, three months on previous three months

Source: Labour Force Survey

1. Other includes Unpaid family workers and Government supported training and employment programmes

Figure 4b Change in employment: full-time/part-time

Percentages, three months on previous three months

Source: Labour Force Survey

the slowdown in employee opportunities by establishing their own businesses. This has probably been aided by low mortgage interest rates which have supported household cash flows – providing resources for start-ups despite a tightening in credit availability from banks and other monetary and financial institutions.

Employment has also been boosted by growing numbers of part-time workers. In fact, **Figure 4b** shows that almost all the growth in employment over the last six months has been due to part-time employment. Even during the recession, when total employment fell markedly, part-time employment increased. As a result, the share of part-time employment in total employment has risen by 2 percentage points from 25.3 per cent in March–May 2008 to 27.3 per cent in June–August 2010.

The increasing incidence of part-time working has reduced the extent to which employment might have fallen during the downturn. However, the evidence suggests that this has manifested itself in underemployment, where people work fewer hours than they would otherwise like at prevailing wage rates. This is shown in **Figure 5** where the numbers of those who gave the reason for working part-time as being unable to find a full-time position has almost doubled between March–May 2008 (667,000) and June–August 2010 (1.14 million) (up from 9.1 per cent to 14.6 per cent of all part-time workers).

Figure 5 Labour market constraints¹

Thousands

Source: Labour Force Survey

Note

1. Some people may be constrained to both part-time and temporary employment so are included in both time series.

There has also been an increase in the numbers constrained to temporary work – that is those who are working in temporary employment even though they would prefer a permanent position. Between June–August 2008 and June–August 2010 these increased by 236,000 (from 25.7 per cent to 37.8 per cent of the total in temporary employment). The latest services PMI reported that recruitment consultants noticed a decline (for the fourth time in five months) in permanent jobs while temporary/contract employment increased at the fastest rate for three months. The Bank's Regional Agents have reported that private sector employment intentions remained cautious about expanding the labour force – reflected by a rise in temporary rather than permanent recruitment – due to uncertainty over demand prospects and ongoing need to control labour costs.

As it is possible to work part-time in temporary positions it is likely that some of those who report to be constrained to temporary employment will also report being constrained to part-time employment. Therefore adding together the two time series in Figure 5 would most probably overstate the numbers reporting to be constrained in the labour market.

Average and total weekly hours increase

Changes in total hours worked each week can be broken down into the contributions from employment and average hours worked per person. The long-term trend has been for average working hours to gradually fall, reflecting changes in working practices, life-style choices and legislation. For example, average working hours on the eve of the recession in March–May 2008 were 32 hours per week, compared to 33.2 hours ten years earlier. Short-term movements in total hours though have tended to be driven by more pronounced changes in economic activity, as employers find it easier to vary hours than employment.

Figure 6a breaks down recent changes in total weekly hours into employment and average hours contributions. When total hours were increasing prior to the recession the employment contribution was greater with little change in the hours component. However, during the recession period, changes in average hours accounted for a sizeable reduction in total hours.

It is not surprising that adjustments will come through average hours as well as headcounts. In the first instance firms can cut back on overtime, and then if necessary use shorter working hours/weeks or extended shut downs to reduce hours further. It is not costless for firms to change the size of their workforce due to severance payments and the costs of searching for and training new workers. With good profitability coming into the recession and with low interest rates reducing debt servicing costs, firms may have sufficient cash to hoard labour through the recession – thereby reducing the pass through from falling output to employment.

One of the consequences of reducing labour intensity though is to sustain the underlying supply capacity of the economy by retaining workers. This opens up spare capacity, making it possible for firms to increase total hours by working the existing labour force more intensively. Therefore, as the economy recovers businesses might have scope for increasing output through productivity

Figure 6a Changes in hours

Million hours, three months on same three months one year ago

Source: Labour Force Survey

Figure 6b Hours and employment

Millions

Source: Labour Force Survey

* Derived from total weekly hours divided by average weekly hours

\$ Derived by dividing total weekly hours by 32.0

The difference between the two implied time series

gains rather than through higher employment. As seen in Figure 6a, the majority of the increase in total hours in the latest three-month period arose through an increase in average hours.

Reductions in average hours (to a low of 31.2 hours in June–August 2009) may have supported employment numbers through the recession period. **Figure 6b** shows the implied levels of employment if total hours fell by the same amount but average weekly hours were maintained at 32.0. Without the reduction in average hours the level of employment may have been up to 1.3 million lower (in June–August 2009). In the latest three-month period, June–August 2010, average hours were 31.6 hours. If the same number of total hours were worked at the average of 32 hours per week then employment would be 812,500 lower. Of course, these calculations assume that everything else is held even. For example, if average hours were fixed then more adjustment in labour costs may have come through average earnings instead.

Public sector leads the fall in vacancies

Figure 7 shows total vacancies by industry. Clearly vacancies declined rapidly as the economy entered recession, from 697,000 in January–March 2008 to 434,000 in April–June 2010. Over this period there were particularly sharp reductions in the manufacturing (-32,000), distribution (-57,000) and professional, technical and scientific activities (-37,000) industries. Public and other services vacancies though were fairly robust, particularly public services where total vacancies fell by a comparatively modest 4,000 (including small increases in education and health vacancies).

Figure 7 **Vacancies by industry**

Thousands

Source: Vacancy survey

This stands in stark contrast to more recent patterns. In the three months July–September 2010 the total number of vacancies fell by 30,000 relative to the previous three-month period, of which 22,000 were accounted for by the predominantly public services industries (public administration, education, health and social work activities). In fact, this is the second successive three-month period in which vacancies have fallen and this is likely to reflect the build up to the Spending Review, with public sector organisations and government departments taking a cautious approach to new hires. Uncertainty generated by the impact of the Spending Review may also have weighed on private sector decisions to recruit. The services PMI reported that companies were choosing not to replace leavers – and as a result payroll numbers fell between September and October.

Redundancies back at pre-recession rates

The redundancy rate, which is the number of redundancies per 1000 employee jobs, has continued its downward path to 5.8 (143,000 redundancies) in the three months June–August 2010. This compares to 12.0 (304,000 redundancies) in March–May 2009 (**Figure 8**). Redundancies are now back close to their pre-recession rates. Figure 8 also shows the redundancy rates of men and women, clearly highlighting the stronger rise in the redundancy rate for men during the recession concurring with the evidence on employment in Figure 3a.

Figure 8 **Redundancy rate**

Redundancy rate

Source: Labour Market Statistics

Redundancies have fallen as businesses come to the end of reorganisations and efficiency programmes following the recession.

Average house prices fall during the third quarter of 2010

According to an average of the Halifax and Nationwide indices, UK average house prices fell by 2.6 per cent in 2010 Q3 (see **Figure 9**). However, after five successive quarters of increases through 2009 house prices remain marginally ahead of where they were in the third quarter of last year. To a certain extent the fall in house prices reflects a reversal of the factors that led to increases in the second half of last year. Specifically, the supply of new properties to the market has moved ahead of demand, as potential vendors look to test the market following last year's house price increases and the abolition of home information packs. This has been reflected in a number of surveys of the UK housing market.

Figure 9 Number of mortgage approvals and average house prices

Source: Halifax, Nationwide and Bank of England Bankstats

The Nationwide house price index reflects the fact that buyers now have 'a better hand' than sellers. But with interest rates remaining low there is little urgency to sell, so prices may remain high for a while and at the expense of volumes. Demand may remain weak due to low earnings growth and the uncertain impact of the fiscal tightening on disposable incomes. The Halifax house price index also reports that the recent fall reflects the changing balance of demand and supply in the market. Demand has been constrained by weak earnings growth but monetary policy is

expected to remain supportive in the immediate term. Low interest rates have reduced the costs of servicing mortgage debts. Typical mortgage payments that were 48 per cent of average disposable incomes in mid 2007 were around 30 per cent in mid 2010. The RICS *Housing Market Survey* also identifies the increased supply of properties coming on to the market as a drag on prices. New buyer inquiries have stabilised and there was a small increase in stocks of unsold houses per surveyor, so ratios of sales to stock have fallen.

The number of mortgage approvals for house purchases, which is a good indicator of both credit availability and the volume of transactions, remains at depressed levels. Despite a small pick up through 2009 the number of mortgage approvals has remained at less than half of its pre-recession levels. It is difficult to identify the extent to which the fall in mortgage approvals reflects demand versus supply side factors, although both are likely to be at play and adversely affected by the recent dampening in house price growth.

These conclusions were reached in the Bank of England's latest *Trends in Lending* publication. Low numbers of approvals were driven by weaker confidence among potential buyers as house prices started to fall and due to the uncertain impact of the well-publicised government spending cuts. Some potential purchasers were reported to be deferring decisions to proceed on transactions. The Bank's Regional Agents noted the importance of the macroeconomic outlook as well as the ongoing credit restrictions facing first time buyers. Margins on lower loan-to-value mortgages have fallen due to increased competition among lenders to attract more secure (higher collateral) borrowers, but not on the higher loan-to-value mortgages typically required by first time buyers. As first time buyers are an important source of liquidity to the whole market, their continued absence may continue to keep sales volumes at depressed levels. As a consequence of low transactions volumes rental demand has remained strong. Despite this, an increased supply of rental properties and lower mortgage interest costs faced by landlords have kept rents low.

Falling house prices and low mortgage interest rates help affordability

Measures of housing affordability are presented in **Figure 10**. Clearly price-to-earnings ratios have fallen due to the sharp reduction in prices (according to the Halifax house price index average prices fell by 22.5 per cent between August 2007 and April 2009, while the Nationwide Index recorded a fall of 20.6 per cent between October 2007 and February 2009). The Halifax price-earnings ratio of 4.59 in 2010 Q3 though is still above the long-term average of 4.05. The Nationwide measure, which applies specifically to first time buyers (FTB), is also above its long-term average of 3.3 despite the recent fall to 4.5. However, there is no reason to believe that the long-term average is an equilibrium ratio to which prices will return. Other factors such as the cost and availability of credit and factors affecting the supply of housing are also likely to be important determinants of prices over time.

In terms of the ratio of mortgage payments to earnings, affordability remains relatively good. According to the Halifax ratio, mortgage interest payments in 2010 Q3 were 29.7 per cent of average earnings compared to a long-term average of 36.9 per cent. The ratio has kept low following sharp reductions in interest rates in December 2008. For first time buyers relatively good affordability has also been maintained since the end of 2008, with mortgage interest payments at

36 per cent of average earnings in 2010 Q2 according to Nationwide figures. Although this is a significantly lower than in 2007 Q4, when mortgage interest payments were 51.5 per cent of incomes, it is slightly above the long-term average of 33 per cent. Many first time buyers may have purchased property at elevated prices and as a result accumulated a high level of debt, which is why mortgage repayments as a proportion of income have been particularly sensitive to mortgage rates.

Figure 10 **Housing affordability**

Source: Nationwide (first time buyer FTB) and Halifax house price surveys

Low interest rates have been an important factor in supporting household balance sheets, offsetting some of the fall in primary incomes (wages and salaries, self-employment income, gross operating surpluses of the household sector). After accumulating a substantial amount of mortgage debt the UK household sector is a net-debtor in interest bearing assets, meaning that a reduction in interest rates will boost net property incomes. This may also be one factor supporting the labour market, enabling people to work part-time or to fund self-employment.

Mortgage equity injections

Mortgage equity withdrawal (MEW) reflects the change in debt secured on the same level of housing stock. As a proportion of disposable incomes, this peaked at 8.6 per cent in 2003 Q4, but remained significantly positive through the period of rapid UK house price inflation (**Figure 11**).

Equity can be withdrawn from housing by replacing an existing mortgage with a greater one or by taking a mortgage out on a property that previously did not have one. As this could be achieved by remortgaging or through other means of secured borrowing, it might have given the impression that households were extracting larger amounts of equity from the homes to possibly fund household consumption.

Figure 11 Mortgage equity withdrawal

Percentage of post-tax income

Source: Bank of England

However, very little MEW was actually done in this way. Most MEW occurs automatically when houses turnover and the vendor is a last time seller – meaning that they are moving into rented or retirement accommodation or that the house has been inherited. In this case, the seller often has little or no mortgage, but the purchaser is likely to have taken out a mortgage to fund the acquisition. In times of strong house price growth these flows will become larger producing more and more equity withdrawal from property. Rather than being used to fund household consumption the proceeds of equity withdrawal were primarily used to accumulate financial assets.

Therefore, the fall in MEW during 2008 to its current negative level (implying that households are injecting equity into their properties) will partly reflect the fact that in the last two years houses have been turning over at lower prices. In the second quarter of 2010 MEW was -£6.2 billion, implying that households were injecting equity into their properties equal to 2.5 per cent of post-tax income. Negative MEW can also arise from home owners over-paying their mortgages, perhaps looking to take advantage of low interest rates in order to pay down secured debts and to avoid negative equity.

Appetite for consumer credit remains weak

The recession has also seen a large fall in unsecured lending to consumers, a reflection of tighter credit conditions imposed by lenders and a reduced appetite for (relatively expensive) consumer credit from individuals. As a result, net lending has been close to zero since 2009, due to a sharp fall in gross lending and also individuals repaying existing debt. Gross consumer credit lending in August 2010 was 7.5 per cent lower than in the same month two years earlier. The total amount of outstanding consumer debt has therefore been falling in nominal terms, and even faster as a proportion of incomes (see **Figure 12**).

Figure 12 **Consumer credit**

£millions

Source: Bank of England Bankstats

Unlike secured lending, household exposure to consumer credit has been diminishing for several years before the economic downturn. In 2005 many credit providers, experiencing an increase in credit impairments, tightened eligibility and scoring, resulting in a fall in net lending. This continues to be the case. The Bank of England's *Credit Conditions Survey* noted that unsecured net lending to households remained weak for the same two reasons – high effective interest rate spreads and tight credit scoring.

Corporations continue to pay down debts

Net lending to the corporate sector (private non-financial corporations, PNFCs) has also fallen significantly since the onset of financial crisis and subsequent recession. In fact net lending to the PNFC sector turned negative in mid 2009 indicating that firms were paying down debts (see **Figure 13a**). Again it is difficult to identify the relative importance of demand and supply factors but both are likely to have had a negative impact on net lending to PNFCs.

Low business demand for credit partly reflects depressed investment intentions. Faced with an uncertain economic outlook and weak demand, firms have been reluctant to invest in future capacity, and as a result demand for longer-term finance has declined. Uncertainty generated by the impact of the Spending Review has undermined confidence further, as reported by several business surveys, which continue to indicate that weakness of future demand is the main determinant in driving investment intentions.

Firms' cash holdings may also have reduced their dependence on external financing (loans). Profitability going into and during the recession was fairly robust and the large subsequent reduction in interest rates has also reduced debt servicing costs, boosting corporate cash flows. The Bank of England's *Credit Conditions Survey* also finds that firms have supported cash flows through better management of working capital – by strongly running down stocks of inventories and purchases of intermediate goods. Furthermore, there is some evidence that businesses increased capital issuances in the early part of the recession so as to pay down debts and strengthen balance sheets (also shown in Figure 13a).

The Bank of England's Regional Agents have conducted a survey on company cash holdings. They found that the aggregate financial surplus of corporations was high going into the recession and rose further during it. A significant majority of firms had cash holdings above normal, especially the larger firms, and increased cash holdings in the last year. These results applied across all sectors. Cash balances resulted from higher profits and larger cash buffers to protect against uncertainty, for example about demand conditions and credit availability (as companies were less confident that short term financing would be available if they were to experience liquidity problems).

On the supply side, there is little evidence that firms are significantly constrained. Business surveys indicate that weakness of demand has depressed investment intentions. The Bank's Regional Agents report that total investment remains below pre-recession levels, and that it is focussed on the replacement of existing capital and on improving efficiency rather than on boosting capacity. Therefore the availability of credit to finance long-term investments/expansions has been a secondary factor. The CBI *Industrial Trends Survey* in October 2010 found that, although credit availability as a constraint on output has picked up, only 9 per cent of firms indicated that it would limit growth in output. This compares to 71 per cent of firms identifying sales or orders as likely to limit growth.

The Bank of England's October edition of *Trends in Lending* reported that gross lending to businesses had fallen and remains below the level of repayments as businesses look to pay down debt, reduce leverage and improve capital management. Credit availability though was particularly weak for smaller businesses.

Figure 13a Net lending to PNFCs and amounts outstanding

£millions

Source: Bank of England Bankstats

Figure 13b Net lending to PNFCs by sector

£ millions

Source: Bank of England Bankstats

Figure 13b shows the same time series for net lending to PNFCs as in Figure 13a but broken down by the main industrial sectors. This shows that the move to reduce borrowing and pay down debts has been a common activity across all sectors.

Of particular interest has been lending to the real estate sector, comprising loans to companies who develop, buy, sell and rent real estate. Following a period of strong growth, in which the share in the total stock of loans to the PNFC sector rose markedly, the slowdown since the start of the financial crisis has been significant. Lending to the real estate sector has contracted at the fastest rate since the late 1980s in line with the downturn in the residential and commercial property markets. For instance, the RICS *Commercial Market Survey* reports that tenant demand, rental expectations and enquiries for occupation have declined across all sectors, and retail, office and industrial available space has increased. However, the stock of real estate lending as a share of total corporate lending has continued to rise as lending to other sectors has fallen more rapidly. The real estate sector typically relies on loans of a longer maturity. Commercial real estate companies are also more likely to be highly leveraged and less able to reduce their working capital in order to pay down debt. This might also explain the relatively large fall in net borrowing by the manufacturing sector where, PMI, CBI and Regional Agents' surveys indicate that destocking has been important in maintaining working capital.

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