Dear Andrew

At the Treasury Committee’s hearing with members of the Monetary Policy Committee on 11 March, John Mann MP asked for a note on whether there were likely to be regional disparities in the pattern of firm survival and firm creation across the UK as Bank Rate increased.¹

The attached note from Bank of England staff answers that request, and makes three points. First, unemployment and business survey data suggest that the economic expansion has been relatively broadly based across regions. Second, company failure rates have been broadly similar across the UK, while net firm creation has been strongest in London. Third, there is no clear regional pattern in company vulnerability to Bank Rate increases.

The MPC will continue to monitor these and other regional differences. Analysis of regional data, including intelligence from the Bank’s Agency network around the UK, forms an important part of the MPC’s assessment of the economy. In addition MPC members make regular visits around the UK to speak to businesses directly — I have spoken to more than a thousand businesses since I started as Governor, and by the end of my first year in office will have visited all the countries of the UK and regions of England. Understanding regional economic conditions helps the MPC understand developments in, and set monetary policy for, the UK as a whole.

I trust this letter and the attached note addresses the questions raised at the hearing in March.

With best wishes,

[Signature]

¹ For a transcript of the hearing see http://data.parliament.uk/writtenevidence/WrittenEvidence.svc/EvidencePdl/7444. The relevant questions, Q72-81, are included as an annex to this letter.
Annex: Extract from transcript of 11 March Treasury Committee hearing

Q72 John Mann: [...] You talked about companies that will go under and other companies that will begin when answering Mr Garnier. What is the analysis of the Bank over the regional disparity in both of those factors?

Dr Carney: We, through our agency network, do look at regional disparities in activity, in unemployment retail sales and so on. As you are well aware, there are considerable regional disparities in all of those factors, with more challenging times in the north of the country than the south-east.

Q73 John Mann: More trying times in the north, so does that mean that your analysis, your prediction, is that more companies will go under in the north and more companies will start up in London and the south-east? Is that what the Bank's analysis demonstrates?

Dr Carney: In terms of specific start-up versus exit, we do not go down to that level. I would say—it is partly a question though—that part of the reason why there are more challenging times in the north is that there has been some of this adjustment already in the north, more so than in the south-east, and obviously, as you are well aware, we make policy for the United Kingdom as a whole.

Q74 John Mann: How do you know that there is more adjustment in the north if you do not keep that level of detail?

Dr Carney: We have agents. We visit these regions, we talk to people and we look at the aggregate figures, yes.

Q75 John Mann: It would be useful to get a proper paper analysing what the regional disparity is, because you use the term, Governor, “There needs to be more recycling of labour” and I think I would be interested—I am sure the Committee and others would—at what that means, which labour is to be recycled.

Dr Carney: The basic point that I was making is that we have seen less adjustment than we have seen historically in terms of new company formation, old company exit. That process itself adds to productivity, and productivity adds to real wages.

Q76 John Mann: I heard that very clearly. I am asking what the propensity is for companies to go under outside London and the south-east compared to London and the southeast, and what is the propensity for new company start-ups outside London and the south-east compared with London and the south-east. Otherwise we will have lots of companies going under in the north and so on, and lots of companies setting up in London. That creates its own issues, so I want to be clear what you mean. You are eulogising the need for more recycling of labour, but I am unclear.

Dr Carney: My eulogy did not have a regional element.

Q77 John Mann: That is why I am asking the question. So you are saying that a regional element is not important then? Is it important to you, Dr Weale, in terms of your decision-making?

Dr Weale: In my decision-making, what I am doing and always have in mind is what Parliament requires me to do, which is to set policy to keep inflation to target, and subject to that, to support the Government's policies for growth and employment. Regional disparities as well as mismatches between different types of occupation and different types of vacancies are one of the things that we can and do take into account when we try to understand how spare capacity in the labour market can affect or is likely to affect future rates of inflation.
Q78 John Mann: But you have also signed up—not you personally—to forward guidance, and therefore if there is to be a natural adjustment of companies going under as interest rates go up, you have to know as a committee whether there is a greater propensity for that to happen in certain regions, otherwise you are going to have labour market problems. You are going to have unemployment in the north as interest rates go up and you are going to have new companies setting up in London and the south-east, and that is a mismatch.

Dr Weale: One of the features of the increase in employment in the recent past has been a big surge in self-employment. That seems to be associated with an increase in construction output. Those people are self-employed. They are not companies and—

Q79 John Mann: But you have not put interest rates up and the Governor’s point was, in answering Mr Garnier, as interest rates go up, there are companies there that will go under because they are surviving because of the abnormally long level of low interest rates. I am asking is there a disparity in where those companies that will go under are based within the economy, and is there a disparity in where the new companies that set up are likely to be?

Dr Weale: We observe, and—as the Governor mentioned—our agents do give us a sense of, the levels of economic activity in the different parts of the country. What I have not done—and I must say I do not think it will be the key influence on economic development in different parts of the country—is look at differential rates of company failure and company formation.

John Mann: Let me turn to—

Chair: Just one last question, John.

Q80 John Mann: These are important questions, Chair, and I have not even come to Professor Miles yet, who I know we will want to hear from, because Professor Miles has outlined how it would be a good idea to have likely future paths of interest rates. What is the future path of interest rates then over the next five years, in your view?

Professor Miles: I do not know. The honest answer is I do not know. If you had asked me five years ago when I joined the committee where did I think bank rate would be five years down the road—that is now—I was more optimistic about a recovery. I would have said, “Maybe bank rate will be back much more toward a normal level, 2% or 3%”. I would have been spectacularly wrong, because things played out in a worse way than I had thought. So I do not think it makes an awful lot of sense for me to give you a path for interest rates and say, “That is what I fully expect to happen”. I think it is more useful to say what will be the drivers of the decision on the bank rate.

Q81 John Mann: But you have called for that, so you are reluctant to give it. Sorry, I am being pressed, so one final question. I will come back to you, Governor, and it is a concern that I have raised before with you, but I now find that the Bank for International Settlements is making a similar concern to the one I have. They say that one of the worrying developments would be if central banks were so concerned about reaction that they delayed raising rates. Is there any danger that you will want to see a delay in raising rates until after the election so that we have a rise in interest rates after the election rather than before? Would it be possible to get some written analysis of the regional disparities I referred to earlier, on whether they exist?

Dr Carney: We are happy to do the latter, granted some time to respond to that. There is absolutely no danger of my vote or anyone on the committee’s vote, in my opinion, being influenced by any political timing.
REGIONAL VARIATION IN COMPANIES’ VULNERABILITY TO BANK RATE INCREASES

Summary

- The UK’s economic expansion appears to be relatively broadly based across regions.

- Company failure rates have been broadly similar across the UK while net firm creation has been strongest in London.

- There is no clear regional pattern in company vulnerability to any increase in Bank Rate.

The UK’s economic expansion appears to be broadly based across regions

1. The economic recovery that began to gather pace in 2013 has been accompanied by a fall in unemployment across all regions of the UK (Table 1). That fall has been most pronounced in the West Midlands, Wales and London, but all other regions have seen unemployment fall by around 2pp. The recent strength of the UK labour market is not concentrated. However, unemployment rates in the North of England and Northern Ireland are further above their pre-crisis averages than elsewhere, reflecting the depth of the recession in those parts of the UK.

2. Official measures of economic activity on a regional basis are published only with a considerable lag. Regional PMI survey data are available on a more timely basis and, like regional unemployment data, suggest the recent expansion has been broad-based across regions (Chart 1).

Table 1    Unemployment rates across the UK

<table>
<thead>
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<th>Region</th>
<th>2002-07 average</th>
<th>Recession peak</th>
<th>Feb to Apr 2014</th>
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<tr>
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<td>6.4</td>
<td>12.0</td>
<td>9.8</td>
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<tr>
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<td>9.6</td>
<td>7.6</td>
</tr>
<tr>
<td>Yorks &amp; Humber</td>
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<td>10.2</td>
<td>8.2</td>
</tr>
<tr>
<td>East Midlands</td>
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<td>8.3</td>
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<tr>
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<tr>
<td>East of England</td>
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</tr>
<tr>
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<td>4.8</td>
</tr>
<tr>
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</tr>
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<tr>
<td>Northern Ireland</td>
<td>4.9</td>
<td>8.5</td>
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</tr>
</tbody>
</table>

Source: ONS

Chart 1    Strengthening in activity is broad-based across regions

Source: Markit Economics (data collected on behalf of Lloyds Bank Commercial Banking) and Bank calculations
Company failure rates are similar across the UK, firm creation strongest in London

3 Chart 2 shows that firm failure rates (i.e. the percentage of firms failing in a given year) have been broadly similar across the UK. Failure rates have historically been smallest in Northern Ireland and Scotland and highest in London and, although the failure rate in Northern Ireland increased the most during the recession, it still remains below that of other parts of the UK. Chart 3 shows that, in each part of the UK, a broadly similar proportion of firms born just before the financial crisis were still in operation in 2012.

![Chart 2: Company failure rates](image1)

![Chart 3: Company survival across the UK](image2)

Source: ONS

4 Firm failure is only half of the picture. As some firms exit the market, other firms are formed. Chart 4 shows the firm creation rate net of the firm failure rate. This chart shows that net firm creation in London recovered robustly from the crisis, while in most other parts of the UK as many firms are being created as are failing. The exception is Northern Ireland, which has experienced a persistent decline in the number of active businesses.

![Chart 4: Net growth in the number of firms across the UK](image3)

Source: ONS
There is no clear regional pattern in company vulnerability to Bank Rate increases

5 The distribution of corporate sector debt will be a key influence on the regional variation in the impact of changes in Bank Rate on corporate cashflows. It will also depend on the characteristics of that debt, for instance whether it is at a variable or fixed interest rate, and if fixed, the remaining duration of that fix. Charts 5 and 6 focus on SMEs, since they are more likely to be concentrated in one particular region. They show that while the most SME debt is held in London and the South East, reflecting the number of companies there, debt relative to turnover is highest in the South West and Wales.

6 Data from three surveys of corporates can also help in gauging how the impact of changes in Bank Rate may vary across the UK.

7 The first is a survey by R3, an association of insolvency practitioners, which considers different aspects of corporate distress, as shown in Chart 7. According to this survey, the greatest proportion of firms that are at present paying only the interest on debt is in the London region. However, were interest rates to rise by a small amount, the proportion of firms that would have difficulty in repaying debts is around 10% not just in London, but also in Scotland, the South East and the East Midlands.

Source: BBA and Bank calculations

Sources: BBA, BIS and Bank calculations

Source: R3, November 2013
Second, the Bank of England conducted a survey of banks’ SME relationship managers in 2013 Q1 as part of a study on forbearance. Relationship managers were asked to judge what proportion of their client SMEs would be more likely than not to default in the next twelve months if the firm’s interest rate were to increase by a given number of basis points. On this metric, the Midlands, North West and Wales would seem most sensitive to an increase of 100 basis points (Chart 8). This survey referred to an interest rate rise in 2013 Q1 which would have represented a potentially large, sudden rise at a time when the economy still appeared weak. It did not ask about the response to an increase in interest rates at a point when overall economic performance was materially improving.

Third, the consultancy Begbies Traynor produces a ‘Red Flag Alert’ which it describes as monitoring the financial health of corporate UK. The most recent report shows that the number of firms with a ‘red flag’, a sign of current corporate distress, is highest in the South East both in absolute terms and as a proportion of companies in the region (Charts 9 and 10). Even in the South East only a very small proportion of firms are recorded as showing signs of distress.

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2 Red Flag Alert put together company warning indicators (red flags) that are triggered through various events, such as when a firm reports a loss, receives a county court judgement or when a director resigns. The latest report can be found here: http://www.begbies-traynorgroup.com/default/news/14-04-16/recovery_firmly_established_as_financial_distress_levels_reduce_year_on_year_but_q1_bites_back.aspx