ARBUTHNOT BANKING GROUP PLC

PERSPECTIVES

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Growth hampered by supply problems as inflationary concerns intensify

11th October 2021

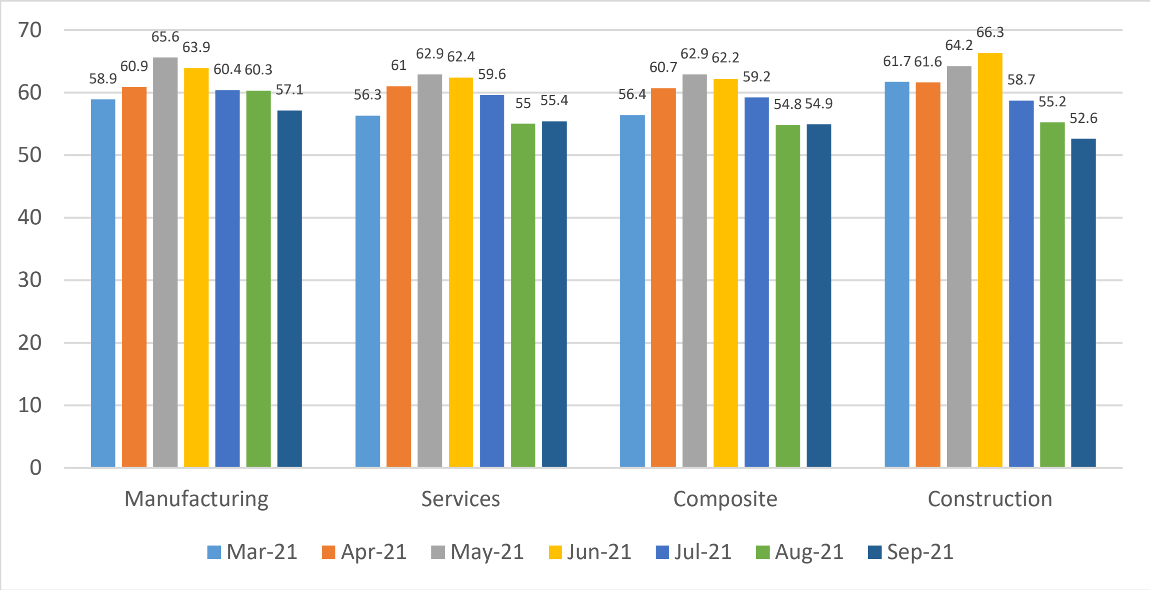
Introduction: Markit surveys report supply problems

Markit surveys for September suggested that growth continued in all three sectors, despite significant supply problems. Manufacturing and construction were weaker, though services industries were, perhaps surprisingly, a tad stronger (chart 1). The surveys indicated that inflationary pressures remained a concern, though respondents in all three sectors remained optimistic.

For the record, the results of the September survey were:

- The Manufacturing PMI slipped further in September to 57.1, after August's 60.3, though it was still well above the 50.0 no-change value.[1] Supply chain delays, slower new order growth and rising material and labour shortages all constrained the UK manufacturing sector in September. Input costs and selling prices continued to "surge higher". However, manufacturers maintained a positive outlook for the year ahead. The confident outlook was attributed to recoveries in both domestic and global markets, reduced difficulties from supply chains, COVID-19 and Brexit and planned new product launches.
- The Services PMI Business Activity Index firmed slightly to 55.4 in September, after August's 55.0.[2] Even though the September data indicated further recovery in UK service sector activity, there were severe supply constraints, which contributed to escalating inflationary pressures, and the slowest rise in new orders since the end of the winter lockdown. Rapid rises in fuel, energy and staff costs were passed on to customers in September. Business optimism eased slightly since August but the majority of panel members (57%) expected a rise in output during the year ahead, while only 8% forecast a fall.
- The seasonally adjusted UK Composite Output Index was 54.9 in September, fractionally above August's 54.8.[3] The Composite Output Index is a weighted average of the UK Manufacturing Output Index (not the PMI) and the UK Services Business Activity Index (PMI). Slower manufacturing production growth was the key factor holding back the UK economy in September (index at 52.7, down from 54.1 in August). The latest increase in manufacturing output was the weakest since February, largely due to severe supply chain difficulties at home and abroad. Service sector growth has now outpaced the manufacturing recovery for four months in a row.
- The Construction Total Activity Index fell to 52.6 in September, after August's 55.2, indicating another growth slowdown.[4] The slowdown was linked to a combination of supply chain issues and softer demand. Around 78% of the survey panel reported a rise in their cost burdens, which was mostly linked to supply shortages and transport surcharges. Nevertheless, construction firms remained upbeat about the business outlook.

Chart 1 UK Markit/CIPS PMIs, March-September 2021



Sources: (i) Markit releases for manufacturing, services and construction PMIs for September 2021; (ii) previous releases for previous data.

The Bank's new Chief Economist voices concerns about inflation…

In written evidence to the Treasury Select Committee (TSC) Huw Pill, the Bank's new Chief Economist, sounded a cautious note, conceding that the inflationary outlook had deteriorated since August. Against a background of high oil and gas prices, he said:[5]

- "Much of the recent rise in UK inflation stems from developments imported goods prices that reflect these dynamics, as well as rises in international commodity prices. As the pandemic recedes and the level and composition of global demand and supply normalise, these inflationary pressures should subside. But the magnitude and duration of the transient inflation spike is proving greater than expected".
- "Taking the August MPR as the benchmark, over recent months inflation has surprised to the upside, UK activity data have disappointed somewhat, while the labour market has tightened. This combination has all the hallmarks of an adverse supply shock, centred on mismatches in the labour market. Supply problems within the UK owe to the 'pingdemic' and shortages of specific skills (such as HGV drivers). Moreover, the rise in wholesale gas prices threatens to raise retail energy costs next year, sustaining CPI inflation rates above 4% into 2022Q2.
- "In my view, [the] balance of risks is currently shifting towards great concerns about the inflation outlook, as the current strength of inflation looks set to prove more long lasting than originally anticipated".

For the record, in August the MPC minutes noted that CPI inflation was projected to rise temporarily in the near term, to 4% in 2021Q4, before falling back to target.[6-7] This view was, however, modified in September, when CPI inflation was expected to rise further in the near term, to slightly above 4% in 2021Q4, owing largely to developments in energy and goods prices.[8-9] The MPC also noted in September that the increase in wholesale gas prices since the August Report represented an upside risk to the MPC's inflation projection from April 2022.

Suffice to say, Huw Pill's view that the balance of risks shifting towards "great concerns about the inflation outlook" reinforced expectations the Bank will raise interest rates in the near future, with markets pricing in a rise before end-2021.[10] Moreover, hawkish MPC member Michael Saunders said in a recent newspaper interview that households must brace for "significantly earlier" interest rate rises as the Bank prepares to head off rising inflation, adding that financial markets were right to bet on faster increases.[11] He even hinted that rates could rise this year, saying "…markets have priced in over the last few months an earlier rise in Bank Rate than previously and I think that's appropriate. The February [2022] one is fully priced in and for December, it's half priced in". Despite surging gas prices, Mr Saunders said widespread labour shortages posed a bigger risk to inflation by feeding into higher pay demands. He noted that "…the best way, really the only way, to achieve a sustained rise in real wages is higher productivity growth." And he added, "…the concern is that, with a tight labour market and inflation expectations having picked up a bit, you might get pay growth creeping above a rate which is consistent with the inflation target, without the accompanying productivity growth."

…whilst the IMF believes inflation expectations remain anchored

The IMF released the inflation chapter from the October *World Economic Outlook* last week (6 October), ahead of the release of the full report (12 October, which will be covered in next week's Perspective).[12]

The IMF said "despite recent increases in headline inflation in both advanced and emerging market economies, long-term inflation expectations remain anchored. Looking ahead, headline inflation is projected to peak in the final months of 2021 but is expected to return to pre-pandemic levels by mid-2022 for most economies. But given the recovery's uncharted nature, considerable uncertainty remains, and inflation could exceed forecasts for a variety of reasons. Clear communication, combined with appropriate monetary and fiscal policies, can help prevent "inflation scares" from unhinging inflation expectations."

The IMF's baseline forecasts for advanced economies showed headline inflation peaking at 3.6% in Autumn 2021 and declining to about 2% by mid-2022.[13] They said that headline inflation had recently been driven by pent-up demand and accumulated savings fuelled by fiscal and monetary stimulus; rapidly rising commodity prices; and input shortages and supply chain disruptions. In addition to the baseline projection, the IMF ran simulations to include prolonged supply disruptions in certain sectors and large swings in commodity prices that could keep headline inflation "significantly higher than the baseline". Adding in a temporary de-anchoring of inflation expectations, this simulation showed "even higher, more persistent and volatile inflation", thereby acknowledging that the baseline forecast may prove to be over-optimistic.

Gas prices rise…

Rocketing gas prices have been much in the news, with wholesale prices reaching record highs last week, though they did fall back after President Putin said Russia would boost gas supplies to Europe and stood ready to stabilise the market.[14-17] Nevertheless, they remain remarkably high. UK natural gas futures were over 220p/therm on 8 October compared with 40p/therm in March 2021.[18] Prices have risen reflecting a boost to demand from global economic recovery, compounded by countries building up stocks ahead of winter, whilst it has been reported that Russia has been constraining supply.[19-20]

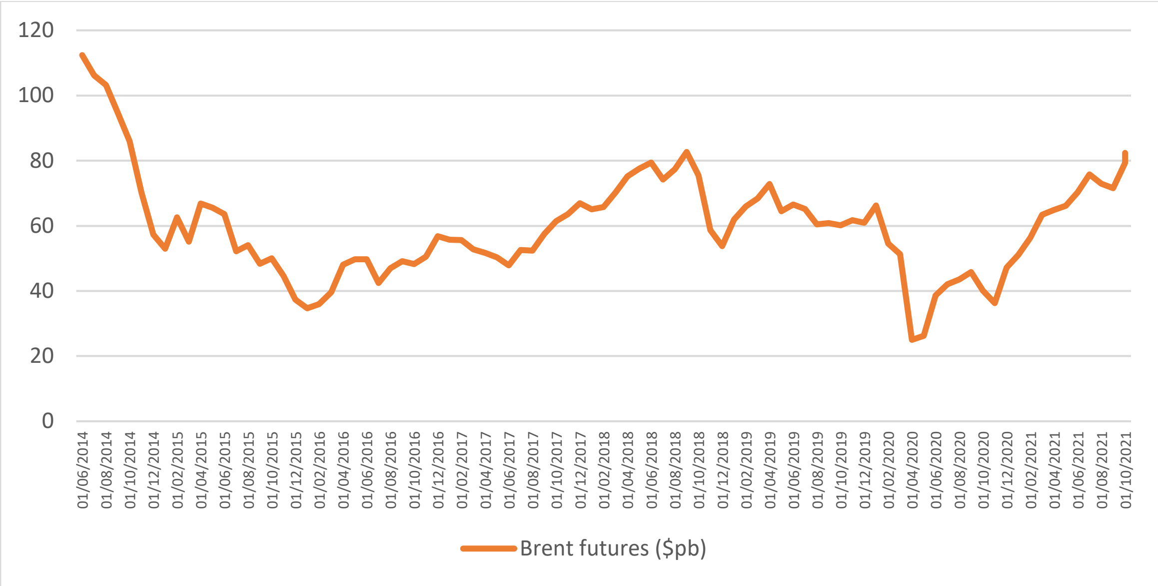
Concerning households, Ofgem's price cap increased by 12% on 1 October, reflecting the higher energy prices, and is expected to rise again (probably sigifncantly) in April 2022.[21-22] (The price cap limits how much energy providers can charge per unit, though it does not apply to all consumers.) Suffice to say, this has direct implications for the Bank's CPI target. Concerning businesses, where there is no price cap operating, the recent increases in energy prices are proving especially problematic for energy intensive users (including those in steel, chemicals, fertilisers, paper, glass, cement and ceramics).[23]

…and oil prices rise

Oil prices have firmed significantly since mid-August, triggered by activity around the world rebounding as economies work to get back on track after the lifting of lockdown restrictions (chart 2).[24] Prices were given another boost after OPEC announced on 4 October (after their 21st OPEC and non-OPEC ministerial meeting) that they would not increasing output above and beyond the decisions made at their 19th meeting (18 July).[25] Specifically, OPEC+ announced in July that they would increase their overall production by 0.4mbd on a monthly basis, starting August 2021.[26] Moreover, they aim to fully phase out the production cuts ("adjustments", introduced in 2020) by the end of September 2022, subject to market conditions.

Specifically, the note of the 21st meeting "…reconfirmed the production adjustment plan and the monthly production adjustment mechanism approved at the 19th OPEC and non-OPEC ministerial meeting and the decision to adjust upward the monthly overall production by 0.4mbd for the month of November 2021."[27]

Chart 2 Brent oil futures, $ per barrel ($pb), monthly prices (1st of month, or nearest), 1 June 2014-1 October 2021, & 8 October 2021



Sources: Brent crude historical prices, www.uk.investing.com; BBC website 1 January-1 October 2021 and 8 October 2021.

Output per hour improved a tad in 2021Q2…

The ONS has released its revised productivity estimates for 2021Q2 (table 1 and annex table 1 for the data tracker).[28] There are two main whole economy indicators: output per hour and output per worker.

Firstly, output per hour (considered to be the main measure of labour productivity, "productivity hours"), rose by 0.1% (QOQ) in 2021Q2, as gross value added (GVA) rose marginally more than total hours worked rose. Total hours worked increased by 5.4% (QOQ) whilst GVA increased by 5.5% (QOQ, revised) in 2021Q2, as lockdown restrictions were eased. The YOY rise was 4.3%, as hours worked increased 18.5% whilst GVA increased by 23.6%, though this comparison is with the low-point of productivity during the pandemic's initial economic effects. Output per hour was 1.7% above the level of pre-pandemic 2019 (average).

The ONS noted that most industries showed strong growth in both GVA and hours worked in 2021Q2, compared with the previous quarter (QOQ). In non-financial services, GVA grew faster than hours worked, lifting whole economy output per hour worked. However, this productivity gain was partially offset by other industries including construction and manufacturing, where hours worked grew a little faster than GVA. The ONS also noted that, as the economy opened further in 2021Q2, economic activity increased more in low-productivity industries than in high-productivity industries compared with the previous quarter. With lower-productivity industries now accounting for a greater share of economic activity, growth in UK economy productivity was lower than it would otherwise have been. Nevertheless, UK productivity in 2021Q2 remained above pre-coronavirus (2019 average, by 1.7%, as noted above) levels because less productive industries still represented a smaller share of the economy than they did before the coronavirus pandemic.

Secondly, output per worker rose by 5.2% (QOQ) in 2021Q2, as employment (workers) picked up by 0.3%, but GVA rose by 5.5%. The YOY rise was 24.8%, reflecting a 1.0% fall in employment whilst GVA increased by 23.6%. Note that these data are distorted by the existence of furloughed workers, who had remained "employed" whist working zero or reduced hours. The ONS commented "…as the number of workers on furlough falls, output per hour worked and output per worker estimates are converging". Output per worker was still 1.6% below the level of pre-pandemic 2019 (average).

Table 1 Productivity measures, growth, 2021Q2

	QOQ	YOY	Compared with 2019
Output per hour	0.1%	4.3%	1.7%
Output per worker	5.2%	24.8%	-1.6%
Constituent data:			
GVA	5.5%	23.6%	…
Hours worked (total)	5.4%	18.5%	…
Employment (workers)	0.3%	-1.0%	…

Sources: (i) *ONS*, "UK productivity overview, UK, 2021Q2", 7 October 2021; (ii) *ONS*, "GDP quarterly national accounts, UK: 2021Q2", 30 September 2021. The data for hours worked and employment (workers) are from the productivity press release (table 8).

…and other UK indicators

Other indicators released last week showed a mixed picture. Firstly, the SMMT reported that September's new car registrations were 34.3% (YOY) lower, the weakest September since 1998 before the twice-a-year number plate system was introduced.[29-30] The SMMT noted that "…September is typically the second busiest month of the year for the industry, but with the ongoing shortage of semiconductors impacting vehicle availability, the 2021 performance was down some 44.7% on the pre-pandemic ten-year average". It also noted that September 2020 was adversely affected by pandemic restrictions "…significantly curtailing economic activity".

Secondly, the Halifax reported that the average UK house price picked up by 1.7% (MOM) in September, the strongest since February 2007, whilst the annual growth rate was 7.4% (after in August's 7.2%).[31] The Halifax commented that "…while the end of the stamp duty holiday in England…may have played some part in these figures, it's important to remember that most mortgages agreed in September would not have completed before the tax break expired. This shows that multiple factors have played a significant role in house price developments during the pandemic. The 'race-for-space' as people changed their preferences and lifestyle choices undoubtedly had a major impact." Concerning the outlook, they noted "…against a backdrop of rising pressures on the cost of living and impending increases in taxes, demand might be expected to soften in the months ahead. Nevertheless, low borrowing costs and improving labour market prospects for those already in employment are likely to continue to provide support. Perhaps the biggest factor in determining the future of house prices remains the limited supply of available properties". For the record, the SDLT nil rate threshold (for England and Northern Ireland) was reduced from £500,000 to £250,000 on 1 July and reverted to £125,000 on 1 October. The tax holiday ended on 31 March 2021 in Scotland and on 30 June 2021 in Wales.

In comparison, the Nationwide reported last week that house prices rose by just 0.1% (MOM, seasonally adjusted) in September to be 10.0% higher YOY, after August's annual growth of 11.0%.[32-33] Additionally, they noted that prices were around 13% higher than when the pandemic began.

Thirdly, the Insolvency Service reported that the number of firms planning redundancies in September was 13,836 (almost the lowest on record), down from 81,670 a year earlier (September 2020), and close to the figure of 12,687 in August 2021.[34-35] This suggests that the fears of mass job cuts as the furlough scheme closed (on 30 September) have not, so far, materialised. Employers must tell the Insolvency Service at least 30 days before making more than 20-99 redundancies, and at least 45 days before making 100+ redundancies.[36] The data, therefore, do not capture small employers.

The Bank: financial stability in focus

The Bank recently released a report, *Financial Stability in Focus*, which examined specific issues relating to financial stability and setting out the views of the Financial Policy Committee (FPC) on these issues.[37] The report concluded that the UK banking system was strong enough to continue to support households and businesses through the economic recovery. Moreover, they noted that major UK banks and building societies had been resilient to the challenges posed by Covid, and their capital and liquidity positions remained strong.

In addition, they said:

- The FPC judged that UK corporate debt vulnerabilities had increased [only] moderately over the Covid pandemic so far, with the increase in debt concentrated in some sectors and types of businesses, in particular, in SMEs.
- The FPC judged there was evidence that risk-taking remained elevated in a number of markets relative to historic levels. And they warned "…asset valuations could correct sharply if, for example, market participants re-evaluate the prospects for growth, inflation or interest rates. This could have consequences for market functioning and financial conditions, and hence the real economy".[38]
- The FPC also warned that "…risks in leveraged loan markets globally continued to build. There are signs of continued loosening in underwriting standards and increased risk-taking in some investment banking businesses. These risks can affect UK financial stability through the direct impact on banks and the indirect impact of losses spreading through other parts of the global financial system". They added, however, that "…the core UK banking system is resilient to direct losses associated with leveraged lending".

US update

The US Senate approved legislation on 7 October to temporarily raise the federal government's debt limit (debt ceiling) by $480bn from $28.4tn in order to avoid the risk of default in mid-October.[39] The bill will go to the House of Representatives (where it is expected to be approved) before going to the President for sign-off. The US Treasury estimated that the increase in the debt ceiling would be adequate to cover borrowings until 3 December.

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17. *Daily Telegraph*, "Putin vows to lift supply after gas prices soar", 7 October 2021.
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39. *Reuters*, “US Senate approves temporary lift of debt ceiling, averts default”, 8 October 2021.

Table 1 UK economic data tracker

Date	Release	Source	Quarter, year	Outcome
10 Sep	GDP, monthly (Jul)	ONS	2021Q3	GDP: 0.1% (MOM)
10 Sep	GDP, industrial breakdown (Jul):	ONS	2021Q3	
10 Sep	• Services	ONS	2021Q3	Flat (MOM)
10 Sep	• Production	ONS	2021Q3	+1.2% (MOM); manufacturing: flat (MOM)
10 Sep	• Construction	ONS	2021Q3	-1.6% (MOM)
10 Sep	Total trade in goods & services (Jul):	ONS	2021Q3	
10 Sep	• Goods	ONS	2021Q3	Deficit: £12.7bn (Jul), £12.0bn (Jun)
10 Sep	• Services	ONS	2021Q3	Surplus: £9.6bn (Jul), £9.5bn (Jun)
10 Sep	• Goods & services	ONS	2021Q3	Deficit: £3.1bn (Jul), £2.5bn (Jun)
14 Sep	PAYE payroll employees (Aug)	ONS	2021Q3	+241,000 (MOM, Aug) to 29.1mn
14 Sep	Employment (3 months to Jul)	ONS	2021Q3	+183k (QOQ, -202k (YOY)
14 Sep	Employment rate (3 months to Jul)	ONS	2021Q3	75.2%, +0.5pp (QOQ), -0.4pp (YOY)
14 Sep	Total weekly hours worked (3 months to Jul)	ONS	2021Q3	1,006.8mn, +43.2mn (QOQ), -45.4mn (3 months to Feb 2020)
14 Sep	Unemployment (3 months to Jul)	ONS	2021Q3	-86k (QOQ), +81k (YOY)
14 Sep	Unemployment rate (3 months to Jul)	ONS	2021Q3	4.6%, -0.3pp (QOQ), +0.3pp (YOY)
14 Sep	Redundancies (3 months to Jul)	ONS	2021Q3	94k, -15k (QOQ), -62k (YOY)
14 Sep	Vacancies (3 months to Aug)	ONS	2021Q3	Total vacancies: 1,034k, +269k (QOQ). Record levels.
14 Sep	Pay (3 months to Jul):	ONS	2021Q3	
14 Sep	• Total pay (inc. bonuses)	ONS	2021Q3	Nominal: 8.3% (YOY); Real: 6.0% (YOY)
14 Sep	• Regular pay (exc. bonuses)	ONS	2021Q3	Nominal: 6.8% (YOY); Real: 4.5% (YOY)
15 Sep	CPI (Aug)	ONS	2021Q3	YOY inflation: 3.2% (Aug), 2.0% (July)
15 Sep	CPIH (Aug)	ONS	2021Q3	YOY inflation: 3.0% (Aug), 2.1% (July)
15 Sep	PPI (output) (Aug)	ONS	2021Q3	YOY inflation: 5.9% (Aug), 5.1% (July)
15 Sep	PPI (input) (Aug)	ONS	2021Q3	YOY inflation: 11.0% (Aug), 10.4% (July)
15 Sep	Sterling effective exchange rate index (EERI) (Aug)	ONS	2021Q3	+0.1% (MOM), +5.0% (YOY)
15 Sep	Crude oil prices (Aug)	ONS	2021Q3	-3.8% (MOM), +49.6% (YOY)
15 Sep	House prices (Jul, official)	ONS	2021Q3	YOY growth: 8.0% (July), 13.1% (June)
15 Sep	House prices (Jul, official)	ONS	2021Q3	-3.7% (MOM, non-seasonally adjusted), -4.4% (MOM, seasonally adjusted)

17 Sep	Retail sales (Aug)	ONS	2021Q3	Volume: -0.9% (MOM), flat (YOY)
17 Sep	Retail sales (3 months to Aug)	ONS	2021Q3	Volume: +0.3% (QOQ), +4.0% (YOY)
17 Sep	Retail sales, online sales proportion (Aug)	ONS	2021Q3	Online sales/total: 27.7% (Aug), 27.1% (July)
21 Sep	Public Sector Net Borrowing (PSNB) (Aug)	ONS	2021Q3	£20.5bn (Aug), compared with £26.1bn (Aug 2020)
21 Sep	PSNB, FY2021 cumulative (5 months to Aug)	ONS	2021Q3	£93.8bn (FY2021), compared with £182.7bn (FY2020)
21 Sep	Public sector net debt (PSND) (end-Aug)	ONS	2021Q3	£2,202.9bn (end-Aug 2021, 97.6% of GDP), compared with £2,018.7bn (end-Aug 2020, 96.0% of GDP)
21 Sep	Public sector debt interest: revenue ratio (DIR) (Aug)	ONS	2021Q3	4.0% (12-months to Aug 2021)
23 Sep	Flash composite output index (Sep)	Markit-CIPS	2021Q3	Index: 54.1 (Sep), 54.8 (Aug). COI comprises services business activity index & manufacturing output index
29 Sep	Unsecured credit (Aug)	BoE	2021Q3	Growth rate (YOY): -2.4% (Aug), -2.6% (July)
29 Sep	Net mortgage borrowing (Aug)	BoE	2021Q3	Monthly change: £5.3bn (Aug)
29 Sep	Mortgage approvals for house purchase (Aug)	BoE	2021Q3	74,500 (Aug), 75,000 (July)
29 Sep	Net bank lending to non-financial businesses (Aug), of which:	BoE	2021Q3	These data include the public sector.
29 Sep	• SMEs	BoE	2021Q3	Growth rate (YOY): 1.4% (Aug), 2.9% (July)
29 Sep	• Large businesses	BoE	2021Q3	Growth rate (YOY): -3.8% (Aug), -2.7% (July)
29 Sep	Sterling money (M4ex) (Aug)	BoE	2021Q3	Growth rate (YOY): 8.2% (Aug), 7.9% (July)
30 Sep	GDP (2021Q2)	ONS	2021Q2	GDP: 5.5% (QOQ), 24.1%, 23.6% (YOY), -3.3% compared with 2019Q4.
30 Sep	GDP, industrial breakdown (2021Q2):	ONS	2021Q2	
30 Sep	• Services	ONS	2021Q2	6.5% (QOQ), 22.9% (YOY)
30 Sep	• Production	ONS	2021Q2	0.5% (QOQ), 20.6% (YOY). Manufacturing: 1.8% (QOQ)
30 Sep	• Construction	ONS	2021Q2	3.8% (QOQ), 57.3% (YOY).
30 Sep	GDP, expenditure breakdown (2021Q2):	ONS	2021Q2	
30 Sep	• Household consumption	ONS	2021Q2	7.2% (QOQ)
30 Sep	• Govt consumption	ONS	2021Q2	8.1% (QOQ)
30 Sep	• GFCF	ONS	2021Q2	0.8% (QOQ); business investment: 4.5% (QOQ)
30 Sep	• External trade	ONS	2021Q2	Exports: 6.2% (QOQ), imports 2.4%(QOQ), positive external trade contribution (volume)
30 Sep	Households' saving ratio	ONS	2021Q2	11.7% (2021Q2), 18.4% (2021Q1)
30 Sep	Current Account, Balance of Payments (2021Q2):	ONS	2021Q2	Balance: -£8.6bn (2021Q2), -£8.8bn (2021Q1)
30 Sep	• Goods, including precious metals	ONS	2021Q2	Deficit: £32.6bn (2021Q2), £38.8bn (2021Q1)
30 Sep	• Services	ONS	2021Q2	Surplus: £33.3bn (2021Q2), £34.6bn (2021Q1)
30 Sep	• Goods & services	ONS	2021Q2	Deficit: £0.7bn (2021Q2), -£4.1bn

				(2021Q1)
30 Sep	• Primary income balance	ONS	2021Q2	Balance: -£5.5bn (2021Q2), -£1.1bn (2021Q1)
30 Sep	• Secondary income balance	ONS	2021Q2	Balance: -£3.8bn (2021Q2), -£3.6bn (2021Q1)
1 Oct	Manufacturing PMI (Sep)	Markit	2021Q3	Index: 57.1 (Sep), 60.3 (Aug)
5 Oct	Services PMI (Sep)	Markit	2021Q3	Index: 55.4 (Sep), 55.0 (Aug)
5 Oct	Composite PMI (Sep)	Markit	2021Q3	Index: 54.9 (Sep), 54.8 (Aug). Weighted average of services PMI & manufacturing output index.
6 Oct	Construction PMI (Sep)	Markit	2021Q3	Index: 52.6 (Sep), 55.2 (Aug)
7 Oct	Productivity (output per hour), 2021Q2	ONS	2021Q2	0.1% (QOQ), 4.3% (YOY)
7 Oct	Productivity (output per worker), 2021Q2	ONS	2021Q2	5.2% (QOQ), 24.8% (YOY)