ARBUTHNOT BANKING GROUP PLC

PERSPECTIVES

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The recovery continues, though growth moderates

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Introduction: the recovery continues…

Few UK economic indicators were released last week, though the Markit "flash" indices for August were of interest. The UK Composite Output Index slipped to 55.3 in August, after July's 59.2, suggesting that the recovery was slowing (chart 1). According to Markit, the index "…signalled the slowest expansion of output since the UK private sector returned to growth in March".[1-2] And Chris Williamson, Markit's Chief Business Economist, said "…although the PMI indicates that the economy continues to expand at a pace slightly above the pre-pandemic average, there are clear signs of the recovery losing momentum in 2021Q3 after a buoyant 2021Q2. Despite COVID-19 containment measures easing to the lowest since the pandemic began, rising virus case numbers are deterring many forms of spending, notably by consumers, and have hit growth via worsening staff and supply shortages."

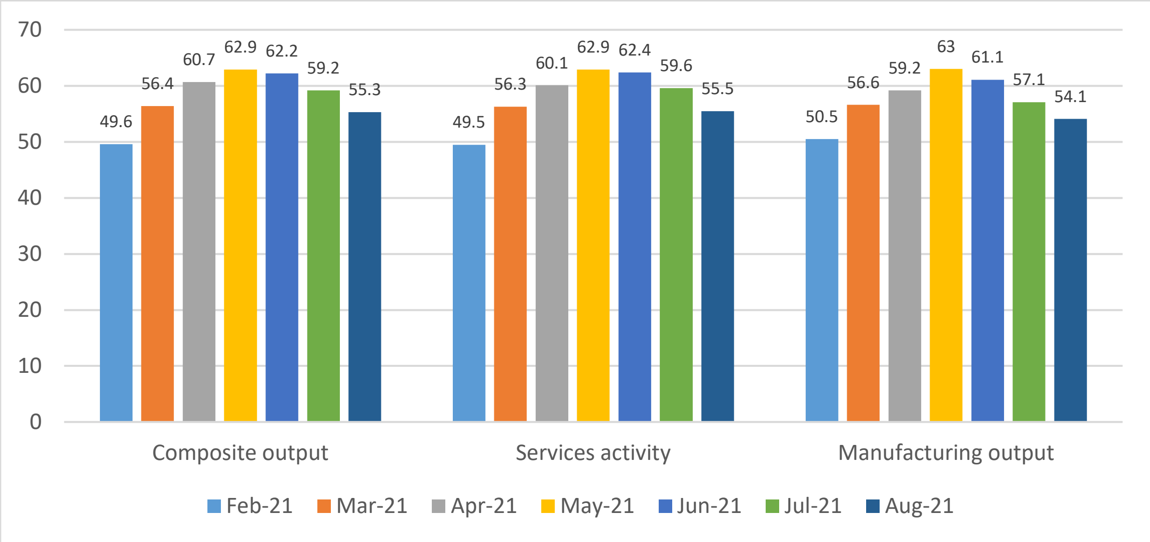
It is, however, important to emphasise that the economy continues to recover and, after notching up GDP growth of 4.8% (QOQ) in 2021Q2, some growth moderation could be expected for 2021Q3. In addition, specific problems were reported relating to staff and materials shortages (vacancies are at record levels).[3-4] Concerning labour shortages, the minutes of the MPC's August meeting noted "…there appear to have been difficulties in matching available jobs and workers. These frictions are for a period reducing effective supply in the economy. Overall, the MPC judges that spare capacity has been eroded over the past couple of quarters, as demand has outstripped growth in effective supply. Frictions in the labour market are judged likely to dissipate over the forecast period, boosting growth in effective supply capacity".[5-6] The MPC also warned of the "…uncertainty around these judgements, including how the economy will adjust to the end of the furlough scheme." Markit's August data were also likely to be adversely affected by "pingdemic", but the relaxation on 16 August of the self-isolation requirements of those contacted by Test and Trace should subsequently have alleviated the business problems caused by the "pingdemic".

Concerning the component indices, and for the record:

- The Markit/CIPS flash UK Services Business Activity Index was 55.5 in August, after July's 59.6. Despite a slowdown in output growth during August, service providers signalled a robust and accelerated rise in employment numbers. Improving optimism towards the year ahead business outlook also supported job creation in August. The latest survey indicated a rebound in business sentiment to its highest since May, which ended a four-month sequence of falling confidence.
- The Manufacturing Output Index was 54.1 in August, after July's 57.1. There were widespread reports that escalating shipping costs and shortages of raw materials had led to intense price pressures. That said, the overall rate of input cost inflation eased to a four-month low during August. Note the wider

manufacturing PMI was 60.1 in August, after July's 60.4. Much weaker production growth was the main drag on the headline PMI, alongside a modest slowdown in job creation. (The manufacturing PMI is a weighted average of new orders, output, employment, suppliers' delivery times, and stocks of purchases.)

Chart 1 UK Markit/CIPS indices, February-August 2021



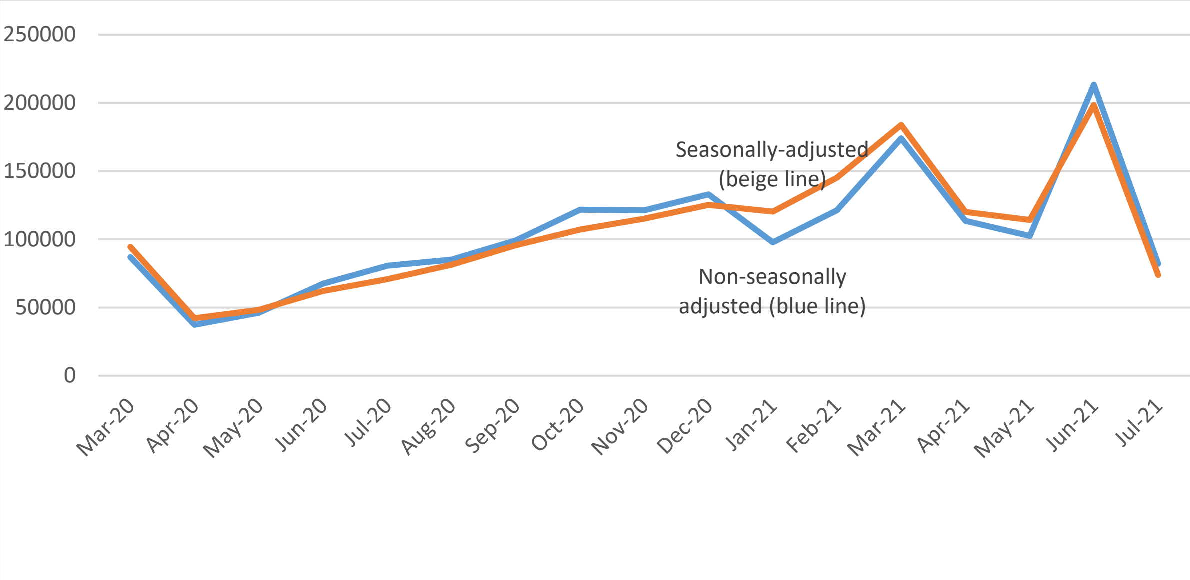
Sources: *Markit/CIPS flash UK composite PMI*, "Recovery loses momentum as supply constraints hit output growth in both the manufacturing and service sectors", 23 August 2021, and earlier releases. The Composite Output Index is a weighted average of the Manufacturing Output Index and the UK Services Business Activity Index, which are comparable indices.

…and other UK indicators

The other indicators released last week were a mixed bunch. Firstly, the SMMT reported that car production fell 37.6% (YOY) in July, the worst July performance since 1956 as manufacturers "grappled with the global shortage of semiconductors and staff absence resulting from the 'pingdemic', with some altering summer shutdown timings to help manage the situation".[7-8] The year-to-July total was, however, 18.3% (YOY) higher, but much of the industry was closed in 2020 during the first lockdown.

Secondly, the HMRC announced that house sales plummeted in July (chart 2).[9-10] Concerning the non-seasonally adjusted data, completed residential transactions fell to 82,110 in July, 61.5% (MOM) lower than in June 2021 (213,370). They were, however, still a tad higher (1.8%, YOY) than in July 2020, when the housing market was recovering after the first lockdown. The HMRC commented that "forestalling activity" had caused two recent peaks in the data. One was in March 2021 (174,080 transactions) caused by a sales rush prior to the initial end-date for the tapering of the stamp duty holiday, after which transactions fell in April. And the second peak was in June prior to the actual end-date for the tapering of the stamp duty holiday. Note that the Stamp Duty Land Tax (SDLT) nil rate threshold (for England and Northern Ireland) was reduced from £500,000 to £250,000 on 1 July (and will revert to £125,000 on 1 October), whilst the tax holiday ended on 31 March 2021 in Scotland and on 30 June 2021 in Wales.

Chart 2 Residential property transactions, number



Source: *HMRC*, "UK monthly property transactions, tables", 24 August 2021. The data are for completed transactions valued at above £40,000.

Thirdly, the ONS released its latest estimates for people on the furlough scheme, which is due to end at end-September. Their latest Business Impact of Coronavirus Survey (BICS) suggested that the proportion of businesses' workforce reported to be on full or partial furlough was 7% in early August, Wave 37 (representing a provisional approximate range of 6%-8% of businesses' workforce), the same as in mid-late July 2021, Wave 36.[11] This represented the joint lowest proportion of businesses' workforce reported to be on furlough leave since the scheme began. The estimated 7% of businesses' workforce equated to around 1.6-2mn people (average 1.8mn).[12] These estimates are included in chart 3a, along with the latest HMRC data which showed around 1.9mn employments (sic) were on furlough on 30 June, compared with 2.4mn on 31 May.[13] The number had peaked at nearly 9mn in early May 2020.

The ONS estimated that in Wave 37, over 67% of the workforce were working at their normal place of work (chart 3b). Concerning furlough, consumer-facing industries (especially "other|" services) still had the greatest proportions of their workforces on furlough leave, as shown in chart 3b, which also covers "working at their normal place of work" and "mainly working from home, instead of their normal place of work". In addition, the ONS reported that about 1% of the workforce were on sick leave or in quarantine (not in chart 3b). The ONS added that among the workforce reported to be on full or partial furlough leave in early August 2021 (Wave 37), 39% were reported to be fully furloughed. The proportion had steadily declined from 69% in mid-January 2021 and was the lowest proportion of furloughed employees reported to be fully furloughed since the question was introduced in October 2020.

Chart 3a Number of furlough (millions), HMRC data (end-month, to end-June 2021), ONS (Wave 36, Wave 37)

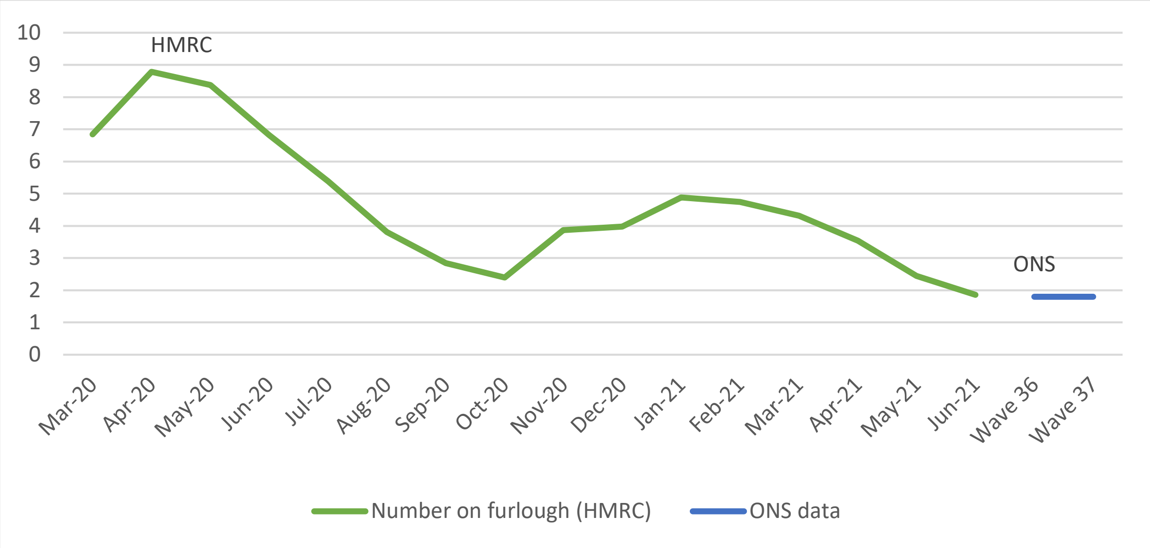
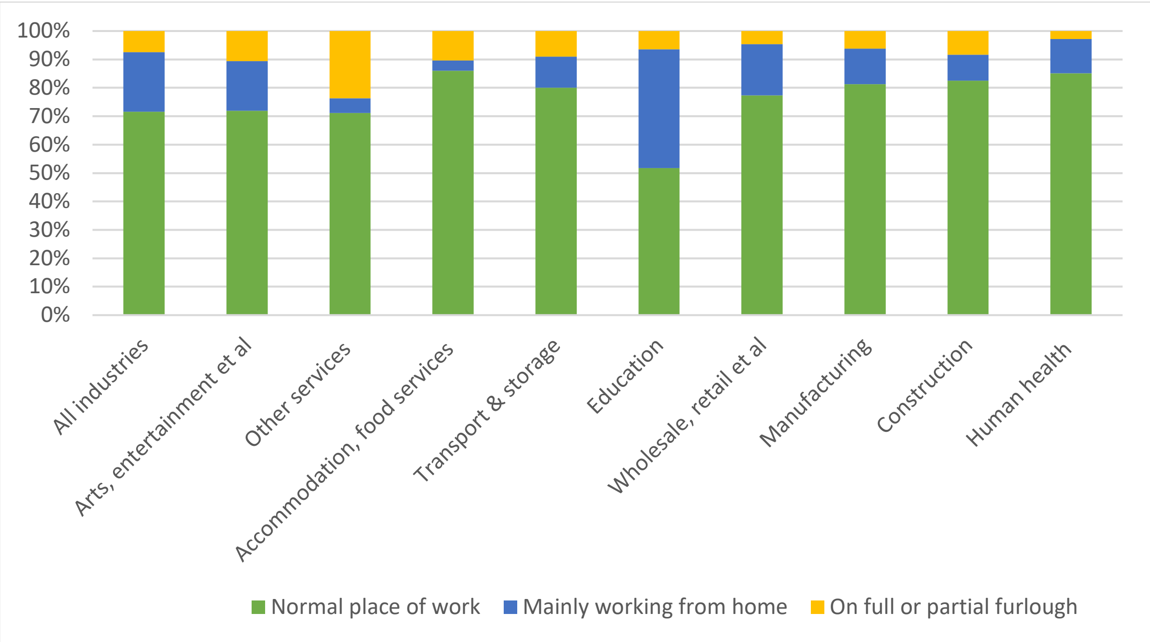


Chart 3b Workforce status: all industries and selected industries (ONS data), Wave 37 (26 July-8 August 2021)



Sources: (i) *HM Government*, "Coronavirus Job Retention Scheme (CJRS) statistics", 29 July 2021", HMRC data; (ii) *ONS*, "Business insights and impact on the UK economy", 26 August 2021.
Note the following sectors are excluded: agriculture, public administration and defence, public provision of education and health, and finance and insurance.
Wave 36=12-25 July 2021; Wave 37=26 July-8 August 2021.

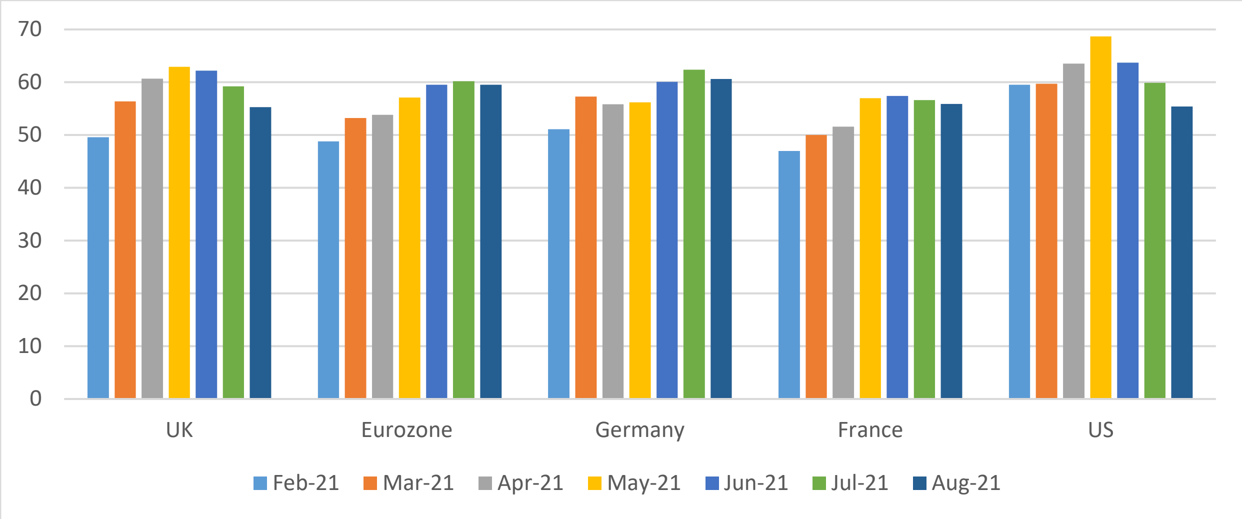
Markit surveys show growth in both the Eurozone and the US, though slowing in the US

Markit's latest flash indices for August have also been released for the Eurozone and the US (chart 4). They suggested that Eurozone business activity continued to grow at one of the strongest rates seen over the past two decades in August, the rate of expansion cooling only slightly despite widespread supply chain delays. Service sector growth exceeded that of manufacturing for the first time since the pandemic, buoyed by the further reopening of the economy. The Composite Output Index slipped marginally in the month to

59.5, after July's 60.2.[14] Within the Eurozone, Germany's Composite Output Index slipped to, a still very strong, 60.6 in August, after July's 62.4.[15] By sector, services activity grew at a sharp rate that was only just shy of July's peak. Manufacturing, on the other hand, showed a more notable loss of momentum. France's Composite Output Index was 55.9 in August (56.6 in July), remaining in "firm growth territory".[16] The slowdown reflected weaker rates of expansion in both manufacturing and services, although, according to respondents from both sectors, growing domestic and international demand and increased tourism supported the robust rise in overall business activity.

The US Composite Output Index eased to 55.4 in August, after July's 59.9.[17] Capacity pressures, material shortages and the spread of the Delta variant reportedly weighed on the output expansion, whilst severe supply chain disruptions led to a further increase in cost burdens at private sector firms. Growth slowed in both manufacturing and services.

Chart 4 Markit PMI Composite Output Index, selected countries, February-August 2021



Sources include: (i) *Markit, Flash Eurozone PMI*, "Eurozone flash PMI holds close to 15-year high, job market booms", 23 August 2021; (ii) *Markit, Flash US PMI*, Private sector expansion slows sharply amid capacity constraints and Delta variant spread", 23 August 2021.

The Fed prepares to reduce pace of asset purchases

In his annual speech at the Jackson Hole Economic Policy Symposium on 27 August, Fed Chair Jerome Powell implied the Fed could start withdrawing monetary stimulus this year as the economy rebounded, but confirmed that it was in no rush to raise interest rates despite a recent spike in inflation (consumer prices inflation was 5.4% in July).[18-19] The next FOMC meeting is on 21-22 September 2021 when, apart from the eagerly anticipated update on tapering, there will be revised economic forecasts.

Crucially, Powell said in his Jackson Hole speech:

- "We have said that we would continue our asset purchases at the current pace until we see substantial further progress toward our maximum employment and price stability goals, measured since last December, when we first articulated this guidance. My view is that the 'substantial further progress' test has been met for inflation. There has also been clear progress toward maximum employment. At the FOMC's recent July meeting, I was of the view, as were most participants, that if the economy evolved broadly as anticipated, it could be appropriate to start reducing the pace of asset purchases this year".
- "The timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate lift-off, for which we have articulated a different and substantially more stringent test. We have said that we will continue to hold the target range for the federal funds rate at its current level until the economy reaches conditions consistent with maximum employment, and inflation has reached 2% and is on track to moderately exceed 2% for some time. We

have much ground to cover to reach maximum employment, and time will tell whether we have reached 2% inflation on a sustainable basis".

Powell's speech followed soon after the release of the minutes of the 27-28 July FOMC meeting, at which policy was left unchanged.[20-21] The Committee agreed in July to continue increasing its holdings of Treasury securities by $80bn per month and of agency mortgage-backed securities (MBS) by $40bn per month.

The general tenor of the minutes, released on 18 August, was very much in line with Powell's Jackson Hole speech.[22-23] They indicated that members were making plans to reduce the pace (taper) of their monthly bond purchases. Concerning the timing, this looked likely to be before the end of 2021, but the minutes noted that "some" members preferred to wait until early in 2022 to start tapering. The minutes stated "…looking ahead, most participants noted that, provided that the economy were to evolve broadly as they anticipated, they judged that it could be appropriate to start reducing the pace of asset purchases this year." The minutes added that the economy had reached its goal on inflation, but committee members broadly agreed that employment had not met the "substantial further progress" benchmark the Fed had set before it would consider raising rates. Tapering should not, therefore, be seen as a precursor to an imminent rate hike.

Brexit stock-take

Our last Perspective which discussed Brexit issues was in early July, when we reported the Chancellor's comment that achieving financial services equivalence had "not happened", as well as the extension for the grace period to 30 September for checking chilled meats going from GB to NI (see annex table 1).[24] This extension followed those announced in March. They were the extension to the grace period for checking certain goods (food, animal products) from GB to NI to "at least 1 October" and the extension to the HMRC's "temporary approach to applying declaration requirements for the movement of goods in parcels" from GB to NI to 1 October.[25]

The most recent major development concerning the GB-NI border was the release of the Government's Command Paper "Northern Ireland Protocol: the way forward" on 21 July.[26-28] The Paper explained that it was "seeking to negotiate significant changes to the Northern Ireland Protocol". The Paper stated there were three fundamental concerns that needed addressing:

- Firstly, ways of removing the burdens on trade in goods within the UK while managing the real risks to the EU Single Market. "We need to find a way of ensuring that full customs and sanitary and phytosanitary (SPS) processes are applied only to goods destined for the EU." Customs checks on goods where the dispatching GB-registered businesses have declared their final destination is NI, and certificates and checks for food products "only ever intended to be consumed in Northern Ireland", should be removed.
- Secondly, how to ensure that businesses and consumers in NI can continue to have normal access to goods from GB. The regulatory environment in NI should tolerate different rules, allowing goods made to UK rules and regulated by UK authorities to circulate freely in NI, as long as they remained in NI. Medicines, for example, that were approved for sale in the UK, but not in the EU, should still be allowed to be sold in NI. (Medicines could be entirely removed from the scope of the protocol.)
- Thirdly, the governance basis of the Protocol should be normalised so that the UK-EU relationship is not ultimately policed by the EU institutions including the Court of Justice. "We should return to a normal Treaty framework in which governance and disputes are managed collectively and ultimately through international arbitration."

The Paper also made clear that the Government had considered the case for triggering Article 16 (the emergency break mechanism in the agreement) and believed that there were clear grounds to justify using it. In response to the Paper, European Commission Vice-President Maroš Šefčovič said the EU was willing to "seek creative solutions within the framework of the protocol" to ease border issues, but he added the EU would not agree to a “renegotiation” of the Brexit deal. He also commented “…respecting international legal obligations is of paramount importance”.[29-30]

Finally, it is worth noting that the sanitary and phytosanitary (SPS) checks on animal and plant products imported into GB from the EU will extended in October 2021, to be more in line with the checks applying to such goods exported by GB to the EU since January 2021, see annex table 2.[31-32]

References

1. *Markit/CIPS flash UK composite PMI*, "Recovery loses momentum as supply constraints hit output growth in both the manufacturing and service sectors", 23 August 2021. The Composite Output Index is a weighted average of the UK Manufacturing Output Index and the UK Services Business Activity Index, which are comparable indices.
2. *BBC,* "UK recovery slows as staff shortages plague firms", 23 August 2021.
3. *Daily Telegraph,* "Christmas supplies at risk as staff shortage expected to last to 2022", 24 August 2021, reported that lorry drivers were particularly short supply.
4. *Daily Telegraph, "*Factories hit by worst ever supply chain disruption", 24 August 2021, reported the results of the CBI's latest Industrial Trends Survey
5. *Bank of England*, "Monetary policy summary and minutes of the MPC meeting ending 4 August 2021", 5 August 2021.
6. Ruth Lea, MPC August meeting: above-target inflation still expected to be "transitory", *Arbuthnot Banking Group*, 9 August 2021, discussed the August MPC meeting.
7. *SMMT*, "UK car production plummets in July", 26 August 2021.
8. *BBC, "*Car production in July hits lowest level since 1956", 26 August 2021.
9. *HMRC*, "UK monthly property transactions commentary", 24 August 2021.
10. *Daily Telegraph*, "House sales plunge as tax holiday ends", 24 August 2021.
11. *ONS*, "Business insights and impact on the UK economy", 26 August 2021.
12. The ONS commented that the BICS number is based on multiplying the BICS weighted furlough proportions by the number of eligible employments published in the HMRC CJRS official statistics, for only those industries covered by the BICS sample (exclusions from BICS are agriculture, public administration and defence, public provision of education and health and finance and insurance). Therefore, the BICS estimate is not fully representative of the true number of employees on furlough.
13. *HM Government*, "Coronavirus Job Retention Scheme (CJRS) statistics", 29 July 2021", HMRC data.
14. *Markit, Flash Eurozone PMI*, "Eurozone flash PMI holds close to 15-year high, job market booms", 23 August 2021.
15. *Markit, Flash Germany PMI*, "German economy continues to grow strongly in August despite further constraints on manufacturing production", 23 August 2021.
16. *Markit, Flash France PMI*, "French economy remains in firm growth territory in August", 23 August 2021.
17. *Markit, Flash US PMI*, "Private sector expansion slows sharply amid capacity constraints and Delta variant spread", 23 August 2021.
18. *Federal Reserve*, "Monetary policy in the time of COVID", speech by Fed Chair Jerome Powell, 27 August 2021. Speech made at the "Macroeconomic Policy in an Uneven Economy," economic policy symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming.
19. *BBC*, "Federal Reserve hints it will start easing US stimulus", 27 August 2021.
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21. Ruth Lea, "MPC August meeting: focus on the inflation forecasts", *Arbuthnot Banking Group*, 2 August 2021, discussed the July meeting.
22. *Federal Reserve*, "Minutes of the Federal Open Market Committee, 27-28 July 2021", 18 August 2021.
23. *CNBC*, "Federal Reserve preparing for taper this year, July minutes show", 18 August 2021.
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25. Ruth Lea, "The Bank: no policy tightening until significant progress in eliminating spare capacity and achieving inflation target", *Arbuthnot Banking Group*, 22 March 2021.
26. *HM Government*, "Government outlines significant changes needed to make Northern Ireland Protocol sustainable", press release, 21 July 2021.
27. *HM Government*, "Northern Ireland Protocol: the way forward, July 2021", CP502, 21 July 2021.
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29. *Daily Telegraph*, "UK ready to pull out of NI Protocol", 22 July 2021.
30. *BBC*, "Brexit: UK wants to redraw Northern Ireland Protocol", 21 July 2021.
31. *Institute for Government*, "The GB-EU border", latest update.

32. Archie Norman, "This fandango of bureaucracy will hurt makers of French cheese and Spanish chorizo as much as it hurts us", *Mail on Sunday*, 29 August 2021.

Annex

Table 1 Key Brexit dates since January 2020

Dates	Key events
31 Jan 2020	UK leaves EU, start of transition period.
24 Dec 2020	UK-EU Trade and Cooperation Agreement (TCA), with Joint Declaration on Financial Services Regulatory Cooperation, agreed. Source: *HM Government*, "UK-EU Trade and Cooperation Agreement: summary", 24 December 2020.
30 Dec 2020	UK-EU Trade and Cooperation Agreement (TCA) signed.
1 Jan 2021	End of transition period, TCA provisionally became operative.
3 March 2021	Northern Ireland Secretary unilaterally announced current grace periods for checks on "imports" of certain goods (food, animal products) from GB to NI would be extended until "at least 1 October 2021".
4 March 2021	HMRC unilaterally announced its "temporary approach to applying declaration requirements for the movement of goods in parcels" from GB to NI would be extended to 1 October 2021.
15 March 2021	European Commission sent a letter of formal notice to UK saying unilateral actions breached Northern Ireland Protocol as well as good faith obligation under Withdrawal Agreement.
26 March 2021	Technical discussions on Memorandum of Understanding (MoU) on financial services (agreed in Joint Declaration on Financial Services Regulatory Cooperation) concluded. Source: *HM Treasury*, "Technical negotiations concluded on UK – EU Memorandum of Understanding", 26 March 2021.
28 April 2021	Announcement of European Parliament's ratification of TCA. Source: *European Parliament*, "Parliament formally approves EU-UK trade and cooperation agreement", 28 April 2021.
30 June 2021	It was agreed that chilled meats from GB, such as sausages, which would otherwise be prohibited in NI, would continue to move from GB to NI after the UK and the EU had agreed to extend the grace period, allowing this until 30 September. In addition, the Commission put forward "solutions" in a number of difficult areas, including the continued supply of medicines, guide dogs and the movement of livestock, as well as a decision waiving the need to show an insurance green card.
1 July 2021	The Chancellor in his Mansion House speech (1 July) conceded that "…as I said in Parliament in November, our ambition had been to reach a comprehensive set of mutual decisions on financial services equivalence. That has not happened".
21 July 2021	*HM Government*, "Northern Ireland Protocol: the way forward, July 2021", CP502.

Table 2 The GB-EU border: customs formalities

	When will the checks apply	
	Imports from EU to GB	Exports from GB to EU
For nearly all goods:		
Customs declarations	January 2021: for standard goods (most goods), simplified customs requirements required; traders can defer full declarations until 1 January 2022. Full declarations required for controlled goods (for example, tobacco & alcohol).	January 2021: full customs declarations required.
	January 2022: full customs declarations required at time of import for all goods.	
Custom duties (tariffs) and VAT, if applicable	January 2021: tariffs payable, but possible to defer payment until customs declarations are made. VAT	January 2021: Payable at time of import,

	also payable, although many traders will be able to defer payment.	unless traders eligible to defer payments.
	January 2022: payable on import, although some traders eligible to defer payment.	
Safety and security declarations	January 2021: EU exit summary declaration required.	January 2021: UK exit summary declaration & EU entry summary declaration required.
	January 2022: UK entry summary declaration required.	
Additional checks only applicable to some goods:		
Checks required by international conventions+	January 2021: checks in place.	January 2021: checks in place.
Sanitary and phytosanitary (SPS) checks ++	January 2021: imports of high-risk live animal & plants (& animal & plant products) must be pre-notified to the UK authorities via IPAFFS, have correct health documentation & may be subject to checks. Physical checks are carried out at the point of destination or other approved premises.	January 2021: full SPS checks in place, including requirement for UK Export Health Certificates.
	October 2021: imports of products of animal origin & high-risk food not of animal origin will require pre-notification to the UK authorities via IPAFFS & must have correct health documentation. Necessary physical checks will take place at the point of destination or other approved premises.	
	January 2022: most products subject to SPS checks will need to transit through a designated Border Control Post. Goods will subject to an increased rate of physical checks. Imports of low-risk plants & plant products will need to pre-notified to UK authorities via IPAFFS & have the correct health documentation.	
	March 2022: Checks on low-risk plants & plant products will take place at Border Control Posts. Checks on live animals will take place at Border Control Posts if capacity allows.	
Excise duties	January 2021: businesses importing excise goods must pay GB excise duties using the Customs Handling of Import & Export Freight (CHIEF) or Customs Declaration System (CDS) systems.	January 2021: excise goods subject to rules applied by importing EU member state.
Other controlled goods+**++**	January 2021: import licenses & other requirements apply to import of some high-risk goods.	January 2021: additional requirements apply, in line with EU/member state rules.

Source: *Institute for Government*, "The GB-EU border", latest update.
+ For example, for endangered species, rough diamonds.
++ Live animals, products of animal origin & some plants & other agri-food products are subject to additional checks at border to ensure they comply with food safety & biosecurity regulations. SPS measures include pre-notification to national authorities before goods are imported (via the Import of Products

Animals, Food and Feed Systems (IPAFFS) system in the UK and the Trade Control and Export System (TRACES) in the EU.
+++ Other potentially hazardous goods, such as chemicals, firearms, nuclear material and pharmaceuticals.