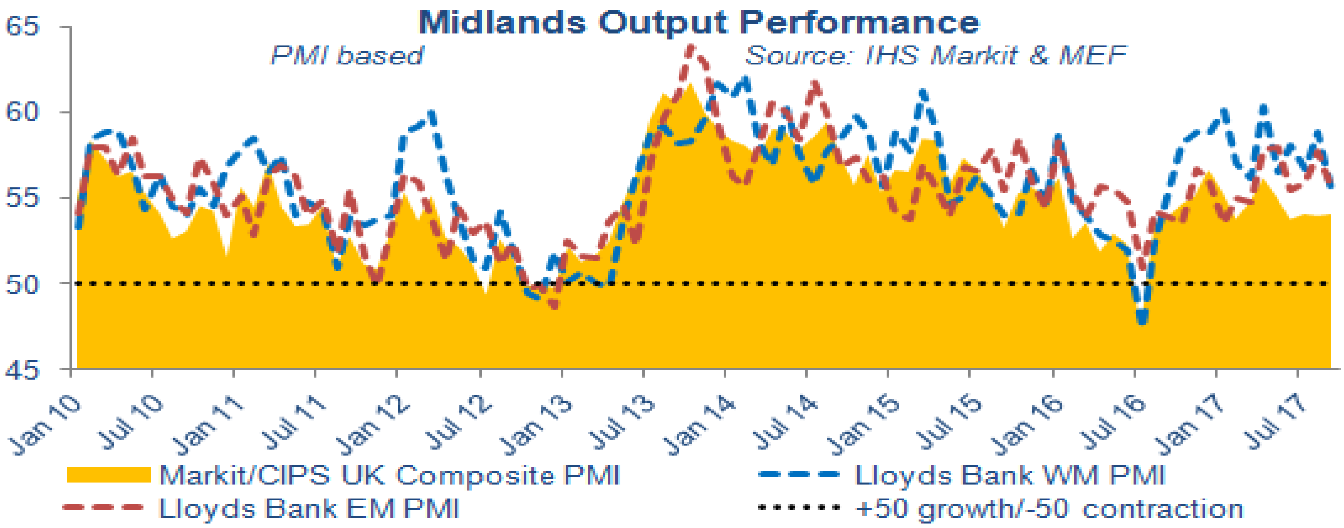
Regional Monitor October 2017

Latest Global Trends, Regional PMI, Output Data, Trade Conditions & Brexit Update

Days since Article 50 activation: 204 **Remaining Brexit Negotiating Days: 60**

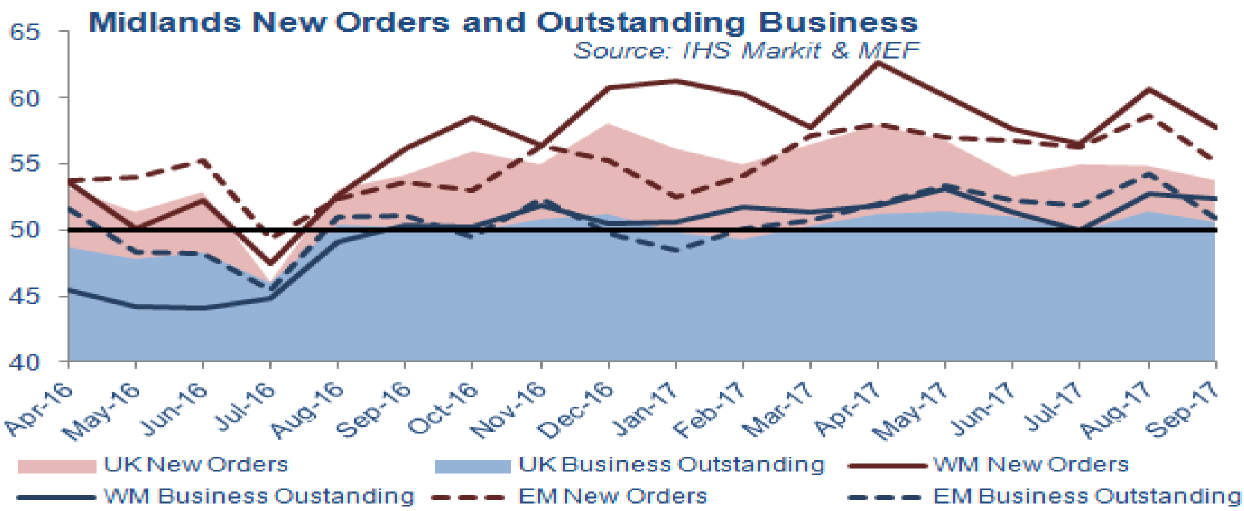
- EM PMI was 55.4 in September, from 57.7 in August, WM recorded 55.2 from 58.6 previously, once again stronger than that achieved nationally of 54.1
- EM PMI recorded strong business activity growth, although the WM PMIs indicated growth softening to a 13-month low
- Nationally, Manufacturing and Services PMIs recorded growth, although Construction saw a decline in September
- This has led to muted confidence, although less pronounced in the Midlands
- Global economic conditions are forecast to improve markedly by the IMF
- Increased business costs due to global commodity prices and adverse forex conditions.
- October's EU summit will determine the pace and scope of Brexit negotiations in the remaining period up until October 2018



The EM Lloyds Bank Regional PMI recorded 55.4 in September, softening slightly from 57.7 in August, while the WM PMI was 55.2 from 58.8 previously. The EM and the WM, ranked 5th and 6th respectively, recorded PMIs above the national average, which was up slightly to 54.1 from 54.0 in August. In the Midlands, new orders and output increased at a robust level, although lower than seen in August, the rate of expansion was still above that of the UK. Businesses reported demand from both existing and new clients, across both manufacturing and services firms.

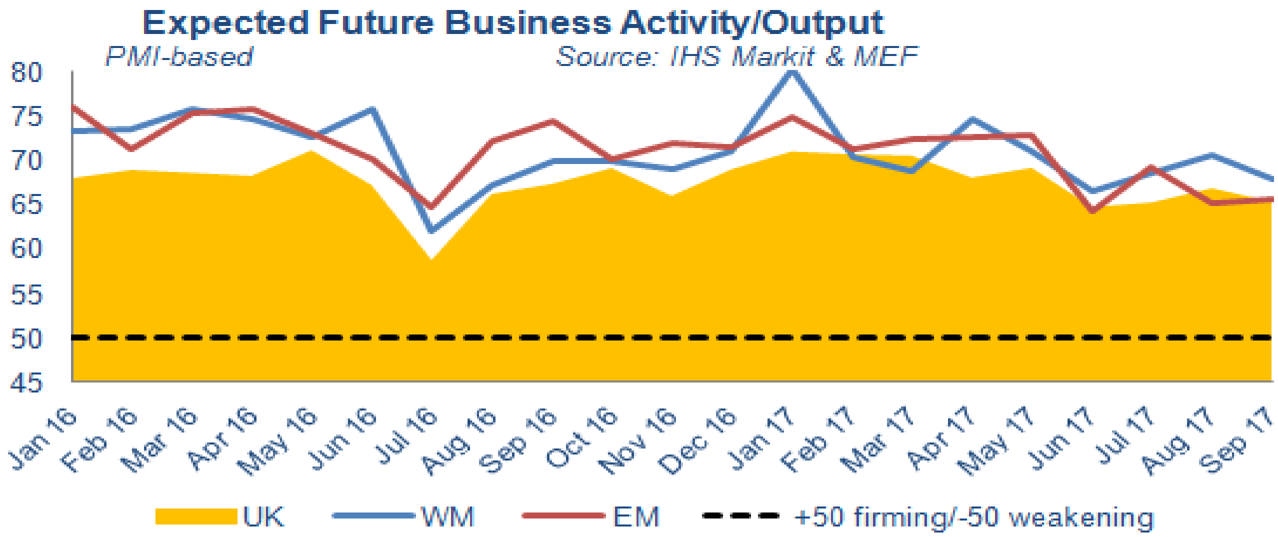
Julian Beer, Deputy Vice-Chancellor at Birmingham City University commented: "The Midlands continues to outperform the UK as a whole, with robust increases in output, new orders and employment, despite some softening from the previous month. Nevertheless, uncertainties surrounding Brexit remain – exacerbated somewhat by events in Europe and the USA - and businesses need clarity in order to continue production at globally competitive levels."

This was reflected in the UK sector PMIs, with the UK Manufacturing PMI reporting production and new business rising, with demand remaining robust from both domestic and foreign markets; Europe, the USA, China and Brazil were all significant export destinations. UK Services firms saw growth in business activity in September, although demand was somewhat subdued – notably in the domestic market- with many firms citing delayed decisions due to Brexit-related uncertainty. The UK Construction PMI, in contrast, saw a decline in September, with falling quantities of new work to replace completed projects. House building was the only sector to register growth in September, although this was softer growth than seen previously.



Growth in output and new business fed into a positive outlook for the majority of manufacturers, according to the PMI survey, as well as to job creation. In contrast, services and construction firms saw weaker rates of job creation, as well as reduced levels of confidence among businesses, with many citing expected lower investment due to Brexit-related uncertainty.

In the Midlands, growth in New Orders and Business Outstanding increased more strongly than in the UK as a whole – this expansion also led to an increase in jobs in the region. Notably, job creation in the Midlands was across both Manufacturing and Services firms, which in the case of Services slightly bucked the national trend. Uncertainty was reported to be higher in the sector PMIs – particularly in construction and services, with the latter recording the weakest confidence since the end of 2011. Manufacturing confidence was stronger, based on positive outlook for export demand. However, all three sector PMIs noted the heightened economic and political uncertainty, particularly around Brexit, as a reason for reduced confidence.



This trend was reflected in the WM, which showed a slight downturn in confidence – although it remains at a higher level than the UK as a whole, but was not reflected in the EM, which showed a slight uptick in confidence in September – although overall levels remain broadly in line with the rest of the UK. Many businesses reported a positive outlook in terms of increased output and sales, but also highlighted the current political uncertainty.

Global Trends

IMF chief, Christine Lagarde, has stated that the IMF World Economic Outlook, to be released this week, will project much a more optimistic outlook than previous forecasts since 2010, with the pattern of growth anticipated to be broad based. She has suggested that all G20 economies, other than the UK, will record stronger growth than last year, with the Eurozone, US, China and Japan recoding more robust performance and India the strongest performer of the Group. This should benefit the Midlands, as a strong exporting region, given expected demand growth in key Midlands export markets. Accommodative Central Bank policies however threaten to undermine these prospects, notably QE which has yet to be successfully unwound. According to outgoing German Finance Minister, Wolfgang Schauble, global monetary policies threaten financial stability from potential asset price bubbles due to spiralling levels of debt and liquidity.

Moreover, political factors continue to impact on economic trends, with volatility increasing in direct proportion to the success and indicative range of North Korea's (intercontinental) missile tests, and President Trump increasingly narrowing his proposed responses. Market concerns may also be raised by the President coupling of North Korea and Iran in some form of axis, threatening to unravel a protracted and complex international agreement to resolve fears regarding Iran's nuclear aspirations. Furthermore, the US does not yet appear to have dampened the continuing diplomatic imbroglio between Qatar and other members of the Gulf Co-operation Council.

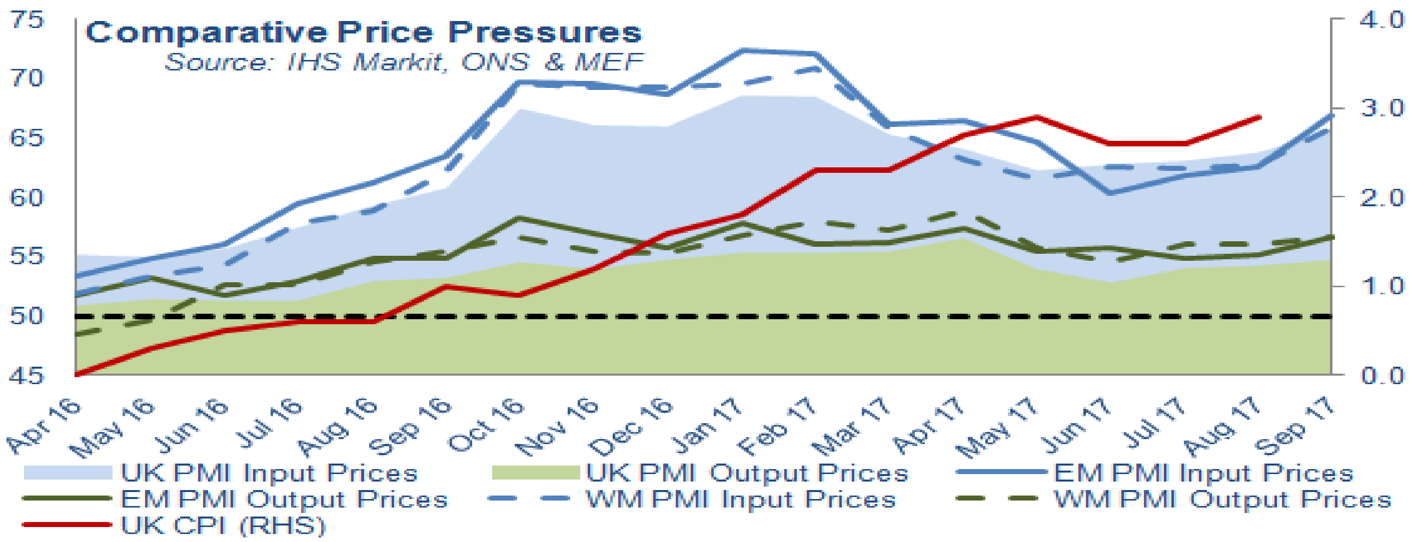
The EU is not itself immune from unsettling political developments; Spain's longer-term integrity and capacity to meet financial obligations may be jeopardised by the unfolding separatist crisis in Catalonia. Both the Madrid and Barcelona authorities adopting intransigent positions that offer limited prospects for a calm resolution of this long-brewing constitutional crisis. Having successfully weathered the potentially disruptive French Presidential elections, last month's German Federal Election has thrown up further concerns for the EU. For the first time, Alternative for Deutschland (AfD) will take seats in the Bundestag as the third largest party and Angela Merkel's CDU/CSU formation is struggling to overcome the reluctance of the Greens and the Free Democrats to form a so-called Jamaica Coalition. It may take some weeks for Merkel to secure a new coalition, with the SPD retreating to opposition given its mauling in the election as its vote share, at 20%, the lowest in almost 70 years. Both French (first round) and German elections indicated a degree of support of anti or at least sceptical EU positions not previously recognised by the European Commission. These factors, in addition to difficulties in Italy, Hungary and Poland, let alone Brexit, will fully test the mettle and competencies of the EU and recently reviving confidence in the Euro.

Rumours of an impending Cabinet re-shuffle, a lack-lustre conference performance and a Parliamentary Brexit debate, ahead of the EU summit, could raise further questions regarding the longevity of Theresa May's administration and likely increase last week's speculative pressure against £.

The growing intensity of Trump's America First Strategy, with the drive seemingly in inverse proportion to his latest opinion poll ratings, is evidenced by the scale of the proposed tariffs imposed on Bombardier C-series aircraft (now amounting to the equivalent of 300%). Boeing, the originator of the complaint to the US authorities, is arguing that Bombardier is both receiving unfair state aid and also selling aircraft in the US at substantially below cost, with a final decision by US Courts expected in February 2018.

UK Input Price Growth Rates (August 2017)		
		Source: ONS & MEF
Product group	1m % change	12m % change
Crude oil	6.2	13.8
Imported metals	4.1	18.1
Imported chemicals	1.4	6.3
Other imported materials	0.8	4.5
Fuel including Climate Change Levy	0.7	3.9
Imported parts and equipment	0.7	4.0
Imported food materials	0.1	4.4
Other home-produced materials	0.0	1.9
Home food materials	-0.6	10.5
All manufacturing	**1.6**	**7.6**

Global commodity prices continue to rise, with all three sector PMIS reporting rising input prices, especially for imports. In the ONS's Producer Price Inflation statistics for August, Crude Oil and Imported Metals were the largest drivers of input price rises. These were also raised in the sector PMI surveys, with rising commodity prices and exchange rate pressures both cited as reasons for increased input costs. In the case of construction, input costs rose despite reduced demand due to lower levels of output.



In the Midlands, input prices rose sharply, but unlike seen previously, broadly in line with the UK overall. Increased costs were attributed to adverse exchange rate conditions in the WM, while EM businesses also saw increases in the prices of raw materials, wages and food. As a result of increase input costs, output prices in the Midlands also rose, and at a faster pace than see in the UK overall. In the WM, this rise was seen broadly across manufacturing and services, but in the EM, manufacturers increased their prices more than services firms.

Brexit Update: *Fog in Channel, Continent Cut Off*

October is a critical month for the future pace of Brexit negotiations as the European Council summit will determine whether to accept the British prognosis that parallel sets of negotiations on both the formal exit from the EU and future trade relations are needed; or to defer to their lead negotiator Michel Barnier, who has repeatedly alluded to the lack of progress during the negotiations and the need to finalise the financial settlement before considering other issues.

Following this week's forthcoming round of Brexit negotiations, there will be some 55 days scheduled for the conclusion of some form of agreement to enable Britain a mutually satisfactorily exit from the EU. According the current EU schedule an agreement has to be concluded by October next year, to enable the respective 27 EU member states (and an indeterminant number of regional assemblies) plus the European Parliament to ratify whatever agreement emerges and before the Article 50 exit deadline of March 2019.

In the approach of this next round of negotiations and the Council summit, the British position has appeared to suffer two major setbacks, notwithstanding the surprise announcement by the EU to define and agree the respective allocations of WTO tariff quotas between the EU and Britain.

Firstly, the USA, Brazil, Argentina and New Zealand have jointly and formally objected to WTO that this effective unilateral reallocation of WTO tariff rate quotas is in breach of normal WTO practice, claiming the EU-British proposal will place their respective exporters at an unfair disadvantage, notably in regard to agricultural products. This may indicate that any future FTA negotiations which Britain attempts with these countries will be conducted contemporaneously with any bilateral WTO adjustments and in reference to their respective sectors perceived to be economically critical. Secondly, the Franco-German response to Britain's proposed post-April 2019 transition (or implementation) phase has been to reject consideration until the outstanding Brexit financial issues have been resolved.

Furthermore, the German equivalent of the CBI, the Bundersverband der Deutschen Industrie (BDI), has criticised the approach of the British government toward Brexit. BDI Managing Director Joachim Lang stating the German firms based in Britain should prepare worst-case contingency plans for the "hardest of Brexits" with no transition period and subsequent significant speculative pressure against Sterling. Currently the BDI estimate that German corporates employ 370,000 people and with investments totalling an estimated €110 billion. Nevertheless, and especially given the current heavy integration of German and British value-added supply chains and the continental destination much of their product, pragmatic responses can already been seen developing by individual German corporates and Lander to ensure the sustainability of post-Brexit economic, trade and investment ties.

The Brexit negotiations to date have highlighted the complexities associated with ending the UK's 40-year relationship. After raising the prospect of "no deal" being better than a "bad deal" in January, Theresa May's government now appears to favour some form of transitional arrangement (perhaps labelled as a period of "implementation"). The proposed nature of this period and its potential impact upon the region remains unclear. There are a number of different perspectives on what such a period should look like and how long it should last. Moreover, differing views are apparent within the Conservative party with Foreign Secretary Boris Johnson arguing in favour of a shortened period and other cabinet members, most notably Philip Hammond, preferring a more extended implementation phase.

Irrespective of the length of the period, there are questions over precisely what it should entail. If the Government's preferred nomenclature of an "implementation period" is to be taken literally, it could imply that negotiations will be complete by the end of March 2019. Implementation would thus merely be a period of time in which to ensure that the correct infrastructure (for example additional customs facilities) is put in place. Such an outcome is unlikely. Most consider that ratification is likely to take 6 months, leaving just one year to complete negotiations. At the present time, the UK and EU have not yet progressed beyond the initial set of "divorce" issues (although the Prime Minister's speech in Florence initially appeared to have facilitated negotiations). The European Commission's chief negotiator Michel Barnier believes that, at best, the two parties will "begin scoping our future relationship" over the next year, which appears to implicitly rule out such a vision of implementation.

A more likely outcome is an agreement to continue the status quo for a time-limited period (potentially with a face-saving formula for the British government vis-à-vis the role of the Court of Justice of the European Union), after agreeing the initial fundamental principles. Many in the UK and EU view this as a pragmatic way to allow extra time to deal with what will undoubtedly be an extremely complex set of negotiations.

A major disadvantage of this approach is that it would involve an extended period of uncertainty for businesses – it could conceivably be 2021 or 2022 before businesses know what the future trade and wider economic relationship with the EU will look like. There is substantial evidence that uncertainty regarding the business environment hinders investment. Although in the year since the referendum, business investment rose, by 2.5% in Q2 2017, overall output growth has been more subdued, GDP increasing by 0.3% in the same quarter. Nevertheless, anecdotal evidence suggests that businesses are holding back on finalising investment decisions going forward with the SMMT reporting that investment in the car industry fell by 30% in 2016 on a year earlier and the latest figures suggest that this may fall further in 2017. This is likely to be of significant concern given the region's specialism in this area.

Indeed, the recent Conservative party conference has exposed already apparent divisions inside the government, both with regards to a transition and Brexit more generally. In his conference speech, the Foreign Secretary suggested that the UK can "win the future", in part by invoking ties with the Commonwealth – pointing out its population of 2.4 billion and alluding to the fact that the group contains some of the world's fastest growing large economies. Executing this vision may prove more problematic than many believe, however. Exports to the Commonwealth make up only around 8.8% of total UK exports, compared to 44.4% for the EU (50.7% when EFTA and the Customs Union are included). It would take unprecedented growth in exports to the Commonwealth to offset reduced access to the European market. The UK is deeply integrated in European supply chains, with the Midlands' automotive and aerospace sectors prime examples of this. Whilst trade barriers are likely to lead to some degree of import substitution, in many cases there are limited (or no) prospects of replacing European suppliers with domestic ones. Many components cross from the UK into Europe and back again multiple times during the course of manufacture. Even modest tariffs and frictions are likely to hit large companies in the West Midlands, even when the ultimate export destination is outside Europe.

The Government's strategy has been termed BINO (Brexit in name only) by the more Europhobe wing of the Conservative Party. This is somewhat reflected in the contrast between the Foreign Secretary more strident positions, than that of the Prime Minister and Chancellor of the Exchequer. All nevertheless sought to minimise focus on Brexit during the Conservative party conference, instead focussing on domestic issues. Additionally, Whitehall departmental turf wars, between the new Cabinet Office centre for Brexit and DExEU threatens to further weaken the capacity of the Government to conduct a vigorous pursuit of negotiations. Moreover, whereas the opposition of the Scottish Government to the British Government's Brexit Strategy is well developed, within the England there is evidence of an increasingly coherent strategy emerging collectively from the regions. According to the FT, Northern Mayors (Manchester, Liverpool and Tees Valley) are lobbying the government to replace EU solidarity funding flows with a proposed UK Shared Prosperity Fund to fund regional development over a minimum 10-year period after a Brexit.

Ends

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Notes to the Editor:

Birmingham City University: Centre for Brexit Studies

The Centre for Brexit Studies (CBS) is an academic facility which supports and encourages the existing work on Brexit within Birmingham City University's schools and faculties. It promotes rigorous engagement with the multifaceted aspects of the "Leave" and "Remain" perspectives in order to enhance understanding of the consequences of withdrawing from the EU. Whilst CBS will have a national focus we will also specifically investigate the impact on Birmingham and the surrounding areas. The work of CBS is primarily undertaken by Birmingham City University staff and students, but we will provide collaborative opportunities with interested businesses, professional organisations and civil society. Our work will be accessible to the general public and we will hold conferences, workshops and seminars to disseminate knowledge and encourage discussion on Brexit. The Centre website will also reference member's publications on Brexit issues.

The last month has seen the Centre consolidate and expand its activities, with a view to making a continued contribution to debate and thought leadership on the subject, with a research examining the potential for trade with Commonwealth countries, employment law implications and future humanitarian relief (particularly in light of recent natural disasters in the Americas) . Forthcoming work will include further analysis on potential future trade links with Commonwealth countries, particularly focussing on India, Australia and Nigeria. In addition, the Centre plans to enhance its communications capabilities and web presence with a series of regular podcasts by academic experts. The "CBS" roadshow planned for November and December will take us across the country in an effort to identify and understand people's current concerns around the Brexit process and what it means for them. Finally, an early "heads up" for the CBS Annual Conference next March, where we can confirm keynote speakers including Professor Patrick Minford of Cardiff University, and Professor Vernon Bogdanor FBA CBE of Gresham College.

Midlands Economic Forum:

The Midlands Economic Forum is a neutral, independent forum bringing together representatives of the public, private and voluntary sectors to evaluate real trends in the local economy. Midlands Economic Forum is part of the West Midlands Economic Forum Group.