

UK Manufacturing PMI

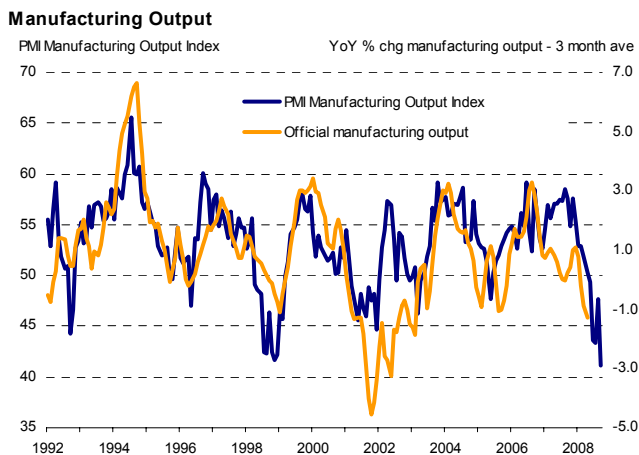
PMI signals manufacturing contraction at fastest rate since 1992

Key findings

- **PMI data signal 2.5% year-on-year contraction in manufacturing output.**
- **Important differences exist between 1998 and the current downturn.**

The CIPS/Markit Manufacturing PMI, released 1 October, showed output, new orders, backlogs of work and employment all falling at the fastest rates seen since the survey began seventeen years ago.

The survey has a good reputation of accurately anticipating official data, and statistical analysis of the relationship of the PMI survey against official data suggests that the latest reading of the survey's Output Index is consistent with manufacturing output falling 2.5% on a year ago.

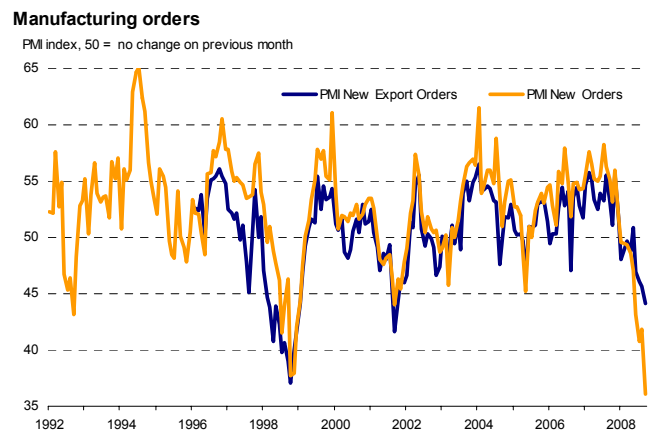


Comparisons with 1998 show differences in composition of demand

The closest that the PMI data have been to recent lows in the past was in 1998, when business conditions turned down sharply in reaction to the Asian and Russian financial crises. However, an interesting difference between the current downturn and that of

1998 is that the recent weakness is, to a large extent, due to falling domestic demand, whereas ten years ago the slump was driven first and foremost by falling exports.

This is illustrated by a comparison of the New Orders Index from the PMI survey (which encompasses both domestic and export sales) against the index tracking just export orders, which shows the biggest divergence between the two indices in the survey history in recent months, indicating that the main pressure subduing order books this autumn is domestic demand.

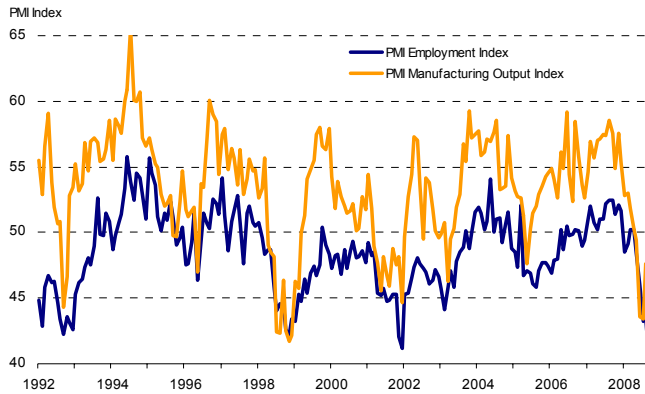


A downturn in the global economy is without doubt also having a clear impact on UK manufacturing exports, but the depreciation of sterling is likely to have helped boost overseas sales in recent months (the Bank of England's monthly average of the effective exchange rate fell to a level not seen since early 1997 in September). Without this exchange rate effect, the recent contraction of manufacturing output would no doubt be far stronger than we are currently seeing.

Employers are also cutting staff at faster rate than 1998...

Another interesting difference between 1998 and 2008 is the faster rate of job shedding in the recent downturn, which is a factor likely to hit consumer confidence further and possibly prolong the downturn.

Manufacturing output and employment

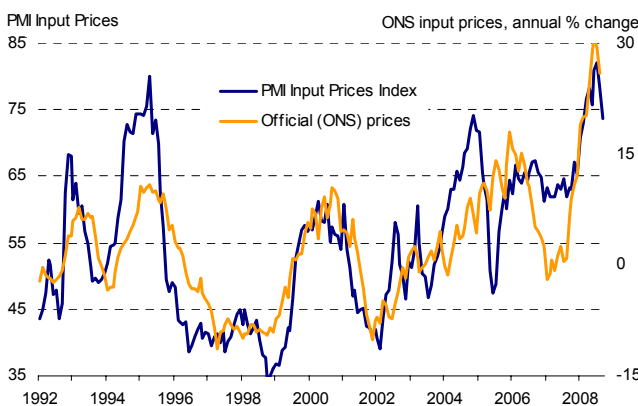


... due to high commodity prices

The job shedding by manufacturers in the latest downturn is linked to high non-staff costs, as elevated prices for oil and other commodities have hit profit margins and caused many to look at boosting labour productivity via redundancies to compensate.

This difference in the inflation environment between now and 1998 is illustrated by the PMI data on manufacturers' input prices. Back in 1998, the PMI's Input Prices Index fell to a record low, whereas this summer the index hit a record high. The Input Prices Index has eased in recent months, but continues to signal a historically strong rate of input cost inflation.

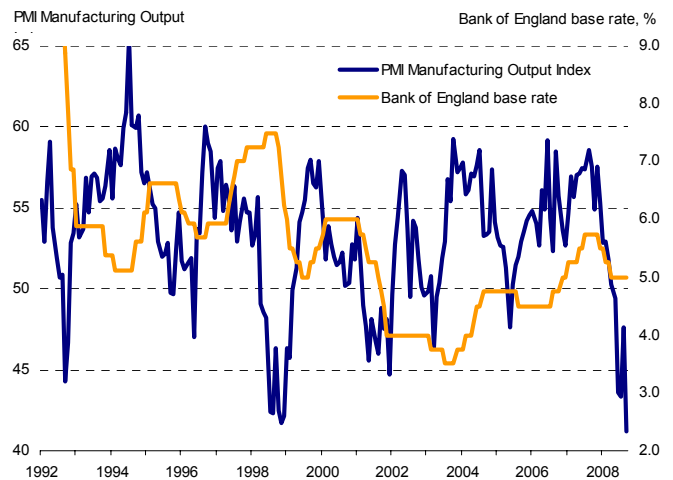
Manufacturers' input prices



The PMI survey for September also showed that, despite falling demand, prices charged by manufacturers registered the joint third-strongest monthly rise in the survey's history, down only slightly from August's record, as companies passed on the higher input costs.

Here perhaps lies the most important difference between 1998 and 2008. The 1998 downturn was promptly followed by a reduction in Bank of England base rates, from 7.5% in September 1998 to a low of 5.0% in June 1999, which helped achieve a quick recovery in growth. At 5.0%, the current Bank of England base rate is already at the same level as the low reached in the aftermath of the 1998 financial crisis, and current inflationary pressures will act as an ongoing deterrent to any significant series of interest rate reductions.

Manufacturing and interest rates



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