Ashfield
DISTRICT COUNCIL

Report To:	**AUDIT COMMITTEE**	**Date:**	**30th NOVEMBER 2020**
Heading:	**TREASURY MANAGEMENT MID YEAR REPORT 2020/21**		
Portfolio Holder:	**COUNCILLOR RACHEL MADDEN PORTFOLIO HOLDER FOR FINANCE & RESOURCES**		
Ward/s:	**ALL**		
Key Decision:	**NO**		
Subject to Call-In:	**NO**		

Purpose of Report

This mid-year report has been written to comply with the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management Code of Practice and covers the following:

- An economic update for the 2020/21 financial year as at 30 September 2020;
- The Council's capital position (including prudential indicators);
- The Council's investment portfolio for 2020/21;
- The Council's borrowing position for 2020/21.

Recommendation(s)

1) To agree changes to the 2020/21 Prudential Indicators following in year changes to the 2020/21 Capital Programme,
2) To note the breach of Treasury Management Strategy, and,
3) To note contents of the report.

Reasons for Recommendation(s)

In accordance with the Council's Financial Regulations Audit Committee is responsible for the implementation and regular monitoring of Treasury Management policies and practices and will receive, as a minimum each year, reports setting out the Annual Treasury Management Strategy and Plan for the coming year; a mid-year review and an annual Treasury Management Performance Report. These reports are also considered at Cabinet.

Alternative Options Considered
(with reasons why not adopted)

Detailed Information

1 Background

1.1 The Council aims to operate a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

1.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer-term cash flow planning to ensure the Council can meet its capital spending commitments. This management of longer-term cash may involve arranging long or short-term loans, or the use of longer-term cash flow surpluses, and on occasion, any debt previously drawn may be restructured to meet Council risk or cost objectives.

1.3 Accordingly, treasury management is defined as:
"The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2 Economics and interest rates to date and the outlook for 2020/21

2.1 In the UK, the first half of the year continued to be impacted on by the on-going Covid-19 Pandemic.

2.2 The Monetary Policy Committee (MPC) of the Bank of England maintained the Bank Rate at 0.10%, which has been in effect since 19th March 2020. It is not expected to introduce negative interest rates in the short term.

2.3 Public Works Loans Board (PWLB) has been the main source of borrowing for the Council. PWLB rates have been increased slightly. The 50 year PWLB (certainty) rate for new long term borrowing increased from 2.34% on the 1 April to 2.40% by 30 September 2020.

2.4 The current PWLB rates include a 1% increase in rates implemented in October 2019. The Government launched a consultation on PWLB borrowing in March 2020, which indicated there is a possibility that the increase may be reversed to some extent. However the consultation made it clear that Local Authorities will not be allowed to borrow money from the PWLB to purchase commercial property, where the aim is to generate an income stream (assets for yield). One of the proposals is to require Local Authorities that wish to access the PWLB to confirm that they do not plan to buy commercial property (assets for yield). Investment Properties are held for yield, which is likely to mean that if the proposal is implemented without any changes following the consultation, we may not have access to PWLB to fund our capital schemes and alternative borrowing would need to be used. Local Authorities are still awaiting the outcome of the consultation.

2.5 The UK's economy is influenced by UK and worldwide events. It will continue to be impacted on by the actions taken in relation to the Covid-19 pandemic and Brexit uncertainties, ahead of the year-end deadline, and the trade deal agreed or not agreed. A full economic update and interest rate forecast provided by Link Asset Services, our Treasury Advisors, is included at Appendix 1.

3 The Council's Capital Position (including Prudential Indicators)

Prudential Indicators

3.1 Capital Programme

3.1.1 Table 1 below shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget in March 2020.

Table 1 – Capital Programme 2020/21

Capital Expenditure by Service	2020/21 Original Estimate £m	2020/21 Revised Estimate £m
General Fund	28.135	35.956
Area Schemes	0.885	1.042
HRA - Decent Homes	11.350	4.638
HRA – Other	1.265	7.605
Total capital expenditure	**41.635**	**49.241**

3.1.2 The main reason for the General Fund change in capital expenditure is due to 2019/20 slippage on the Investment Properties being added to the 2020/21 programme. The change in the HRA - Decent Homes Schemes is due to the impact of Covid-19 pandemic e.g. difficulties gaining access to properties during full lockdown and complications with ensuring social distancing. The increase in the HRA – Other capital expenditure is due to the addition of the 2019/20 slippage and the inclusion of additional new approved Affordable Housing developments, being Hucknall Infill Sites and Maun View, Sutton in Ashfield developments.

3.1.3 Table 2 below draws together the main treasury management strategic elements of the capital expenditure plans (above), highlighting the original and the revised estimated financing arrangements of this capital expenditure.

Table 2 – Capital Expenditure Funding

Capital Expenditure	2020/21 Original Estimate £m	2020/21 Revised Estimate £m
Total capital expenditure	**41.635**	**49.241**
Financed by:		
Capital receipts	1.193	1.553
Capital grants	1.800	5.772
Capital reserves	11.423	9.706
Total financing	**14.416**	**17.031**
Borrowing requirement	**27.219**	**32.210**

3.1.4 The borrowing requirement has increased as a result the investment property expenditure slippage from 2019/20 and changes to HRA expenditure. The borrowing need may also be supplemented by maturing debt and other treasury requirements.

3.2 Capital Financing Requirement, Operational Boundary and Authorised Limit

3.2.1 Any changes to borrowing in the Capital Programme affect the Capital Financing Requirement (CFR). The CFR represents the Council's underlying need to borrow for capital expenditure. The CFR increases by the amount of capital expenditure funded by borrowing and reduces by making revenue charges for the repayment of debt (the Minimum Revenue Provision).

Table 3 – Capital Financing Requirement (CFR)

	2020/21 Original Estimate £m	2020/21 Revised Estimate (Adjusted for Slippage) £m
Prudential Indicator – Capital Financing Requirement		
CFR Non-Housing	107.724	110.662
CFR – Housing	80.081	80.131
Total CFR	**187.805**	**190.793**
Prudential Indicator – the Operational Boundary for external debt		
Borrowing	191.000	194.000
Other Long Term Liabilities	0.000	0.000
Total debt 31st March	**191.000**	**194.000**
Prudential Indicator – the Authorised Limit for external debt		
Borrowing	206.000	211.000
Other Long Term Liabilities	0.000	0.000
Total debt 31st March	**206.000**	**211.000**

3.2.2 The 2020/21 Capital Financing requirement has increased as result of a change in the spend profile for the Kirkby Leisure Centre scheme. The Operational Boundary has been revised upward to reflect the change in CFR, it includes an amount for working capital payments. The Authorised Limit has been increased in line with changes to the Operational Boundary. The difference between the Authorised Limit and the Operational Boundary reflects the worst case scenario of having to borrow to finance that part of the capital programme that is not proposed to be financed through borrowing.

3.3 Estimate of ratio of financial cost to net revenue stream for the current year split between the Housing Revenue Account and General Fund

3.3.1 For the HRA this is calculated by dividing the HRA capital financing costs by the total estimated Council Dwelling Income. For the General Fund this is calculated by dividing the General Fund capital financing costs by the estimated Council Tax Receipt plus Central Government Grants.

Table 4 - Estimate of ratio of financial cost to net revenue stream

	Original 2020/21 Estimate %	Revised 2020/21 Estimate %
Housing Revenue Account	13.79	13.79
Non HRA (General Fund)	26.60	21.64

3.3.2 The change to the General Fund estimate is mainly due to external borrowing being less than originally estimated.

3.4 Estimate of the Incremental impact of capital investment decisions on the Council Tax and Rent Levels

3.4.1 These indicators have been prepared using the revised Capital Programme, approved by Council on the 1st October 2020. For the General Fund these are calculated by dividing the estimated capital financing costs by the estimated Council Tax Band D equivalents. There is no borrowing planned for the Housing Revenue Account (HRA) therefore these ratios have zeros. If in future years there was to be HRA borrowing the ratio would be calculated by dividing the estimated capital financing costs by the estimated number of council dwellings.

Table 5 - Incremental impact of capital investment decisions on the Council Tax and Rent Levels

	Original 2020/21 Estimate £	Revised 2020/21 Estimate £
General Fund (Band D)	59.62	60.13
HRA (52 Weeks)	0	0

3.4.2 The incremental impact of capital investment decisions is broadly in line with the original estimate.

4. Prudential Indicators for Treasury Management

4.1 Interest rate exposure

4.1.1 Local authorities are required to set limits for the upper limits on exposure to the effects of changes in interest rates. The indicators relate to both fixed and variable rate interest, and are net of any investments.

4.1.2 Depending on the level of interest rates and their expected movement in the year, the Council may take up all of its new borrowings in the form of either fixed or variable rate debt. The figures in Table 6 give the following maximum levels, when compared to the operational boundary, of exposure to fixed and variable interest rates, which are prudent limits for the forthcoming years:

Table 6 - Interest Rate Exposure

Principal Outstanding	2020/2021 30th September 2020 Actual	2020/2021 Revised
	£m	£m
Fixed Rates	82.0	211.0
Variable Rates (No more than 40% of the operational boundary).	15.0	84.4

4.1.3 The 2020/21 revised values represent the maximum amount of fixed rate debt and the maximum amount of variable rate date the Authority could hold based on the new recommended Authorised Limit. The 30th September 2020 Actual values represent the actual level of fixed rate and variable rate debt the Council had on 30th September 2020.

4.2 Maturity Structure of borrowing

4.2.1 For the next three years' the authority is required to set both lower and upper limits for the maturity structure of its borrowing. This indicator relates only to fixed rate debt and is therefore a measure of the longer-term exposure to interest rate risk.

4.2.2 Table 7 shows the proposed lower and upper limits for all three years, given the current structure of the Council's debt portfolio:

Table 7 - Maturity Structure of Debt

Maturity Structure of Fixed Rate Borrowing	Actual Position for 30/09/2020	Lower Limit %	Upper Limit %
Under 12 Months	0.00%	0%	5%
Under 24 Months	6.70%	0%	10%
Under 5 years	12.32%	0%	20%
Under 10 Years	24.46%	0%	25%
Under 20 Years	37.86%	0%	40%
Under 30 Years	43.01%	0%	50%
Under 40 Years	73.93%	0%	80%
Under 50 Years	100.00%	0%	100%
50 Years and Above	0.00%	0%	0%

4.3 Principal sums invested for more than 364 days

4.3.1Where a local authority invests, or plans to invest for periods of more than 364 days it must set an upper limit for each year for the maturity of such investments. The purpose of setting this limit is to contain any exposure to losses, which might arise in the event of having to seek early repayment of the investment and / or adverse movements in shorter-term interest rates.

4.3.2 It is suggested, that the use of longer-term investments be limited to a maximum of £5m in each of the next three years to tie in with the Council's already approved policy of not investing more than £5m with any one bank or building society at the same time.

4.3.3 The Authority currently does not have any long term investments.

5. Investment Portfolio 2020/21

5.1 In accordance with the Code, it is the Council's priority to ensure security of capital, liquidity and to obtain an appropriate level of return, which is consistent with the Council's risk appetite. It is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are still very low and in line with the 0.10% Bank of England Base Rate. Table 8 provides a summary of the Council's total investments as at 30th September 2020.

Table 8 – Summary of Investments

Borrower	**Balance at 30/09/20 £000's**
Call Accounts	5,066
Money Market Funds	14,365
Fixed Term Deposits	0
Total	**19,431**

5.2 Call Accounts

5.2.1 In total, the Council held £5.07m of call account investments (see table below) as at 30 September 2020 (£0.4m at 31 March 2020) and the average investment portfolio yield for all investments in the first six months of the year is 0.22%, which is due to low interest rates.

Table 9 – Call Accounts

Borrower	Balance at 30/09/20 £000's
Barclays Bank	48
Handelsbanken	5,018

5.2.2 The average interest rate across counterparties for Call deposits is 0.17%

5.3 Money Market Funds

5.3.1 The Council currently has three Low Volatility Net Asset Value (LVNAV) Money Market Funds. This means that the value of the shares that the Council holds in these funds may go down as well as up. However, it is unlikely that there will be a change in the price of the Money Market Fund shares between the prices paid and monies received when the shares are sold.

Table 10 – Money Market Funds

Borrower	Balance at 30/09/20 £000's
Aberdeen Standard Liquidity – Money Market Fund	5,000
Insight Investments – Money Market Fund	4,365
Federated Hermes – Money Market Fund	5,000

The average interest rate across counterparties for Call deposits is 0.18%

5.4 Fixed Term Deposits

5.4.1 As at 31st March 2020, the Council had a £2.0m fixed term deposit with Thurrock Council. At the end of September, the Council had no fixed term deposits. There have also been term deposits with other Local Authorities, Banks and the UK Government Debt Management Office, for various periods between 1st April and 30th September 2020.

Table 11 – Fixed Term Deposits

Opening Balance £000's	New Investments £000's	Repayments £000's	Closing Balance £000's
2,000	42,750	44,750	0

5.4.2 The comparison below shows the performance of these fixed term deposit investments against the current Bank of England (BoE) base rate.

Table 12 – Fixed Term Deposits Comparison to Bank of England base rate

BoE Base Rate as at 30th September	Council Performance	Investment Interest Earned £000's
0.1%	0.49%	£7k

5.5 Interest Receivable Budget

5.5.1 The Council's budgeted investment return for 2020/21 is £35k and performance for the half year to 30 September 2020 is £23k, which comprises £7k from term deposits, £11k from Money Market Funds and £5k from call deposits. The estimated full year outturn is still expected to be £35k, as balances in the Money Market Funds are expected to diminish in the second half of the year.

5.5.2 There is the possibility of negative interest rates for Money Market Funds (MMFs) even if Bank of England Base rates do not turn negative. For the short term, it is expected that if interest rates do turn negative for MMFs then these will be offset by a reduction in fees.

5.6 Investment Strategy Breaches

5.6.1 There was one occasion were the Investment Strategy was breached:

i) Handelsbanken – Interest was added to the £5m investment which caused the balance to exceed the £5m limit.

6 Borrowing

6.1 The borrowing activities undertaken during the year to 30 September 2020 are summarised below:

Table 13 – Council's borrowing activities to 30th September 2020

Type of Loan	As at 31 March 2020 £'000	Borrowed £'000	Repaid £'000	As at 30 Sept 2020 £'000
Fixed PWLB	62.536	0	0	62.536
Private Placement Loans – LOBO	19,500	0	0	19,500
Private Placement Loans – Fixed	15,000	0	0	15,000
Total External Debt	**97,036**	**0**	**0**	**97,036**

7 Investment Properties

7.1 As at the 1st April 2020 the Council had spent £58.506m on investment properties. In 2020/21 it has purchased one other property for £3.260m. The total net expenditure to date on investment properties is £61.766m. These investment properties are expected to generate £4.320m gross rental income per annum which is a gross yield of 7%. The CFR and therefore MRP charges have increased as a result of activity in investment properties.

Glossary of Terms

Call Accounts
Is a bank account for investment funds it has no fixed deposit period, provides instant access to funds and allows unlimited withdrawals and deposits.

Gross Domestic Product (GDP)
This is the monetary value of all the finished goods and services produced by a country within its borders in a specific time period, usually a year.

Consumer Price Index (CPI)
The official measure of inflation of consumer prices of the United Kingdom.

LIBID
The London Interbank Bid Rate, that is, the interest rate at which banks bid to take short-term deposits from other banks.

Retail Price Index (RPI)
A measure of inflation by measuring changes in the price levels of a sample of representative goods and services purchased by households. They use different items and different formulae for the calculations which means that CPI is often lower than RPI.

y/y
Year on year is a method of evaluating two or more measured events to compare the results of one time period with those of a comparable time period on an annualised basis.

Monetary Policy Committee (MPC)
This is a committee of the Bank of England which decides the official interest rate in the UK (the Bank of England Base Rate) and also directs other monetary policy such as quantitative easing and forward guidance.

Public Works Loan Board (PWLB)
The PWLB is a statutory body operating within the UK Debt Management Office to lend money from the National Loan Fund to local authorities and to collect the repayments.

Quantitative Easing (QE)
An unconventional form of monetary policy where a Central Bank creates new money electronically to buy financial assets, like government bonds. This process aims to directly increase private sector spending in the economy and return inflation to target.

Implications

Corporate Plan:

Effective treasury management and investment in properties is providing an income stream to support delivery of the key services within the Corporate Plan.

Legal:

Requirement to adhere to the CIPFA Prudential Code. Ensures compliance with Financial Regulations.

Finance:

Budget Area	**Implication**
General Fund – Revenue Budget	No significant implications
General Fund – Capital Programme	No significant implications
Housing Revenue Account – Revenue Budget	No significant implications
Housing Revenue Account – Capital Programme	No significant implications

Risk:

Risk	**Mitigation**
Risk that the investment properties become void or fall in value	Spread of assets within the portfolio and a reserve to cushion any void periods.

Human Resources:

No Human Resources implications contained in this report.

Environmental/Sustainability

No implications.

Equalities:

No implications.

Other Implications:

No implications.

Reason(s) for Urgency

Not Applicable

Reason(s) for Exemption

Not Applicable.

Background Papers

Link Asset Services – Treasury Management Strategy Statement and Annual Investment Strategy Mid-Year Review Report 2020/21.

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Appendix 1

Economics update

- As expected, the Bank of England's Monetary Policy Committee kept Bank Rate unchanged on 6th August. It also kept unchanged the level of quantitative easing at £745bn. Its forecasts were optimistic in terms of three areas:

    - The fall in **GDP** in the first half of 2020 was revised from 28% to 23% (subsequently revised to -21.8%). This is still one of the largest falls in output of any developed nation. However, it is only to be expected as the UK economy is heavily skewed towards consumer-facing services – an area which was particularly vulnerable to being damaged by lockdown.
    - The peak in the **unemployment rate** was revised down from 9% in Q2 to 7½% by Q4 2020.
    - It forecast that there would be excess demand in the economy by Q3 2022 causing CPI **inflation** to rise above the 2% target in Q3 2022, (based on market interest rate expectations for a further loosening in policy). Nevertheless, even if the Bank were to leave policy unchanged, inflation was still projected to be above 2% in 2023.

- It also squashed any idea of using **negative interest rates**, at least in the next six months or so. It suggested that while negative rates can work in some circumstances, it would be "less effective as a tool to stimulate the economy" at this time when banks are worried about future loan losses. It also has "other instruments available", including QE and the use of forward guidance.
- The MPC expected the £300bn of **quantitative easing** purchases announced between its March and June meetings to continue until the "turn of the year". This implies that the pace of purchases will slow further to about £4bn a week, down from £14bn a week at the height of the crisis and £7bn more recently.
- In conclusion, this would indicate that the Bank could now just sit on its hands as the economy was recovering better than expected. However, the MPC acknowledged that the "medium-term projections were a less informative guide than usual" and the minutes had multiple references to **downside risks,** which were judged to persist both in the short and medium term. One has only to look at the way in which second waves of the virus are now impacting many countries including Britain, to see the dangers. However, rather than a national lockdown, as in March, any spikes in virus infections are now likely to be dealt with by localised measures and this should limit the amount of economic damage caused. In addition, Brexit uncertainties ahead of the year-end deadline are likely to be a drag on recovery. The wind down of the initial generous furlough scheme through to the end of October is another development that could cause the Bank to review the need for more support for the economy later in the year. Admittedly, the Chancellor announced in late September a second six month package from 1st November of government support for jobs whereby it will pay up to 22% of the costs of retaining an employee working a minimum of one third of their normal hours. There was further help for the self-employed, freelancers and the hospitality industry. However, this is a much less generous scheme than the furlough package and will inevitably mean there will be further job losses from the 11% of the workforce still on furlough in mid September.
- Overall, **the pace of recovery** is not expected to be in the form of a rapid V shape, but a more elongated and prolonged one after a sharp recovery in June through to August which left the economy 11.7% smaller than in February. The last three months of 2020 are now likely to show no growth as consumers will probably remain cautious in spending and uncertainty over the

outcome of the UK/EU trade negotiations concluding at the end of the year will also be a headwind. If the Bank felt it did need to provide further support to recovery, then it is likely that the tool of choice would be more QE.

- There will be some **painful longer term adjustments** as e.g. office space and travel by planes, trains and buses may not recover to their previous level of use for several years, or possibly ever. There is also likely to be a reversal of globalisation as this crisis has shown up how vulnerable long-distance supply chains are. On the other hand, digital services is one area that has already seen huge growth.
- One key addition to **the Bank's forward guidance** was a new phrase in the policy statement, namely that "it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably". That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years' time, do not expect any action from the MPC to raise Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate
- The **Financial Policy Committee** (FPC) report on 6th August revised down their expected credit losses for the banking sector to "somewhat less than £80bn". It stated that in its assessment "banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC's central projection". The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC's projection, with unemployment rising to above 15%.
- **US.** The incoming sets of data during the first week of August were almost universally stronger than expected. With the number of new daily coronavirus infections beginning to abate, recovery from its contraction this year of 10.2% should continue over the coming months and employment growth should also pick up again. However, growth will be dampened by continuing outbreaks of the virus in some states leading to fresh localised restrictions. At its end of August meeting, the Fed tweaked **its inflation target** from 2% to maintaining an average of 2% over an unspecified time period i.e.following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time. This change is aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary "trap" like Japan. It is to be noted that inflation has actually been under-shooting the 2% target significantly for most of the last decade so financial markets took note that higher levels of inflation are likely to be in the pipeline; long term bond yields duly rose after the meeting. The Fed also called on Congress to end its political disagreement over providing more support for the unemployed as there is a limit to what monetary policy can do compared to more directed central government fiscal policy. The FOMC's updated economic and rate projections in mid-September showed that officials expect to leave the fed funds rate at near-zero until at least end-2023 and probably for another year or two beyond that. There is now some expectation that where the Fed has led in changing its inflation target, other major central banks will follow. The increase in tension over the last year between the US and China is likely to lead to a lack of momentum in progressing the initial positive moves to agree a phase one trade deal.
- **EU.** The economy was recovering well towards the end of Q2 after a sharp drop in GDP, (e.g. France 18.9%, Italy 17.6%). However, the second wave of the virus affecting some countries could cause a significant slowdown in the pace of recovery, especially in countries more dependent on tourism. The fiscal support package, eventually agreed by the EU after prolonged disagreement between various countries, is unlikely to provide significant support and quickly enough to make an appreciable difference in weaker countries. The ECB has been struggling to get inflation up to its 2% target and it is therefore expected that it will have to

provide more monetary policy support through more quantitative easing purchases of bonds in the absence of sufficient fiscal support.

- **China.** After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and has enabled it to recover all of the contraction in Q1. However, this was achieved by major central government funding of yet more infrastructure spending. After years of growth having been focused on this same area, any further spending in this area is likely to lead to increasingly weaker economic returns. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.
- **Japan.** There are some concerns that a second wave of the virus is gaining momentum and could dampen economic recovery from its contraction of 8.5% in GDP. It has been struggling to get out of a deflation trap for many years and to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. The resignation of Prime Minister Abe is not expected to result in any significant change in economic policy.
- **World growth.** Latin America and India are currently hotspots for virus infections. World growth will be in recession this year. Inflation is unlikely to be a problem for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

Interest rate forecasts

The Council's treasury advisor, Link Group, provided the following forecasts on 11th August 2020 (PWLB rates are certainty rates, gilt yields plus 180bps):

Link Group Interest Rate View 11.8.20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month average earnings	0.05	0.05	0.05	0.05	0.05	-	-	-	-	-
6 month average earnings	0.10	0.10	0.10	0.10	0.10	-	-	-	-	-
12 month average earnings	0.15	0.15	0.15	0.15	0.15	-	-	-	-	-
5yr PWLB Rate	1.90	2.00	2.00	2.00	2.00	2.00	2.10	2.10	2.10	2.10
10yr PWLB Rate	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30
25yr PWLB Rate	2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70	2.70	2.70
50yr PWLB Rate	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50	2.50	2.50

The coronavirus outbreak has done huge economic damage to the UK and economies around the world. After the Bank of England took emergency action in March to cut Bank Rate to first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its meeting on 6th August (and the subsequent September meeting), although some forecasters had suggested that a cut into negative territory could happen. However, the Governor of the Bank of England has made it clear that he currently thinks that such a move would do more damage than good and that more quantitative easing is the favoured tool if further action becomes necessary. As shown in the forecast table above, no increase in Bank Rate is expected within the forecast horizon ending on 31st March 2023 as economic recovery is expected to be only gradual and, therefore, prolonged.

GILT YIELDS / PWLB RATES. There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020. In addition, there were growing expectations of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued. Combined, these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers. This means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. The consequence of this has been the gradual lowering of the overall level of interest rates and bond yields in financial markets over the last 30 years. Over the year prior to the coronavirus crisis, this has seen many bond yields up to 10 years turn negative in the Eurozone. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.

Gilt yields had therefore already been on a generally falling trend up until the coronavirus crisis hit western economies during March. After gilt yields spiked up during the initial phases of the health crisis in March, we have seen these yields fall sharply to unprecedented lows as major western central banks took rapid action to deal with excessive stress in financial markets, and started massive quantitative easing purchases of government bonds: this also acted to put downward pressure on government bond yields at a time when there has been a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in "normal" times would have caused bond yields to rise sharply. At the close of the day on 30th

September, all gilt yields from 1 to 6 years were in negative territory, while even 25-year yields were at only 0.76% and 50 year at 0.60%.

From the local authority borrowing perspective, HM Treasury imposed **two changes of margins over gilt yields for PWLB rates** in 2019-20 without any prior warning. The first took place on 9th October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then at least partially reversed for some forms of borrowing on 11th March 2020, but not for mainstream General Fund capital schemes, at the same time as the Government announced in the Budget a programme of increased infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; this was to end on 4th June, but that date was subsequently put back to 31st July. It is clear HM Treasury will no longer allow local authorities to borrow money from the PWLB to purchase commercial property if the aim is solely to generate an income stream (assets for yield).

Following the changes on 11th March 2020 in margins over gilt yields, the current situation is as follows: -

- **PWLB Standard Rate** is gilt plus 200 basis points (G+200bps)
- **PWLB Certainty Rate** is gilt plus 180 basis points (G+180bps)
- **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
- **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
- **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

It is possible that the non-HRA Certainty Rate will be subject to revision downwards after the conclusion of the PWLB consultation; however, the timing of such a change is currently an unknown, although it would be likely to be within the current financial year.

As the interest forecast table for PWLB certainty rates, (gilts plus 180bps), above shows, there is likely to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020/21.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably relatively even, but is subject to major uncertainty due to the virus.
- There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, could impact gilt yields, (and so PWLB rates), in the UK.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- **UK -** second nationwide wave of virus infections requiring a national lockdown
- **UK / EU trade negotiations** – if it were to cause significant economic disruption and a fresh major downturn in the rate of growth.

- **UK - Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis.** The ECB has taken monetary policy action to support the bonds of EU states, with the positive impact most likely for "weaker" countries. In addition, the EU recently agreed a €750bn fiscal support package. These actions will help shield weaker economic regions for the next year or so. However, in the case of Italy, the cost of the virus crisis has added to its already huge debt mountain and its slow economic growth will leave it vulnerable to markets returning to taking the view that its level of debt is unsupportable. There remains a sharp divide between northern EU countries favouring low debt to GDP and annual balanced budgets and southern countries who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come.
- Weak capitalisation of some **European banks**, which could be undermined further depending on extent of credit losses resultant of the pandemic.
- **German minority government & general election in 2021.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. The CDU has done badly in subsequent state elections but the SPD has done particularly badly. Angela Merkel has stepped down from being the CDU party leader but she intends to remain as Chancellor until the general election in 2021. This then leaves a major question mark over who will be the major guiding hand and driver of EU unity when she steps down.
- **Other minority EU governments.** Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been a rise in anti-immigration sentiment in Germany and France.
- **Geopolitical risks,** for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe haven flows.
- **US – the Presidential election in 2020:** this could have repercussions for the US economy and SINO-US trade relations.

Upside risks to current forecasts for UK gilt yields and PWLB rates

- **UK -** stronger than currently expected recovery in UK economy.
- **Post-Brexit** – if an agreement was reached that removed the majority of threats of economic disruption between the EU and the UK.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.