Ashfield
DISTRICT COUNCIL

Report To:	**AUDIT COMMITTEE**	**Date:**	**18th OCTOBER 2021**
Heading:	**TREASURY MANAGEMENT MID YEAR REPORT 2021/22**		
Portfolio Holder:	**PORTFOLIO HOLDER FOR FINANCE, REVENUES AND BENEFITS – CLLR DAVID MARTIN**		
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 2021/22 financial year as at 30 September 2021;
- The Council's capital position (including prudential indicators);
- The Council's investment portfolio for 2021/22;
- The Council's borrowing position for 2021/22.

Recommendation(s)

1) To agree changes to the 2021/22 Prudential Indicators following in year changes to the 2021/22 Capital Programme, and,
2) To note contents of the report.

Reasons for Recommendation(s)

In accordance with the Council's Financial Regulations, the Audit Committee is responsible for ensuring effective scrutiny of the Treasury Management Strategy and policies.

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 <u>Economics and interest rates to date and the outlook for 2021/22</u>

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, the forecast is for the Bank Rate to remain at this level for the remainder of the year. It is no longer expected that negative interest rates will be introduced as the economy is starting to recover.

2.3 Public Works Loans Board (PWLB) has been the main source of borrowing for the Council. PWLB rates have reduced slightly. The 50 year PWLB (certainty) rate for new long term borrowing reduced from 2.03% on the 1 April to 1.97% by 30 September 2021. During the first 6 months of 2021/22 rates have been as low as 1.49% and as high as 2.06%.

2.4 The UK's economy is influenced by UK and worldwide events. It will continue to be impacted by the economic recovery in relation to the Covid-19 pandemic and the impacts of Brexit. A full economic update and interest rate forecast provided by Link Asset Services, our Treasury Advisors, is included at Appendix 1.

3 <u>The Council's Capital Position (including Prudential Indicators)</u>

<u>Prudential Indicators</u>

3.1 <u>Capital Programme</u>

3.1.1 Table 1 below shows the revised estimates for capital expenditure taking into account the changes since the capital programme was agreed at the Budget.

<u>Table 1 – Capital Programme 2021/22</u>

Capital Expenditure by Service	2021/22 Original Estimate £m	2021/22 Revised Estimate £m
General Fund	22.242	32.557
Area Schemes	0.382	0.977
HRA - Decent Homes	10.073	7.293
HRA – Other	5.285	10.298
Total capital expenditure	**37.982**	**51.125**

3.1.2 The main reasons for the increase in the General Fund capital expenditure is due to additions of £5m for Future High Street Fund Schemes, £3.1m for Town Fund Schemes and £1.3m slippage on 2020/21 Town Fund Schemes. The change in the HRA - Decent Homes Schemes is largely due to capital components lasting longer than their anticipated lifecycle. The increase in the HRA – Other capital expenditure is due to the addition of the 2020/21 slippage, bringing forward the Davies Avenue Scheme and the inclusion Green Home Grant scheme. The increase in area schemes is mainly due to slippage from 2020/21.

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	2021/22 Original Estimate £m	2021/22 Revised Estimate £m
Total capital expenditure	**37.982**	**51.125**
Financed by:		
Capital receipts	2.197	3.347
Capital grants	5.484	13.001
Capital reserves	11.931	13.301
Total financing	**19.612**	**29.649**
Borrowing requirement	**18.370**	**21.476**

3.1.4 The borrowing requirement for 2021/22 has increased largely because of expenditure slippage from 2020/21.

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)

	2021/22 Original Estimate £m	2021/22 Revised Estimate (Adjusted for Slippage) £m
Prudential Indicator – Capital Financing Requirement		
CFR Non-Housing	102.418	101.265
CFR – Housing	80.131	80.061
Total CFR	**182.549**	**181.326**
Prudential Indicator – the Operational Boundary for external debt		
Borrowing	186.000	186.000
Other Long Term Liabilities	0.000	0.000
Total debt 31st March	**186.000**	**186.000**
Prudential Indicator – the Authorised Limit for external debt		
Borrowing	205.000	205.000
Other Long Term Liabilities	0.000	0.000
Total debt 31st March	**205.000**	**205.000**

3.2.2 The 2021/22 Capital Financing requirement has decreased largely as a result of leased assets being included in the original estimate due to the introduction of a new accounting standard. The introduction of this standard has been delayed by one year.

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 2021/22 Estimate %	Revised 2021/22 Estimate %
Housing Revenue Account	14.60	14.59
Non HRA (General Fund)	20.32	16.98

3.3.2 The change to the General Fund estimate is mainly due to external borrowing being less than originally estimated and slippage on the 2020/21 capital programme has resulted in less MRP being charged in 2021/22.

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 23rd September 2021. For the General Fund this is 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 are nil. 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 2021/22 Estimate £	**Revised 2021/22 Estimate £**
General Fund (Band D)	25.33	26.06
HRA (52 Weeks)	0	0

3.4.2 The incremental impact of capital investment on the General Fund is slightly higher due to slippage on the 2020/21 capital programme.

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 Table 6 give the following maximum levels, when compared to the authorised limit, of exposure to fixed and variable interest rates, which are prudent limits for the forthcoming years:

Table 6 - Interest Rate Exposure

Principal Outstanding	**2021/2022 30th September 2021 Actual**	**2021/2022 Original**
	£m	**£m**
Fixed Rates	97.0	205.0
Variable Rates (No more than 40% of the authorised limit).	15.0	82.0

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 30/09/2021	Lower Limit %	Upper Limit %
Under 12 Months	0.00%	0%	5%
Under 24 Months	0.00%	0%	10%
Under 5 years	15.14%	0%	20%
Under 10 Years	17.23%	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

4.3.1 Where 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 The strategy for 2021/22 set a limit of a maximum of £5m in each of the next three years to be placed in longer-term investments. The Authority currently does not have any long-term investments.

5. Investment Portfolio 2021/22

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 6 provides a summary of the Council's total investments as at 30th September 2021.

Table 8 – Summary of Investments

Borrower	Balance at 30/09/21 £000’s
Call Accounts	10,317
Money Market Funds	19,900
Fixed Term Deposits	5,000
Total	**35,217**

5.2 Bank Accounts

5.2.1 In total, the Council held investments in banks of £10.315m as at 30 September 2021, (£6.5m as at 31 March 2021).

Table 9 – Call Accounts

Borrower	Balance at 30/09/21 £000’s
Barclays Bank	364
Handelsbanken	4,951
Total	**5,315**

5.2.2 The average investment portfolio yield for call account investments in the first six months of the year is 0.03%, which is due to low interest rates.

Table 10 – Notice Accounts

Borrower	Balance at 30/09/21 £000’s
Santander 35 Day Notice Account	5,000

5.2.3 The average interest rate across all bank investments (call accounts and notice accounts) counterparties is 0.13%.

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 11 – Money Market Funds

Borrower	Balance at 30/09/21 £000's
Aberdeen Standard Liquidity – Money Market Fund	5,000
Insight Investments – Money Market Fund	4,900
Federated Hermes – Money Market Fund	5,000
Aviva Investments – Money Market Fund	5,000

The average interest rate across counterparties for Call deposits is 0.01%

5.4 Fixed Term Deposits

5.4.1 As at 31st March 2021, the Council had a £2.0m fixed term deposit with The Royal Borough of Windsor and Maidenhead. At the end of September, the Council had two fixed term deposits, with Al Rayan Bank. There have also been term deposits with Banks and the UK Government Debt Management Office, for various periods between 1st April and 30th September 2021.

Table 11 – Fixed Term Deposits

Opening Balance £000's	New Investments £000's	Repayments £000's	Closing Balance £000's
2,000	44,000	41,000	5,000

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%	0.03%	£4k

5.5 Interest Receivable Budget

5.5.1 The Council's budgeted investment return for 2021/22 is £5k and performance for the half year to 30 September 2021 is £9k, which comprises £4k from term deposits, £1.5k from Money Market Funds and £3.5k from call deposits. The estimated full year outturn is expected to be £13k; £8k greater than budget.

5.6 Investment Strategy Breaches

5.6.1 There was one breach of the Investment Strategy where the operational bank account exceeded £5m:

i) Barclays – A large investment property rental payment was received on 22 September after the cut off time for placing funds in investments which caused the balance to exceed the £5m limit by £388k. The funds were moved the following day.

6 Borrowing

6.1 The borrowing activities undertaken during the year to 30 September 2021 are summarised below:

Table 13 – Council's borrowing activities to 30th September 2021

Type of Loan	**As at 31 March 2021 £'000**	**Borrowed £'000**	**Repaid £'000**	**As at 30 Sept 2021 £'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 2021 the Council had spent £61.810m on investment properties. These investment properties are expected to generate £4.518m gross rental income per annum which is a gross yield of 7.3%. The CFR and therefore MRP charges have increased as 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.

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

Federal Reserve (Fed)
The central banking system of the United States of America.

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.

Gilts
Gilts are UK Government Bonds which offer a very low risk of default and a corresponding low rate of return.

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

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 implications.

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 2021/22
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Economics and interest rates

Appendix 1

1.1 Economics update

MPC meeting 24.9.21

- The Monetary Policy Committee (MPC) voted unanimously to leave Bank Rate unchanged at 0.10% and made no changes to its programme of quantitative easing purchases due to finish by the end of this year at a total of £895bn; two MPC members voted to stop the last £35bn of purchases as they were concerned that this would add to inflationary pressures.

- There was a major shift in the tone of the MPC's minutes at this meeting from the previous meeting in August which had majored on indicating that some tightening in monetary policy was now on the horizon, but also not wanting to stifle economic recovery by too early an increase in Bank Rate. In his press conference after the August MPC meeting, Governor Andrew Bailey said, "the challenge of avoiding a steep rise in unemployment has been replaced by that of ensuring a flow of labour into jobs" and that "the Committee will be monitoring closely the incoming evidence regarding developments in the labour market, and particularly unemployment, wider measures of slack, and underlying wage pressures." In other words, it was flagging up a potential danger that labour shortages could push up wage growth by more than it expects and that, as a result, CPI inflation would stay above the 2% target for longer. It also discounted sharp increases in monthly inflation figures in the pipeline in late 2021 which were largely propelled by events a year ago e.g., the cut in VAT in August 2020 for the hospitality industry, and by temporary shortages which would eventually work their way out of the system: in other words, **the MPC had been prepared to look through a temporary spike in inflation.**

- So, in August the country was just put on alert. However, this time the MPC's words indicated there had been a marked increase in concern that more recent increases in prices, particularly the increases in gas and electricity prices in October and due again next April, are, indeed, likely to lead to **faster and higher inflation expectations and underlying wage growth, which would in turn increase the risk that price pressures would prove more persistent next year than previously expected. Indeed, to emphasise its concern about inflationary pressures, the MPC pointedly chose to reaffirm its commitment to the 2% inflation target in its statement;** this suggested that it was now willing to look through the flagging economic recovery during the summer to prioritise bringing inflation down next year. This is a reversal of its priorities in August and a long way from words at earlier MPC meetings which indicated a willingness to look through inflation overshooting the target for limited periods to ensure that inflation was 'sustainably over 2%'. Indeed, whereas in August the MPC's focus was on getting through a winter of temporarily high energy prices and supply shortages, believing that inflation would return to just under the 2% target after reaching a high around 4% in late 2021, now its primary concern is that underlying price pressures in the economy are likely to get embedded over the next year and elevate future inflation to stay significantly above its 2% target and for longer.

- Financial markets are now pricing in a first increase in Bank Rate from 0.10% to 0.25% in February 2022, but this looks ambitious as the MPC has stated that it wants to see what happens to the economy, and particularly to employment once furlough ends at the end of September. At the MPC's meeting in February it will only have available the employment figures for November: to get a clearer picture of employment trends, it would need to wait until the May meeting when it would have data up until February. At its May meeting, it will also have a clearer understanding of the likely peak of inflation.

- **The MPC's forward guidance on its intended monetary policy** on raising Bank Rate versus selling (quantitative easing) holdings of bonds is as follows: -
  1. Placing the focus on raising Bank Rate as "the active instrument in most circumstances".
  2. Raising Bank Rate to 0.50% before starting on reducing its holdings.
  3. Once Bank Rate is at 0.50% it would stop reinvesting maturing gilts.
  4. Once Bank Rate had risen to at least 1%, it would start selling its holdings.

- **COVID-19 vaccines.** These have been the game changer which have enormously boosted confidence that **life in the UK could largely return to normal during the summer** after a third wave of the virus threatened to overwhelm hospitals in the spring. With the household saving rate having been exceptionally high since the first lockdown in March 2020, there is plenty of pent-up demand and purchasing power stored up for services in hard hit sectors like restaurants, travel and hotels. The big question is whether mutations of the virus could develop which render current vaccines ineffective, as opposed to how quickly vaccines can be modified to deal with them and enhanced testing programmes be implemented to contain their spread.

US. See comments below on US treasury yields.

EU. The slow role out of vaccines initially delayed economic recovery in early 2021 but the vaccination rate has picked up sharply since then. After a contraction in GDP of -0.3% in Q1, Q2 came in with strong growth of 2%, which is likely to continue into Q3, though some countries more dependent on tourism may struggle. Recent sharp increases in gas and electricity prices have increased overall inflationary pressures but the ECB is likely to see these as being only transitory after an initial burst through to around 4%, so is unlikely to be raising rates for a considerable time.
German general election. With the CDU/CSU and SDP both having won around 24-26% of the vote in the September general election, the composition of Germany's next coalition government may not be agreed by the end of 2021. An SDP-led coalition would probably pursue a slightly less restrictive fiscal policy, but any change of direction from a CDU/CSU led coalition government is likely to be small. However, with Angela Merkel standing down as Chancellor as soon as a coalition is formed, there will be a hole in overall EU leadership which will be difficult to fill.

China. After a concerted effort to get on top of the virus outbreak in Q1 2020, economic recovery was strong in the rest of the year; this enabled China to recover all the initial contraction. During 2020, policy makers both quashed the virus and implemented a programme of monetary and fiscal support that was particularly effective at stimulating short-term growth. At the same time, China's economy benefited from the shift towards online spending by consumers in developed markets. These factors helped to explain its comparative outperformance compared to western economies during 2020 and earlier in 2021. However, the pace of economic growth has now fallen back after this initial surge of recovery from the pandemic and China is now struggling to contain the spread of the Delta variant through sharp local lockdowns - which will also depress economic growth. There are also questions as to how effective Chinese vaccines are proving. In addition, recent regulatory actions motivated by a political agenda to channel activities into officially approved directions, are also likely to reduce the dynamism and long-term growth of the Chinese economy.

Japan. 2021 has been a patchy year in combating Covid. However, after a slow start, nearly 50% of the population are now vaccinated and Covid case numbers are falling. After a weak Q3 there is likely to be a strong recovery in Q4. The Bank of Japan is continuing its very loose monetary policy but with little prospect of getting inflation back above 1% towards its target of 2%, any time soon: indeed, inflation was negative in July. New Prime Minister Kishida has promised a large fiscal stimulus package after the November general election – which his party is likely to win.

World growth. World growth was in recession in 2020 but recovered during 2021 until starting to lose momentum more recently. Inflation has been rising due to increases in gas and electricity prices, shipping costs and supply shortages, although these should subside during 2022. It is likely that we are heading into a period where there will be a reversal of **world globalisation** and a decoupling of western countries from dependence on China to supply products, and vice versa. This is likely to reduce world growth rates from those in prior decades.

Supply shortages. The pandemic and extreme weather events have been highly disruptive of extended worldwide supply chains. At the current time there are major queues of ships unable to unload their goods at ports in New York, California and China. Such issues have led to mis-distribution of shipping containers around the world and have contributed to a huge increase in the cost of shipping. Combined with a shortage of semi-conductors, these issues have had a disruptive impact on production in many countries. Many western countries are also hitting up against a difficulty in filling job vacancies. It is expected that these issues will be gradually sorted out, but they are currently contributing to a spike upwards in inflation and shortages of materials and goods on shelves.

1.2 Interest rate forecasts

The Council's treasury advisor, Link Group, provided the following forecasts on 29th September 2021 (PWLB rates are certainty rates, gilt yields plus 80bps):

Link Group Interest Rate View 29.9.21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.75
3 month ave earnings	0.10	0.10	0.20	0.20	0.30	0.40	0.50	0.50	0.60	0.70
6 month ave earnings	0.20	0.20	0.30	0.30	0.40	0.50	0.60	0.60	0.70	0.80
12 month ave earnings	0.30	0.40	0.50	0.50	0.50	0.60	0.70	0.80	0.90	1.00
5 yr PWLB	1.40	1.40	1.50	1.50	1.60	1.60	1.60	1.70	1.70	1.70
10 yr PWLB	1.80	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.10
25 yr PWLB	2.20	2.20	2.30	2.30	2.40	2.40	2.40	2.50	2.50	2.60
50 yr PWLB	2.00	2.00	2.10	2.20	2.20	2.20	2.20	2.30	2.30	2.40

Additional notes by Link on this forecast table: -

- *LIBOR and LIBID rates will cease from the end of 2021. Work is currently progressing to replace LIBOR with a rate based on SONIA (Sterling Overnight Index Average). In the meantime, our forecasts are based on expected average earnings by local authorities for 3 to 12 months.*
- *Our forecasts for average earnings are averages i.e., rates offered by individual banks may differ significantly from these averages, reflecting their different needs for borrowing short term cash at any one point in time.*

The coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings.

As shown in the forecast table above, one increase in Bank Rate from 0.10% to 0.25% has now been included in quarter 2 of 2022/23, a second increase to 0.50% in quarter 2 of 23/24 and a third one to 0.75% in quarter 4 of 23/24.

Significant risks to the forecasts

- COVID vaccines do not work to combat new mutations and/or new vaccines take longer than anticipated to be developed for successful implementation.
- The pandemic causes major long-term scarring of the economy.
- The Government implements an austerity programme that supresses GDP growth.
- The MPC tightens monetary policy too early – by raising Bank Rate or unwinding QE.
- The MPC tightens monetary policy too late to ward off building inflationary pressures.
- Major stock markets e.g. in the US, become increasingly judged as being over-valued and susceptible to major price corrections. Central banks become increasingly exposed to the "moral hazard" risks of having to buy shares and corporate bonds to reduce the impact of major financial market sell-offs on the general economy.
- Geo-political risks are widespread e.g. German general election in September 2021 produces an unstable coalition or minority government and a void in high-profile leadership in the EU when Angela Merkel steps down as Chancellor of Germany; on-going global power influence struggles between Russia/China/US.

The balance of risks to the UK economy: -

- The overall balance of risks to economic growth in the UK is now to the downside, including residual risks from Covid and its variants - both domestically and their potential effects worldwide.

Forecasts for Bank Rate

Bank Rate is not expected to go up fast after the initial rate rise as the supply potential of the economy has not generally taken a major hit during the pandemic, so should be able to cope well with meeting demand without causing inflation to remain elevated in the medium-term, or to inhibit inflation from falling back towards the MPC's 2% target after the surge to around 4% towards the end of 2021. Three increases in Bank rate are forecast in the period to March 2024, ending at 0.75%. However, these forecasts may well need changing within a relatively short time frame for the following reasons: -

- There are increasing grounds for viewing the economic recovery as running out of steam during the summer and now into the autumn. This could lead into stagflation which would create a dilemma for the MPC as to which way to face.
- Will some current key supply shortages e.g., petrol and diesel, spill over into causing economic activity in some sectors to take a significant hit?
- Rising gas and electricity prices in October and next April and increases in other prices caused by supply shortages and increases in taxation next April, are already going to deflate consumer spending power without the MPC having to take any action on Bank Rate to cool inflation. Then we have the Government's upcoming budget in October, which could also end up in reducing consumer spending power.
- On the other hand, consumers are sitting on around £200bn of excess savings left over from the pandemic so when will they spend this sum, in part or in total?
- There are 1.6 million people coming off furlough at the end of September; how many of those will not have jobs on 1st October and will, therefore, be available to fill labour shortages in many sectors of the economy? So, supply shortages which have been driving up both wages and costs, could reduce significantly within the next six months or so and alleviate the MPC's current concerns.
- There is a risk that there could be further nasty surprises on the Covid front, on top of the flu season this winter, which could depress economic activity.

In summary, with the high level of uncertainty prevailing on several different fronts, it is likely that these forecasts will need to be revised again soon - in line with what the new news is.

It also needs to be borne in mind that Bank Rate being cut to 0.10% was an emergency measure to deal with the Covid crisis hitting the UK in March 2020. At any time, the MPC could decide to simply take away that final emergency cut from 0.25% to 0.10% on the grounds of it no longer being warranted and as a step forward in the return to normalisation. In addition, any Bank Rate under 1% is both highly unusual and highly supportive of economic growth.

Forecasts for PWLB rates and gilt and treasury yields
As the interest forecast table for PWLB certainty rates above shows, there is likely to be a steady rise over the forecast period, with some degree of uplift due to rising treasury yields in the US.
There is likely to be **exceptional volatility and unpredictability in respect of gilt yields and PWLB rates** due to the following factors: -

- How strongly will changes in gilt yields be correlated to changes in US treasury yields?
- Will the Fed take action to counter increasing treasury yields if they rise beyond a yet unspecified level?
- Would the MPC act to counter increasing gilt yields if they rise beyond a yet unspecified level?
- How strong will inflationary pressures turn out to be in both the US and the UK and so impact treasury and gilt yields?
- How will central banks implement their new average or sustainable level inflation monetary policies?
- How well will central banks manage the withdrawal of QE purchases of their national bonds i.e., without causing a panic reaction in financial markets as happened in the "taper tantrums" in the US in 2013?
- Will exceptional volatility be focused on the short or long-end of the yield curve, or both?

The forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU within our forecasting period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China / North Korea and Iran, which have a major impact on international trade and world GDP growth.

Gilt and treasury yields
Since the start of 2021, there has been a lot of volatility in gilt yields, and hence PWLB rates. During the first part of the year, US President Biden's, and the Democratic party's determination to push through a $1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the Covid pandemic was what unsettled financial markets. However, this was in addition to the $900bn support package already passed in December 2020 under President Trump. This was then followed by additional Democratic ambition to spend further huge sums on infrastructure and an American families plan over the next decade which are caught up in Democrat / Republican haggling. Financial markets were alarmed that all this stimulus, which is much bigger than in other western economies, was happening at a time in the US when: -

1. A fast vaccination programme has enabled a rapid opening up of the economy.
2. The economy had already been growing strongly during 2021.

3. It started from a position of little spare capacity due to less severe lockdown measures than in many other countries. A combination of shortage of labour and supply bottle necks is likely to stoke inflationary pressures more in the US than in other countries.
4. And the Fed was still providing monetary stimulus through monthly QE purchases.

These factors could cause an excess of demand in the economy which could then unleash stronger and more sustained inflationary pressures in the US than in other western countries. This could then force the Fed to take much earlier action to start tapering monthly QE purchases and/or increasing the Fed rate from near zero, despite their stated policy being to target average inflation. It is notable that some Fed members have moved forward their expectation of when the first increases in the Fed rate will occur in recent Fed meetings. In addition, more recently, shortages of workers appear to be stoking underlying wage inflationary pressures which are likely to feed through into CPI inflation. A run of strong monthly jobs growth figures could be enough to meet the threshold set by the Fed of "substantial further progress towards the goal of reaching full employment". However, the weak growth in August, (announced 3.9.21), has spiked anticipation that tapering of monthly QE purchases could start by the end of 2021. These purchases are currently acting as downward pressure on treasury yields. As the US financial markets are, by far, the biggest financial markets in the world, any trend upwards in the US will invariably impact and influence financial markets in other countries. However, during June and July, longer term yields fell sharply; even the large non-farm payroll increase in the first week of August seemed to cause the markets little concern, which is somewhat puzzling, particularly in the context of the concerns of many commentators that inflation may not be as transitory as the Fed is expecting it to be. Indeed, inflation pressures and erosion of surplus economic capacity look much stronger in the US than in the UK. **As an average since 2011, there has been a 75% correlation between movements in 10 year treasury yields and 10 year gilt yields. This is a significant UPWARD RISK exposure to our forecasts for longer term PWLB rates. However, gilt yields and treasury yields do not always move in unison.**

There are also possible **DOWNSIDE RISKS** from the huge sums of cash that the UK populace have saved during the pandemic; when savings accounts earn little interest, it is likely that some of this cash mountain could end up being invested in bonds and so push up demand for bonds and support their prices i.e., this would help to keep their yields down. How this will interplay with the Bank of England eventually getting round to not reinvesting maturing gilts and then later selling gilts, will be interesting to keep an eye on.

The balance of risks to medium to long term PWLB rates: -

- There is a balance of upside risks to forecasts for medium to long term PWLB rates.

A new era – a fundamental shift in central bank monetary policy

One of the key results of the pandemic has been a fundamental rethinking and shift in monetary policy by major central banks like the Fed, the Bank of England and the ECB, to tolerate a higher level of inflation than in the previous two decades when inflation was the prime target to bear down on so as to stop it going <u>above</u> a target rate. There is now also a greater emphasis on other targets for monetary policy than just inflation, especially on 'achieving broad and inclusive "maximum" employment in its entirety' in the US before consideration would be given to increasing rates.

- The Fed in America has gone furthest in adopting a monetary policy based on a clear goal of allowing the inflation target to be symmetrical, (rather than a ceiling to keep under), so that inflation averages out the dips down and surges above the target rate, over an unspecified period of time.
- The Bank of England has also amended its target for monetary policy so that inflation should be 'sustainably over 2%' and the ECB now has a similar policy.
- ***<u>For local authorities, this means that investment interest rates and very short term PWLB rates will not be rising as quickly or as high as in previous decades when the economy recovers from a downturn and the recovery eventually runs out of spare capacity to fuel continuing expansion.</u>***
- Labour market liberalisation since the 1970s has helped to break the wage-price spirals that fuelled high levels of inflation and has now set inflation on a lower path which makes this shift in monetary policy practicable. In addition, recent changes in flexible employment practices, the rise of the gig economy and technological changes, will all help to lower inflationary pressures.
- Governments will also be concerned to see interest rates stay lower as every rise in central rates will add to the cost of vastly expanded levels of national debt; (in the UK this is £21bn for each 1% rise in rates). On the other hand, higher levels of inflation will help to erode the real value of total public debt.