Manchester City Council
Report for Information

Report to:	Audit Committee – 27 July 2021
Subject:	Treasury Management Annual Report 2020/21
Report of:	Deputy Chief Executive and City Treasurer

Purpose

To report on the Treasury Management activities of the Council 2020/21.

Recommendations

The Audit Committee is asked to note the contents of the report.

Wards Affected: Not Applicable

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Background documents (available for public inspection):

Treasury Management Strategy Statement and Borrowing Limits and Annual Investment Strategy Report 2020/21 (Executive - 12 February 2020, Resource and Governance Scrutiny Committee - 24 February 2020, Council - 6 March 2020).

1 Introduction and Background

1.1 Treasury Management in Local Government is regulated by the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management in Local Authorities (the Code). The City Council has adopted the Code and complies with its requirements. A primary requirement of the Code is the formulation and agreement by full Council of a Treasury Policy Statement which sets out Council, Committee and Chief Financial Officer Responsibilities, and delegation and reporting arrangements.

1.2 CIPFA amended the CIPFA Treasury Management in the Public Services Code of Practice in late 2011. The revised Code recommended local authorities include, as part of their Treasury Management Strategy Statement, the requirement to report to members at least twice a year on the activities of the Treasury Management function. This report, along with the Interim Treasury Management report received by the Audit Committee on the 10th November 2020, therefore ensures that the Council meets the requirements of the Strategy, and therefore the Code.

1.3 Treasury Management in this context is defined as:

'*The management of the organisation's 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*'.

1.4 This outturn report covers:

Section 1:	Introduction and Background
Section 2:	The Council's Portfolio Position as at 31st March 2021
Section 3:	Review of Economic Conditions 2020/21
Section 4:	Public Works Loans Board (PWLB) Consultation
Section 5:	Treasury Management Borrowing in 2020/21
Section 6:	Compliance with Prudential Indicators and Treasury Limits
Section 7:	Investment Strategy for 2020/21
Section 8:	Temporary Borrowing and Investment Outturn 2020/21
Section 9:	COVID-19 Pandemic and Negative Rates
Section 10:	Conclusion

Appendix A:	Public Works Loans Board (PWLB) Interest Rates
Appendix B:	Treasury Management Prudential Indicators
Appendix C:	Review of Economic Conditions, provided by advisors
Appendix D:	Glossary of Terms

2 The Council's Portfolio Position as at 31st March 2021

2.1 As outlined in the approved Treasury Management Strategy Statement (TMSS) for 2020/21 it was anticipated that there would be a need to undertake some permanent borrowing in 2020/21 to fund the capital programme and to replace some of the internally borrowed funds.

2.2 As noted in the interim report, the Council continues to face unparalleled circumstances due to the COVID-19 pandemic which puts significant strain on cash due to the reduction in income from business rates, council tax, and other sources. Temporary borrowing was required during the first half of the year to unwind internal borrowing and further support the cash flow throughout the pandemic.

2.3 As suggested in the interim report, additional temporary borrowing was required in the second half of the year to maintain liquidity in the ongoing turbulent market environment whilst supporting COVID-19 related activities and underlying budgeted activities.

2.4 The Council's debt position at the beginning and the end of the year was as follows:

Loan Type	**31st March 2020**				**31st March 2021**			
			Principal	Average			Principal	Average
	GF	HRA		Rate	GF	HRA		Rate
	£m	£m	£m	%	£m	£m	£m	%
PWLB	150.0	0.0	150.0	2.45	150.0	0.0	150.0	2.45
Temporary Borrowing	30.8	0.0	30.8	0.98	177.2	0.0	177.2	0.67
Market Loans	336.8	61.9	398.7	4.48	336.8	61.9	398.7	4.48
Stock	0.9	0.0	0.9	4.00	0.9	0.0	0.9	4.00
Government Lending	26.8	0.0	26.8	0.00	23.5	0.0	23.5	0.00
Gross Total	**545.3**	**61.9**	**607.2**	**3.60**	**688.4**	**61.9**	**750.3**	**3.03**
Temporary Deposits	(128.4)	0.0	(128.4)	0.33	(27.4)	0.0	(27.4)	0.03
Internal Balances (GF/HRA)	42.3	(42.3)	0.00	0.00	58.4	(58.4)	0.00	0.00
Net Total	**459.2**	**19.6**	**478.8**	**-**	**719.4**	**3.5**	**722.9**	**-**

2.5 The temporary borrowing and deposit figures fluctuate daily to meet the cash flow requirements of the Council. The figures for these categories in the table above represent, therefore, a snapshot at a particular point in time.

2.6 Throughout the financial year 2020/21 a total of £367.3m of new temporary borrowing was taken and a total of £220.9m matured. The structure of this borrowing varied to better manage the Council's liquidity position, consisting of £109.3m on call basis, £90.0m on notice, £15.0m on 6months fixed maturities, £150.0m on 364 fixed day maturities, and £3.0m on 2-year fixed maturities. The loans were mainly sourced from other local authorities, and the rates continued to reflect the low rate environment.

2.7 Total Government Debt dropped from £26.8m to £23.5m due to the repayment of £3.3m SALIX loans.

2.8 Total Gross Debt has therefore increased by £143.1m throughout the financial year 2020/21.

3 Review of Economic Conditions 2020/21

3.1 The Bank of England maintained the lending rate at 0.10% throughout the financial year since March 2020 when the key lending rate was dropped initially from 0.75% to 0.25% followed by a further reduction to 0.10% on the 19th of March 2020.

3.2 Appendix C provides a more detailed review of the economic situation.

4 Public Works Loans Board (PWLB) Consultation

4.1 The Council has access to the Public Works Loan Board (PWLB) for debt, which is an executive agency of HM Treasury. Acting as a lender to the local authority sector, it provides debt at interest costs closely linked to the equivalent debt costs of Government, known as Gilts.

4.2 As noted in outturn report for 2019/20, the PWLB changed its policy to increase the margin from Gilts plus 100 basis points to Gilts plus 200 basis points in October 2019, and therefore the margin on the Certainty Rate, which local authorities can apply for, to Gilts plus 180 basis points.

4.3 Following the government's consultation in 2020/21 with Local Authorities to develop a targeted intervention to prevent 'debt-for-yield' activity funded from the PWLB, while protecting the crucial work the local authorities perform on service delivery, housing, and regeneration, the rates have reversed back to Gilts plus 100 basis points on the 26th November 2020.

4.4 Additional requirements to borrow from PWLB at the Certainty Rate, which is 0.20% lower than the published rate, were introduced. Each local authority that wishes to borrow from the PWLB is required to submit a high-level description of their capital spending and financing plans for the following three years, including their expected use of the PWLB. Any investment assets bought primarily for yield will not be supported by PWLB, and could lead to access to the PWLB being limited to refinancing existing debt only.

Local Authorities are asked to:

i. Categorise Capital Spending into: Service Spending, Housing, Regeneration, Preventative Action, Treasury Management, and Debt for Yield activity.

ii. Provide a short description covering at least 75% of the spending in each category.

iii. Provide assurance from the section 151 officer or equivalent that the local authority is not borrowing in advance of need and does not intend to buy investment assets primarily for yield.

4.5 The Council submitted this information in May 2021, and therefore has retained access to the PWLB Certainty Rate.

5 Treasury Management Borrowing in 2020/21

5.1 PWLB interest rates during the year are illustrated in the table below and the graph at Appendix A.

Published PWLB Borrowing Rates 2020/21 for 1 to 50 years					
	1 Year	**5 Year**	**10 Year**	**25 Year**	**50 Year**
Low	0.85%	0.92%	1.20%	1.73%	1.52%
Date	04/01/2021	14/12/2020	11/12/2020	11/12/2020	11/12/2020
High	2.14%	2.19%	2.48%	3.06%	2.91%
Date	08/04/2020	08/04/2020	11/11/2020	11/11/2020	11/11/2020
Average	1.63%	1.70%	2.01%	2.53%	2.34%

5.2 As noted above, the Council is on the approved list of authorities that can access the PWLB Certainty Rate going forward, giving the Council access to a 20 basis points reduction on the published PWLB rates.

5.3 No new PWLB borrowing was taken in the financial year 2020/21. The outcome of the PWLB consultation and the subsequent reduction in the margin on rates means that the Council has refinanced the majority of the outstanding temporary borrowing with the PWLB during early 2021/22.

5.4 For any additional borrowing required further market assessments will be undertaken and the risks and benefits of any approach will be reviewed before any decision is made.

Temporary Borrowing

5.5 As noted in the Interim Report 2020/21, the Council has focused on temporary borrowing until the PWLB Consultation concluded. This meant the interest rates on the debt were relatively low and provided both liquidity and refinancing opportunities given PWLB rates were expected to fall.

5.6 A total of £367.3m of temporary borrowing was taken with a total of £220.9m maturing in 2020/21 as outlined in paragraph 2.6.

Salix Borrowing

5.7 Salix Finance Ltd provides interest-free Government funding to the public sector to improve their energy efficiency, reduce carbon emissions and lower energy bills. The supported scheme in relation to LED lighting Council projects will be repaid by 1st April 2023.

5.8 During the year, the Council made scheduled repayments of £3.3m, bringing the total value of Salix debt to £15.0m on 31st March 2021.

5.9 The borrowing strategy will remain under constant review to support achieving value for money for the Council whilst balancing the treasury risks that any approach will create.

6 Compliance with Prudential Indicators and Treasury Limits

6.1 As noted in the interim report 2020/21, the prudential indicators had to be revised to reflect the additional capital expenditure incurred due to the financial support to Manchester Airport Group, which was not part of the budget in February 2020 on which the prudential indicators were based. The Council operated within the updated prudential indicators, and performance against these is shown in Appendix B.

6.2 The Council also sets an operational limit on the cleared balance that is left within the Council’s current accounts. The limit is set by the Council and is aimed at minimising the cash held in these accounts which attracts no interest and thereby maximises the investment return for the authority. The limit is set at £400k and this was met during the financial year 2020/21 except for the breaches described below, which should be considered in the context of a very challenging year. With regards to the Business Rates Support Grants, c. £188m were paid, and the breaches reflect the scale of the activity undertaken.

6.3 Where the limit is breached it means that the Council either incurred interest costs due to being in an overdraft position or lost potential investment income due to excess cash not being invested. It is important to note that any such breach will be rectified the following working day, and therefore the financial impact is minimised.

6.4 During the period 1st April 2020 to 31st March 2021 there were thirty breaches of the daily £0-400k limit on the Barclays current account, which can be broken down into two categories:

i. COVID-19 related: on twenty-two occasions, Treasury Management purposely kept the current account in surplus to enable the Shared Service Centre to process COVID-19 Business Support Grants throughout the evening and following early morning. This arrangement ensured the payments were processed in time mitigating the risk of support payments not being made due to the lack of funds.

ii. Unexpected receipts after working hours: on eight occasion, the limit was breached due to various late afternoon receipts which the Treasury Management team had not been made aware of. Where possible, officers are asked to inform the team of any expected receipts or payments over £50k in order to efficiently manage cash.

6.5 Each breach was notified to the Deputy Chief Executive and City Treasurer and action taken on the following working day to bring balances back within approved limits. No additional costs arose as a result, other than the opportunity cost incurred of not investing the surplus cash, which in the current interest market is minimal.

7 Investment Strategy for 2020/21

7.1 The Treasury Management Strategy Statement (TMSS) for 2020/21 was approved by Executive on 12th February 2020. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as:
(a) the security of capital, and (b) the liquidity of investments.

7.2 The Council continues to operate a total of five Money Market Funds (MMFs) with an upper limit of £15.0m per fund. The Council also holds ongoing contingency call accounts with two major banks to help maintain liquidity.

7.3 The current strategy means that a significant proportion of the Council's investments are with the chosen five MMFs, the Debt Management Office (DMO), and other Local Authorities. This highlights the relatively low rate of credit risk that the Council takes when investing.

7.4 It should be noted that, whilst seeking to broaden the investment base, officers will continue to seek high quality investments to limit the level of risk taken by the Council. It is not expected that the measures considered above will have a significant impact on the rates of return the Council currently achieves.

7.5 During the financial year the Council's temporary cash balances have been managed by the Deputy Chief Executive and City Treasurer in-house and invested with those institutions listed in the Council's Approved Lending List. Officers can confirm these institutions meet the security criteria set out in the Annual Investment Strategy.

8 Temporary Borrowing and Investment Outturn 2020/21

8.1 As noted above, this financial year has been unparalleled. Cash flows and markets were unpredictable, so the Council shifted to a treasury management strategy more focussed on liquidity by securing temporary borrowing which ensured cash was available to support both COVID-19 related activity and the underlying budgeted activity.

8.2 Investment rates available in the market continued to be at historical low point. The average level of funds available for investment purposes in 2020/21 was just over £106.9m. These funds were available on a temporary basis and the level of funds available was mainly dependent on the timing of precept payments, the receipt of grants, progress on the capital programme, and working capital.

8.3 While the ongoing PWLB Consultation was taking place, short term temporary borrowing was taken in order to support the cash flow, as anticipated in the

TMSS for 2020/21, resulting with the average level of temporary borrowing £188.4m.

8.4 Detailed in the next table is the temporary investment and borrowing undertaken by the Council, which is benchmarked against the LIBID and LIBOR respectively. As illustrated, the Council over performed the benchmark by 27 basis points on investments due to the effective search for better inter Local Authority market rates.

8.5 The temporary borrowing portfolio consisted of loans with various investment tenors ranging from call terms to fixed 2-year maturities. The average cost was higher by 45 basis points when compared to the average 12-month benchmark rate, which is mainly due to the timing of when the temporary borrowings was secured as well as the various structures. In the first three months of the financial year when majority of the debt was taken, the average 12-month benchmark rate averaged at c. 0.68%, after which it has significantly dropped throughout the remainder of the year pushing the overall average to 0.29%.

	Average temporary Investment/borrowing	Net Return/Cost	Benchmark Return / Cost *
Temporary Investments	£106.9m	0.20%	-0.07%
Temporary Borrowing	£188.4m	0.74%	0.29%

**Average 7-day LIBID / 12-month LIBOR rate*

8.6 None of the institutions in which investments were made, such as banks, local authorities and MMFs, showed any difficulty in repaying investments and interest during the year. The list of institutions in which the Council invests is kept under continuous review.

9 COVID-19 Pandemic and Negative Rates

9.1 The COVID-19 pandemic has created a challenging market environment in which the Council must conduct its treasury management activities. The future of the markets remains uncertain resulting in mounting pressures on income and therefore the overall cash flow liquidity.

9.2 Although the Bank of England has been clear it did not intend to set a negative bank rate at this stage, in February 2021, the Bank of England has asked firms to be ready for the implementation of negative interest rates as it remains a viable option of its Monetary Policy Toolkit. Officers are continuing to assess the impact negative rates could have on the Council’s debt and investment strategies.

9.3 The Debt Management Office (DMO) began offering investments at a negative interest rate on the 25th of September 2020 with low fluctuating levels remaining in place until the 31st of March 2021. This meant that if the

Council were to place cash with the DMO, there would be a cost for making that investment. Officers continued to view this as an option of last resort if a positive return is achievable elsewhere.

9.4 No investments at a negative rate were undertaken in 2020/21.There is however a risk the market will enter an environment where the conditions do not allow for a positive return in the short term. If this were to happen, the investment strategy would shift focus onto minimising costs while ensuring security of cash and reasonable liquidity.

10 Interest on mortgages

10.1 For the purposes of charging interest on mortgages that the Council has provided, the Local Average Rate is 3.93%, being the weighted average rate on the Council's long term debt.

11 Conclusion

11.1 The financial year 2020/21 has demonstrated exceptional market conditions putting significant pressure on the Council's cash liquidity. While the PWLB consultation was ongoing, short term temporary borrowing was acquired ensuring a stable cash flow. Overall, cash balances remained low throughout the year.

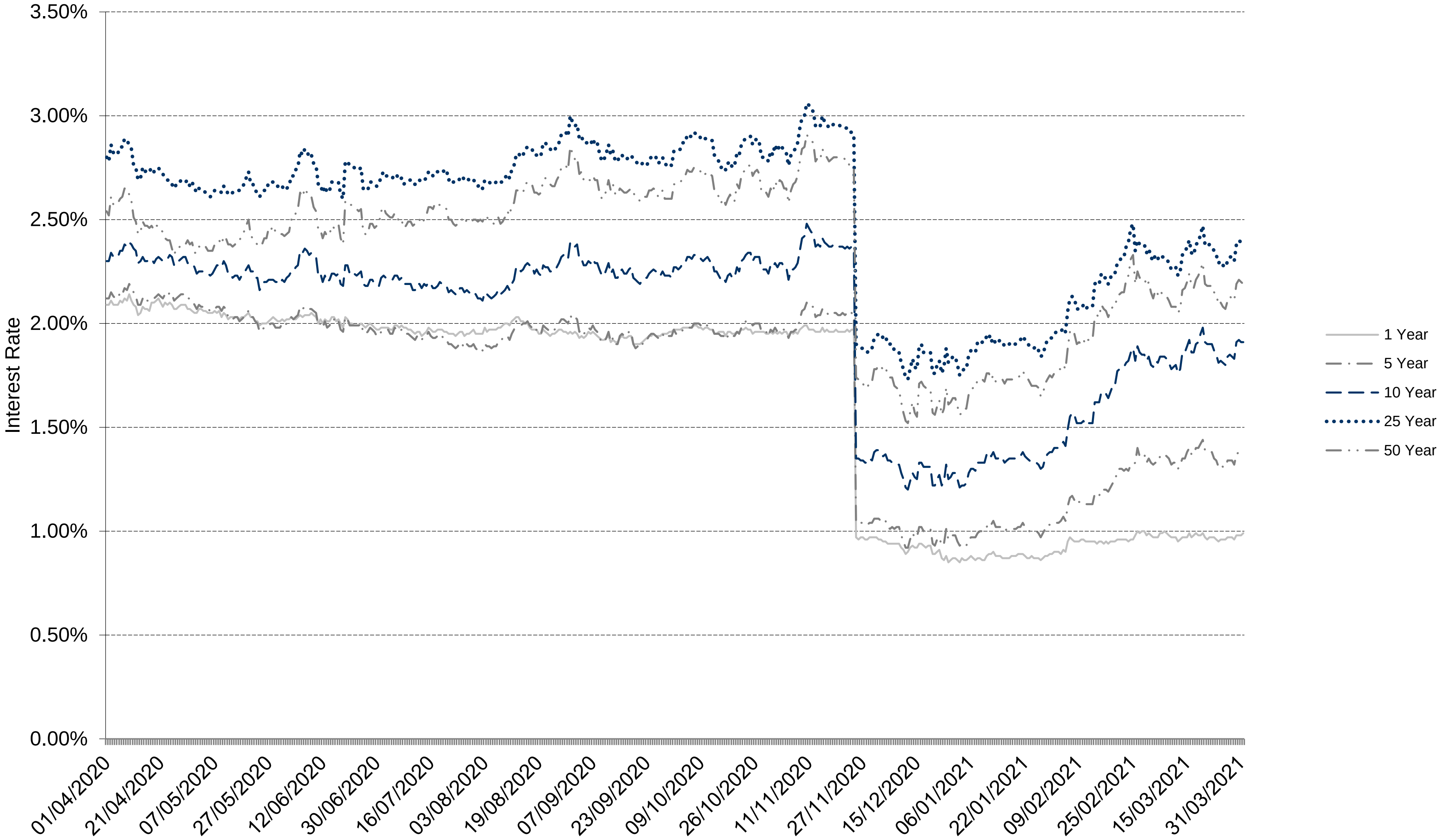
11.2 The current borrowing position reflects the strong balance sheet of the Council. It enables net interest costs to be minimised and reduces credit risk by making temporary use of internal borrowing (reserves, provisions, positive cash flows, etc). The Council's policy remains to keep cash as low as possible and not to borrow in advance of need for capital purposes.

11.3 In the second half the year, the PWLB consultation was concluded, additional requirements were introduced, and the rates were reversed by 100bps as outlined in Section 4 of this report.

11.4 Proactive treasury management during the year has enabled the Council to achieve an average net return on investments of 0.20%, in excess of the benchmark average 7-day LIBID rate of -0.07% and also higher than the rate offered by the DMO, which is the default option if there are no other investment opportunities based on the credit criteria set.

11.5 Future years are likely to bring continuing instability arising from the longer term implications of COVID-19, further implications as a result of the end of UK's transition period after Brexit, and the possibility that market rates go negative, all of which could have a detrimental impact on costs and income and overall cash flow stability. Officers will continue monitoring the market, and engage with market participants including banks, investment firms, brokers and advisors to review the debt opportunities available to the Council.

Appendix A – PWLB Rates 2020/21



Appendix B

Treasury Management Prudential Indicators: 2020/21

	Original (*from 2020/21 TMSS*) £m	Minimum In Year to 31st Mar 2021 £m	Maximum In Year to 31st Mar 2021 £m
Operational Boundary for External Debt:			
Borrowing	1,006.2	680.8	793.6
Other Long Term Liabilities	216.0	153.8	153.8
Authorised Limit for External Debt:			
Borrowing	1,384.5	680.8	793.6
Other Long Term Liabilities	216.0	153.8	153.8
		Actual as at 31st Mar 2021	
The Council has adopted CIPFA's Code of Practice for Treasury Management in the Public Services	Yes	Yes	
Upper Limit for Principal Sums Invested for over 364 days	£0	£0	

Maturity structure of Fixed Rate Borrowing	**Lower Limit**	**Upper Limit**	
	2020/21 Original	**2020/21 Original**	**Actual as at 31st Mar 2021**
under 12 months	0%	80%	41%
12 months and within 24 months	0%	70%	18%
24 months and within 5 years	0%	60%	9%
5 years and within 10 years	0%	50%	1%
10 years and above	20%	80%	31%

Appendix C

REVIEW OF ECONOMIC CONDITIONS FOR 2020/21 AND FUTURE OUTLOOK

This section has been prepared by the Council's Treasury Advisors, Link Asset Services, for the 31st of March Closedown and includes their forecast for future interest rates after the PWLB policy change referenced in the report.

1. Economics update

UK. The key quarterly Monetary Policy Report meeting of the Bank of England's Monetary Policy Committee kept **Bank Rate** and quantitative easing (QE) unchanged on 4th February, (as it also did at its 18th March meeting). However, it revised its economic forecasts to take account of a third national lockdown which started on 5th January, which is going to further delay economic recovery and do further damage to the economy. Although its short-term forecasts were cut for 2021 due to the start of a third lockdown in early January, the medium-term forecasts were more optimistic than in November, based on an assumption that the current lockdown will be gradually eased after Q1 as vaccines are gradually rolled out and life can then start to go back to some sort of normality. The Bank's main assumptions were:

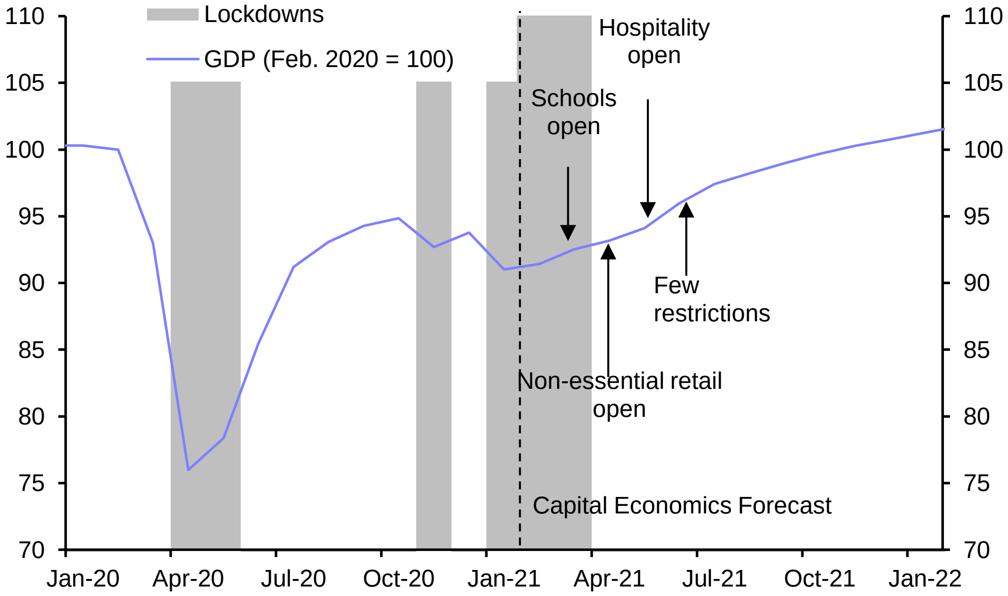
- The economy would start to recover strongly from Q3 2021 although it acknowledged there were downside risks from virus mutations etc.
- £125bn of savings made by consumers during the pandemic will give a big boost to the pace of economic recovery once lockdown restrictions are eased and consumers can resume high street shopping, going to pubs and restaurants and taking holidays.
- The economy would still recover to reach its pre-pandemic level by Q1 2022 despite a long lockdown in Q1 2021. **Spare capacity** in the economy would be eliminated in Q1 2022 and there would be **excess demand** in the economy by Q4 2022.
- **CPI inflation** was forecast to rise quite sharply towards the 2% target in the first half of 2021 due to some temporary factors, (e.g. the reduction in VAT for certain services comes to an end) and given developments in energy prices. CPI inflation was projected to be close to 2% in 2022 and 2023.
- The MPC reiterated its previous guidance that Bank Rate would not rise until inflation was sustainably above 2%. This means that it will tolerate inflation running above 2% from time to time to balance out periods during which inflation is below 2%. This is termed **average inflation targeting.** While financial markets are pricing in Bank Rate starting to rise by the end of 2022, this policy could mean that Bank Rate does not rise until as late as 2026.
- The Bank of England removed **negative interest rates** as a possibility for at least six months as financial institutions were not ready to implement them. As in six months' time the economy should be starting to grow strongly, this effectively means that negative rates occurring were unlikely during the

current downturn. (**Gilt yields and PWLB rates** jumped upwards after the removal of negative rates as a key risk in the short-term.)

There are two views in respect of Bank Rate beyond our three-year time horizon:

a. The MPC will be keen to raise Bank Rate as soon as possible in order for it to be a usable tool when the next economic downturn comes along. This is in line with thinking on Bank Rate over the last 20 years; financial markets are currently pricing in Bank Rate starting to rise by the end of 2022.

b. Conversely, that we need to adjust to the new post-pandemic era that we are now in. In this new era, **the shift to average inflation targeting** has set a high bar for raising Bank Rate i.e. only when inflation has demonstrated that it has risen sustainably above 2%. In addition, many governments around the world have been saddled with high levels of debt. When central bank rates are low, and below the average GDP growth rate, the debt to GDP ratio will gradually fall each year without having to use fiscal tools such as raising taxes or austerity programmes, (which would depress economic growth and recovery). This could therefore result in governments revising the setting of mandates to their national central banks to allow a higher rate of inflation linked to other economic targets. This is the Capital Economics view – that Bank Rate will not rise for the next five years and could then struggle to get to 1% within 10 years.



- **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 second half of 2021** after a third wave of the virus threatened to overwhelm hospitals around the start of the year. 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 the still-depressed sectors like restaurants, travel and hotels. The UK has made fast progress with giving a first jab to half of all adults and this programme should be completed in the second half of the year. The big question is whether mutations of the virus could develop which render current vaccines ineffective, as opposed to how quickly can vaccines be modified to deal with them and enhanced testing programmes be implemented to contain their spread.

- **The Budget on 3rd March** increased fiscal support to the economy and employment during 2021 and 2022 followed by substantial tax rises in the following three years to help to pay the cost for the pandemic. This will help further to strengthen the economic recovery from the pandemic and to return the government's finances to a balanced budget on a current expenditure and income basis in 2025/26. This will stop the Debt to GDP ratio rising further from 100%. An area of concern, though, is that the government's debt is now twice as sensitive to interest rate rises as before the pandemic due to QE operations substituting fixed long-term debt for floating rate debt; there is, therefore, much incentive for the Government to promote Bank Rate staying low e.g. by using fiscal policy in conjunction with the monetary policy action by the Bank of England to keep inflation from rising too high, and / or by amending the Bank's policy mandate to allow for a higher target for inflation.
- **Brexit.** The final agreement on 24th December 2020 eliminated a significant downside risk for the UK economy. The initial agreement only covered trade so there is further work to be done on the services sector where temporary equivalence has been granted in both directions between the UK and EU; that now needs to be formalised on a permanent basis. There was much disruption to trade in January as form filling has proved to be a formidable barrier to trade. This appears to have eased somewhat since then but is an area that needs further work to ease difficulties, which are still acute in some areas.
- **US.** The Democrats won the presidential election in November 2020 and have control of both Congress and the Senate, although power is more limited in the latter. This enabled the Democrats to pass a $1.9trn (8.8% of GDP) stimulus package in March on top of the $900bn fiscal stimulus deal passed by Congress in late December. These, together with the vaccine rollout proceeding swiftly to hit the target of giving a first jab to over half of the population within the President's first 100 days, will promote a rapid easing of restrictions and strong economic recovery during 2021. The Democrats are also planning to pass a $2trn fiscal stimulus package aimed at renewing infrastructure over the next decade. Although this package is longer-term, if passed, it would also help economic recovery in the near-term.
- After Chair Jerome Powell unveiled the **Fed's adoption of a flexible average inflation target** in his Jackson Hole speech in late August 2020, the mid-September meeting of the Fed agreed by a majority to a toned down version of the new inflation target in his speech - that *"it would likely be appropriate to maintain the current target range until labour market conditions were judged to be consistent with the Committee's assessments of maximum employment and inflation had risen to 2% and was on track to moderately exceed 2% for some time."* This change was 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, (and this year), 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. There is now some expectation that where the Fed has led in changing its policy towards implementing its inflation and full employment mandate, other major central banks will follow, as indeed the Bank of England has done so already. The Fed expects strong economic growth this year to have only a transitory impact on inflation, which explains why the majority of Fed officials project US interest rates to remain near-zero through to the end of 2023. The key message is still that policy will remain unusually accommodative – with near-zero rates and asset purchases – continuing for several more years. This is likely to result in keeping treasury yields at historically low levels – **which will also have an influence on gilt yields in this country.**

- **EU.** Both the roll out and take up of vaccines has been disappointingly slow in the EU, at a time when many countries are experiencing a sharp rise in cases which are threatening to overwhelm hospitals in some major countries; this has led to renewed severe restrictions or lockdowns during March. This will inevitably put back economic recovery after the economy had staged a rapid rebound from the first lockdowns in Q3 but contracted slightly in Q4 to end 2020 only 4.9% below its pre-pandemic level. Recovery will now be delayed until Q3 of 2021 and a return to pre-pandemic levels is expected in the second half of 2022.
- Inflation is likely to rise sharply to around 2% during 2021 for a short period, but as this will be transitory due to one-off factors, it will cause **the ECB** little concern. It is currently unlikely that it will cut its central rate even further into negative territory from -0.5%, although the ECB has stated that it retains this as a possible tool to use. The ECB's December 2020 meeting added a further €500bn to the PEPP scheme, (purchase of government and other bonds), and extended the duration of the programme to March 2022 and re-investing maturities for an additional year until December 2023. Three additional tranches of TLTRO, (cheap loans to banks), were approved, indicating that support will last beyond the impact of the pandemic, implying indirect yield curve control for government bonds for some time ahead. The total PEPP scheme of €1,850bn of QE which started in March 2020 is providing protection to the sovereign bond yields of weaker countries like Italy. There is, therefore, **unlikely to be a euro crisis** while the ECB is able to maintain this level of support. The March ECB meeting also took action to suppress the rise in long bond yields by stepping up its monthly PEPP purchases.
- **China.** After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and then into Q3 and Q4; this has enabled China to recover all of the contraction in Q1. Policy makers have both quashed the virus and implemented a programme of monetary and fiscal support that has been particularly effective at stimulating short-term growth. After making a rapid recovery in 20/21, growth is likely to be tepid in 21/22.
- **Japan.** A third round of fiscal stimulus in early December took total fresh fiscal spending in 2020 in response to the virus close to 12% of pre-virus GDP. That

is huge by past standards, and one of the largest national fiscal responses. The budget deficit is now likely to reach 16% of GDP in 2020/21. Coupled with Japan's relative success in containing the virus without draconian measures so far, and the roll out of vaccines gathering momentum, the government's latest fiscal effort should help to ensure a strong recovery and to get back to pre-virus levels by Q3 2021 – around the same time as the US and much sooner than the Eurozone.

- **World growth.** World growth was in recession in 2020. Inflation is unlikely to be a problem in most countries for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.
- **Impact on gilt yields and PWLB rates in 2021.** Since the start of 2021 gilt yields and PWLB rates have risen sharply. What has unsettled financial markets has been a $1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the Covid pandemic, in addition to the $900bn support package passed in December. Financial markets have been alarmed that the two packages could cause an excess of demand in the economy which could **unleash inflationary pressures** and force the FOMC to take much earlier action to start increasing the Fed rate from near zero, despite their stated policy being to target average inflation and saying that increases were unlikely in the next few years.
- A further concern in financial markets is **when will the Fed end quantitative easing (QE) purchases of treasuries** and how they will gradually wind it down. These ongoing monthly purchases are currently acting as downward pressure on treasury yields. Nonetheless, during late February and in March, yields rose sharply. As the US financial markets are, by far, the biggest financial markets in the world, any trend upwards there will invariably impact and influence financial markets in other countries. It is noticeable that gilt yields moved higher after the MPC meeting in early February as a result of both developments in the US, and financial markets also expecting a **similarly rapid recovery of the UK economy as in the US;** both countries were expected to make similarly rapid progress with vaccinating their citizens and easing Covid restrictions. They are therefore, expecting inflation to also increase more quickly in the UK and cause the MPC to respond by raising Bank Rate more quickly than had previously been expected.
- **Deglobalisation.** Until recent years, world growth has been boosted by increasing globalisation i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last 30 years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. In March 2021, western democracies implemented limited sanctions against a few officials in charge of government policy on the Uighurs in Xinjiang; this led to a much bigger retaliation by China and is likely to mean that the China / EU investment deal then being negotiated, will be torn up. After the pandemic exposed how frail extended supply lines were around the world, both factors are now likely to lead to a sharp retrenchment of economies into two blocs of western democracies v. autocracies. It is,

therefore, 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.

- **Central banks' monetary policy.** During the pandemic, the governments of western countries have provided massive fiscal support to their economies which has resulted in a big increase in total government debt in each country. It is therefore very important that bond yields stay low while debt to GDP ratios slowly subside under the impact of economic growth. This provides governments with a good reason to amend the mandates given to central banks to allow higher average levels of inflation than we have generally seen over the last couple of decades. Both the Fed and Bank of England have already changed their policy towards implementing their existing mandates on inflation, (and full employment), to hitting an average level of inflation. Greater emphasis could also be placed on hitting subsidiary targets e.g. full employment before raising rates. Higher average rates of inflation would also help to erode the real value of government debt more quickly.

2. Interest rate forecasts

The Council has appointed Link Group as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The PWLB rate forecasts below are based on the Certainty Rate (the standard rate minus 20 bps) which has been accessible to most authorities since 1st November 2012.

Link Group Interest Rate 8.3.21												
	Jun-21	Sep-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	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
5 yr PWLB	1.20	1.20	1.20	1.20	1.20	1.20	1.30	1.30	1.40	1.40	1.40	1.40
10 yr PWLB	1.60	1.60	1.60	1.70	1.70	1.70	1.80	1.80	1.90	1.90	1.90	1.90
25 yr PWLB	2.10	2.10	2.20	2.30	2.30	2.30	2.40	2.40	2.50	2.50	2.50	2.50
50 yr PWLB	1.90	1.90	2.00	2.10	2.10	2.10	2.20	2.20	2.30	2.30	2.30	2.30

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.*
- *We will maintain continuity by providing clients with LIBID investment benchmark rates on the current basis.*

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 first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its subsequent meetings, although some forecasters had suggested that a cut into negative territory could happen. However, the minutes of the Monetary Policy Committee in February 2021 made it clear that commercial banks could not implement negative rates within six months, and by that time the economy would be expected to be recovering strongly and so there would be no requirement for negative rates. As shown in the forecast table above, no increase in Bank Rate is expected within the forecast horizon ending on 31st March 2024.

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 year prior to the coronavirus crisis, this resulted in many bond yields up to 10 years turning negative in the Eurozone. In addition, there was, at times, an inversion of bond yields in the US whereby 10 year yields fell below shorter-term yields. In the past, this has been a precursor of a recession.

Gilt yields had, therefore, already been on a generally falling trend up until the coronavirus crisis hit western economies during March 2020. After gilt yields initially spiked upwards in March, yields fell sharply in response to major western central banks taking rapid policy action to deal with excessive stress in financial markets during March, and starting massive quantitative easing driven purchases of government bonds: these actions also acted to put downward pressure on government bond yields at a time when there was 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.

As at 31st December 2020, all gilt yields from 1 to 8 years were still in negative territory: however, since then all gilt yields have now become positive and have risen sharply, especially medium and longer-term yields.

- 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 non-HRA capital schemes. A consultation was then held with local authorities and **on 25th November 2020, the Chancellor announced the conclusion to the review of margins over gilt yields for PWLB rates;** the standard and certainty margins were reduced by 1% but a prohibition was introduced to deny access to borrowing from the PWLB for any local authority which had purchase of assets for yield in its three year capital programme. The new margins over gilt yields are as follows: -.

- **PWLB Standard Rate** is gilt plus 100 basis points (G+100bps)
- **PWLB Certainty Rate** is gilt plus 80 basis points (G+80bps)
- **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)

As the interest forecast table for PWLB certainty rates, (gilts plus 80bps), above shows, there is likely to be little upward movement in PWLB rates over the next three years as the Bank of England is not expected to raise Bank Rate during that period as inflation is not expected to be sustainably over 2%.

APPENDIX D

Glossary of Terms

Authorised Limit - This Prudential Indicator represents the limit beyond which borrowing is prohibited and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. It is the expected maximum borrowing need, with some headroom for unexpected movements.

Bank Rate – the rate at which the Bank of England offers loans to the wholesale banks, thereby controlling general interest rates in the economy.

Constant Net Asset Value (CNAV) – refers to Funds which use amortised cost accounting to value all of their assets. The aim is to maintain a Net Asset Value (NAV), or value of a share of the Fund at £1.

Counterparty – one of the opposing parties involved in a borrowing or investment transaction

Credit Rating – A qualified assessment and formal evaluation of an institution's (bank or building society) credit history and capability of repaying obligations. It measures the probability of the borrower defaulting on its financial obligations, and its ability to repay these fully and on time.

Discount – Where the prevailing interest rate is higher than the fixed rate of a long-term loan, which is being repaid early, the lender can refund the borrower a discount, the calculation being based on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender is able to offer the discount, as their investment will now earn more than when the original loan was taken out.

Fixed Rate Funding - A fixed rate of interest throughout the time of the loan. The rate is fixed at the start of the loan and therefore does not affect the volatility of the portfolio, until the debt matures and requires replacing at the interest rates relevant at that time.

Gilts - The loan instruments by which the Government borrows. Interest rates will reflect the level of demand shown by investors when the Government auctions Gilts.

High/Low Coupon – High/Low interest rate

LIBID (London Interbank Bid Rate) – This is an average rate, calculated from the rates at which individual major banks in London are willing to borrow from other banks for a particular time period. For example, 6 month LIBID is the average rate at which banks are willing to pay to borrow for 6 months.

LIBOR (London Interbank Offer Rate) – This is an average rate, calculated from the rates which major banks in London estimate they would be charged if they borrowed from other banks for a particular time period. For example, 6 month LIBOR is the average rate which banks believe they will be charged for borrowing for 6 months.

Liquidity – The ability of an asset to be converted into cash quickly and without any price discount. The more liquid a business is, the better able it is to meet short-term financial obligations.

LOBO (Lender Option Borrower Option) – This is a type of loan where, at various periods known as call dates, the lender has the option to alter the interest rate on the loan. Should the lender exercise this option, the borrower has a corresponding option to repay the loan in full without penalty.

Market - The private sector institutions - Banks, Building Societies etc.

Maturity Profile/Structure - an illustration of when debts are due to mature, and either have to be renewed or money found to pay off the debt. A high concentration in one year will make the Council vulnerable to current interest rates in that year.

Monetary Policy Committee – the independent body that determines Bank Rate.

Operational Boundary – This Prudential Indicator is based on the probable external debt during the course of the year. It is not a limit and actual borrowing could vary around this boundary for short times during the year. It should act as an indicator to ensure the Authorised Limit is not breached.

Premium – Where the prevailing current interest rate is lower than the fixed rate of a long-term loan, which is being repaid early, the lender can charge the borrower a premium, the calculation being based on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender may charge the premium, as their investment will now earn less than when the original loan was taken out.

Prudential Code - The Local Government Act 2003 requires the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

PWLB - Public Works Loan Board. Part of the Government's Debt Management Office, which provides loans to public bodies at rates reflecting those at which the Government is able to sell Gilts.

Specified Investments - Sterling investments of not more then one-year maturity. These are considered low risk assets, where the possibility of loss of principal or investment income is very low.

Non-specified investments - Investments not in the above, specified category, e.g., foreign currency, exceeding one year or outside the Council's minimum credit rating criteria.

Variable Rate Funding - The rate of interest either continually moves reflecting interest rates of the day or can be tied to specific dates during the loan period. Rates may be updated on a monthly, quarterly or annual basis.

Volatility - The degree to which the debt portfolio is affected by current interest rate movements. The more debt maturing within the coming year and needing replacement, and the more debt subject to variable interest rates, the greater the volatility.

Yield Curve - A graph of the relationship of interest rates to the length of the loan. A normal yield curve will show interest rates relatively low for short-term loans compared to long-term loans. An inverted Yield Curve is the opposite of this.