Manchester City Council
Report for Information

Report to: Audit Committee – 23 November 2021

Subject: Treasury Management Interim Report 2021-22

Report of: Deputy Chief Executive and City Treasurer

Purpose

To report the Treasury Management activities of the Council during the first six months of 2021-22.

Recommendations

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

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Wards Affected: Not Applicable

Contact Officers:

Name: Carol Culley
Position: Deputy Chief Executive and City Treasurer
Telephone: 0161 234 3406
E-mail: carol.culley@manchester.gov.uk

Name: Tom Wilkinson
Position: Deputy City Treasurer
Telephone: 0161 234 1445
E-mail: tom.wilkinson@manchester.gov.uk

Name: Tim Seagrave
Position: Group Finance Lead – Capital and Treasury Management
Telephone: 0161 234 3445
E-mail: timothy.seagrave@manchester.gov.uk

Name: Amanda Samuriwo
Position: Treasury Manager
Telephone: 0161 600 8490
E-mail: amanda.samuriwo@manchester.gov.uk

Background documents (available for public inspection):

The following documents disclose important facts on which the report is based and have been relied upon in preparing the report. Copies of the background documents are available up to 4 years after the date of the meeting. If you would like a copy please contact one of the contact officers above.

Treasury Management Strategy Statement 2021/22, including Borrowing Limits and Annual Investment Strategy (Executive – 17 February 2021, Resource and Governance Scrutiny Committee – 1 March 2021, Council – 5 March 2021)

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 2009, and the revised Code recommended that local authorities include, as part of their Treasury Management Strategy Statement (TMSS), the requirement to report to members at least twice a year on the activities of the Treasury Management function. The recommendation was first included within the 2010/11 TMSS approved by the Executive on the 10th February 2010. The requirement has also been included and approved as part of each the annual TMSS since 2010/11. This report therefore ensures that the Council meets the requirements of the Strategy, and therefore the Code.

1.3 The Code was revised in 2017 and this report has been prepared in accordance with the revised Code. The sections of this report are shown below:

Section 1: Introduction and Background
Section 2: Portfolio Position as at 30th September 2021
Section 3: Review of Economic Conditions 2021-22 to date
Section 4: Public Works Loans Board (PWLB) Consultation
Section 5: Treasury Borrowing in 2021-22 to date
Section 6: Compliance with Prudential Indicators and Treasury Limits
Section 7: Investment Strategy for 2021-22 to date
Section 8: Temporary Borrowing and Investment for 2021-22 to date
Section 9: CIPFA Consultation on Prudential and Treasury Management Codes of Practice
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 Portfolio Position as at 30th September 2021

2.1 As outlined in the approved TMSS for 2021/22 it is anticipated that there will be a need to undertake some permanent borrowing in 2021/22 to fund the capital programme and to replace some of the internally borrowed funds.

2.2 The Council has faced unparalleled circumstances during the COVID-19 pandemic creating a challenging market environment in which the Council must conduct its treasury management activities.

2.3 During the first half of the year, the temporary borrowing taken last year matured and has been refinanced with long term debt from the Public Works Loan Board (PWLB). Further borrowing is likely to be required during the second half of the year. The Council's debt position at the beginning of the financial year and at the end of September is compared in the table below. The gross debt is significantly below both the Council's capital financing requirement, and the authorised limit shown in appendix B.

Loan Type	**31 March 2021**				**30 September 2021**			
	GF	HRA	Principal	Avg. Rate	GF	HRA	Principal	Avg. Rate
	£m	£m	£m	%	£m	£m	£m	%
PWLB	150.0	0.0	150.0	2.45	300.0	0.0	300.0	2.20
Temporary Borrowing	177.2	0.0	177.2	0.67	10.1	0.0	10.1	0.61
Market Loans	336.8	61.9	398.7	4.48	335.1	61.6	396.7	4.47
Stock	0.9	0.0	0.9	4.00	0.9	0.0	0.9	4.00
Government Lending	23.5	0.0	23.5	0.00	21.4	0.0	21.4	0.00
Gross Total	**688.4**	**61.9**	**750.3**	**3.03**	**667.5**	**61.6**	**729.1**	**2.25**
Temporary Deposits	(27.4)	0.0	(27.4)	0.03	(59.5)	0.0	(59.5)	0.01
Internal Balances (GF/HRA)	58.4	(58.4)	0.00	0.00	44.5	(44.5)	0.0	0.00
Net Total	**719.4**	**3.5**	**722.9**	**-**	**652.5**	**17.1**	**669.6**	**-**

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

2.5 Total Government Debt dropped from £23.5m to £21.4m due to a repayment of £2.1m of Salix loans.

2.6 Total debt has therefore reduced by £21.2m during the first six months of 2021/22.

2.7 The cash flow forecast suggests the level of deposits will continue to fall resulting in further borrowing being required prior to year-end. Markets and independent forecasts are being monitored on a daily basis by the Treasury team to optimise the interest rates borrowed at and the blend of short term and long term borrowing that is appropriate given the market conditions and outlook. Any such activity will be reported in the outturn report.

3 Review of Economic Conditions 2021-22 to date

3.1 The Bank of England maintained the lending rate at 0.10% in the first half of the financial year. In March 2020 the Bank of England dropped the key lending rate initially from 0.75% to 0.25% followed by a further reduction to 0.10% on the

19th of March 2020 in efforts to stimulate the economy during COVID-19.

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 the previous outturn report for 2020/21, following consultation the lending arrangements for the PWLB have changed and require local authorities to provide information on capital plans before being able to access the PWLB. The technical details for accessing loans have subsequently changed, with loans being made available 5 days after an application is made, rather than 2, to allow HM Treasury to review the information provided.

5 Treasury Borrowing in 2021-22 to date
PWLB

5.1 PWLB interest rates during the first 6 months of the year are illustrated in the table below and the graph at Appendix A.

PWLB Standard Borrowing Rates 2021-22 to date for 1 to 50 years					
	1 Year	**5 Year**	**10 Year**	**25 Year**	**50 Year**
Low	0.78%	1.05%	1.39%	1.75%	1.49%
Date	08/04/2021	08/07/2021	05/08/2021	17/08/2021	10/08/2021
High	0.98%	1.42%	1.81%	2.27%	2.06%
Date	24/09/2021	28/09/2021	28/09/2021	13/05/2021	13/05/2021
Average	0.84%	1.16%	1.60%	2.02%	1.81%

5.2 The Council borrowed £150m from the PWLB during the first half of the year, as detailed in the table below, at an average rate of c. 1.97%. This was to refinance the temporary borrowing taken last year, and ultimately is to fund the Council’s capital programme.

Maturity Date	Value (£m)	Interest Rate (%)
17/06/2055	15	2.05
17/06/2062	25	1.99
17/06/2063	25	1.99
17/06/2064	20	1.98
17/06/2068	20	1.94
17/06/2069	15	1.93
17/06/2070	15	1.92
17/06/2071	15	1.91
Total	150	1.97

5.3 A number of loans were taken out, with maturities spread over a number of years to allow the repayments to be manageable, and closer aligned to the likely MRP charges that the Council makes for the council when the loans mature.

5.4 Manchester continues to be 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 in the previous table.

Temporary Borrowing

5.5 As noted above, the temporary borrowing previously agreed became due for repayment during the first half of the financial year, with c. £167.1m repaid. This was predominantly refinanced through the PWLB debt taken.

Salix Borrowing

5.6 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.

5.7 In the first half of the year, the Council repaid £2.1m, bringing the total value of Salix debt to £12.9m on 30th of September 2021.

6 Compliance with Prudential Indicators and Treasury Limits

6.1 The Council sets an operational limit on the cleared balance that is left within the Council's current accounts. The limit 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 first half of the financial year with the exception of the breaches described below.

6.2 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.

6.3 During the period 1st April to 30th September 2021 there were nine breaches of the daily £0-400k limit on the Barclays current account.

i. On eight occasions, Treasury Management purposely kept the current account in surplus following a payment made in error by the bank for the amount of £3.3m, the limit was breached for 8 days while the bank investigated.
ii. On the final 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.

6.4 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 2021-22 to date

7.1 The Treasury Management Strategy Statement (TMSS) for 2021-22 was approved by Executive on 17th February 2021. 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 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 agreed at Executive in February and Council in March.

8 Temporary Borrowing and Investment for 2021-22 to date

8.1 Compared to the previous twelve months, the Council's cash flows have been far more predictable, as the economy and our finances have stabilised after the pandemic. Liquidity has remained a key focus for the treasury management function, alongside the refinancing of the temporary borrowing.

8.2 Investment rates available in the market continue to be at an historic low point. The average level of funds available for investment purposes in the first six months of 2021/22 was £43.3m. 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, payments of COVID-19 related grants, progress on the capital programme, and working capital.

8.3 As noted, a significant amount of short term borrowing was repaid during the first half of the year and refinanced with long term debt. The average level of temporary borrowing in this period was £69.8m.

8.4 Detailed on the next table is the temporary investment and borrowing undertaken by the Council. As illustrated, the Council over performed the benchmark by 10 basis points on investments due to the effective search for better inter Local Authority market rates and the use of Money Market Funds which on average had a higher return.

8.5 The temporary borrowing portfolio consisted of loans with various investment tenors ranging from 14 day notice terms to fixed two-year maturities. The average cost was therefore higher by 19 basis points when compared to the 12 month benchmark.

	Average temporary investment /borrowing	Net Return/Cost	Benchmark Return / Cost *
Temporary Investments	£43.3m	0.02%	-0.08%
Temporary Borrowing	£69.8m	0.57%	0.38%

* *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 CIPFA Consultation on Prudential and Treasury Management Codes of Practice

9.1 CIPFA have consulted with local authorities on proposed changes to the Prudential Code and the Treasury Management Code, which form the risk management framework within which local authorities should make capital investment and treasury management decisions.

9.2 The main changes reflect the recent changes to the terms of lending for the PWLB, in that they seek to reinforce the requirement that local authorities should not borrow purely for yield, thus discouraging investment which is purely commercial in nature and provides no direct service benefit to the authority.

9.3 Other changes include significant changes to the prudential indicators to support decision making, and changes to the Capital Strategy and Treasury Management Strategy documents to ensure that a local authority's approach to service and commercial investments, including commercial property, are included along with how the risks of such investment are managed.

9.4 The consultation on both Codes closes in mid-November, with the revised Codes expected to be published before the end of the calendar year.

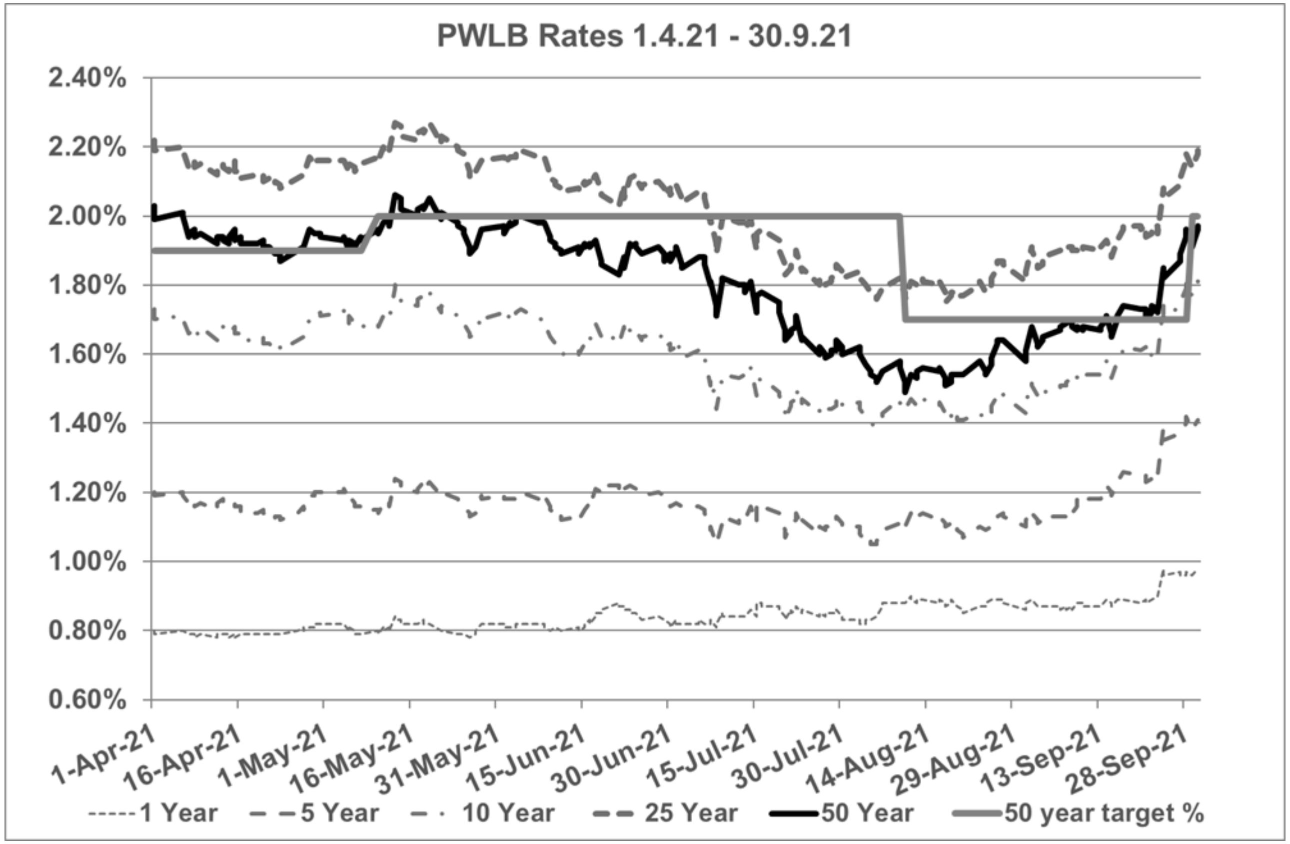
10 Conclusion

10.1 The first six months of year 2021/22 have so far demonstrated extraordinary market conditions putting enormous pressure on the Council's cash liquidity. The next six months are likely to further put more pressure on the Council's income and therefore cash flow. Cash balances have been low during the first half of the year and based on current forecasts an additional borrowing requirement is expected during the second half of 2021/22.

10.2 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.

10.3 Proactive treasury management during the year has enabled the Council to achieve an average net return on investments of 0.02%, in excess of the benchmark average 7-day LIBID rate of -0.08% 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.

APPENDIX A
PWLB RATES APRIL TO SEPTEMBER 2021



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.78%	1.05%	1.39%	1.75%	1.49%
Date	08/04/2021	08/07/2021	05/08/2021	17/08/2021	10/08/2021
High	0.98%	1.42%	1.81%	2.27%	2.06%
Date	24/09/2021	28/09/2021	28/09/2021	13/05/2021	13/05/2021
Average	0.84%	1.16%	1.60%	2.02%	1.81%
Spread	0.20%	0.37%	0.42%	0.52%	0.57%

APPENDIX B

Treasury Management Prudential Indicators: 2021-22 to date

	Original	**Minimum In Year to 30 Sept 2021**	**Maximum In Year to 30 Sept 2021**
	£m	***£m***	***£m***
Operational Boundary for External Debt:			
Borrowing	1,350.3	644.8	783.7
Other Long Term Liabilities	190.0	156.4	156.4
Authorised Limit for External Debt:			
Borrowing	1,711.6	644.8	783.7
Other Long Term Liabilities	190.0	156.4	156.4
		Actual as at 30 Sept 2021	
Authority 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 2021-22 Original**	**Upper Limit 2021-22 Original**	**Actual as at 30 Sept 2021**
under 12 months	0%	80%	17%
12 months and within 24 months	0%	80%	8%
24 months and within 5 years	0%	70%	23%
5 years and within 10 years	0%	70%	0%
10 years and above	20%	90%	52%

APPENDIX C

REVIEW OF ECONOMIC CONDITIONS FOR FIRST SIX MONTHS OF 2021-22 AND FUTURE OUTLOOK

This section has been prepared by the Council's Treasury Advisors, Link Asset Services, for the 30th of September 2021 and includes their forecast for future interest rates after the PWLB policy change referenced in the report.

1 ECONOMIC PERFORMANCE TO DATE 2021-22

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.

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.

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.