

## APPENDIX I

REPORT TO	ON
Council	24 February 2021

TITLE	REPORT OF
Treasury Management Policy Statement 2021/22	Deputy Director of Finance (Section 151 Officer)

Is this report confidential?	No
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### PURPOSE OF THE REPORT

- 1.1 To present for approval the Prudential and Treasury Indicators and Treasury Management and Investment Strategies for 2021/22 to 2023/24, and the Minimum Revenue Policy Statement for 2021/22.

### 2. RECOMMENDATION(S)

2.1 That Council approve:

- The capital expenditure Prudential Indicators for 2021/22 to 2023/24 in Tables 1 to 5.
- The annual Minimum Revenue Provision (MRP) Policy statement starting at paragraph 10.3.
- The Treasury Management Strategy and treasury management Prudential Indicators for 2021/22 to 2023/24, in Tables 6 to 10.
- The Annual Investment Strategy 2021/22 including Investment Counterparties starting at paragraph 12.

### 3. REASONS FOR RECOMMENDATIONS

- 3.1 Setting the annual budget is a statutory requirement part of which is the Treasury Management Policy.

### 4. OTHER OPTIONS CONSIDERED AND REJECTED

- 4.1 None

### 5. CORPORATE OUTCOMES

1. The report relates to the following corporate priorities:

An exemplary council	✓	Thriving communities	
A fair local economy that works for everyone		Good homes, green spaces, healthy places	

### 6. BACKGROUND TO THE REPORT

- 6.1 For each financial year the Council sets a balanced budget so that cash income raised during the year is sufficient to meet all of its cash expenditure commitments. One of the key functions of the Council's treasury management activity is to ensure that these cash flows are effectively managed, so that cash is available when it is needed. Surplus cash is invested having regard to risk, liquidity and yield.
- 6.2 A further key function of the treasury management activity is to ensure that the Council has sufficient funds to pay for its capital and other investment plans. These capital plans, which are set out in the Capital Programme, identify the borrowing needs of the Council over a longer time horizon than the current year. In managing its longer-term cash flow requirements for capital expenditure the Council will take out loans or alternatively use its cash flow surpluses in lieu of external borrowing. This latter practice is referred to as "internal borrowing". In managing its loans, it may at times be advantageous for the Council to repay or restructure its borrowings to optimise interest payments or achieve a balanced debt portfolio.
- 6.3 Having regard to these activities, the Chartered Institute of Public Finance and Accountancy (CIPFA) defines treasury management as:
- "The management of the Council'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."*
- 6.4 As treasury management decisions involve borrowing and investing substantial sums of money, the Council is exposed to potentially large financial risks, including the loss of invested funds and the revenue effect of changing interest rates. The identification, control and monitoring of risk are therefore integral elements of treasury management activity.
- 6.5 The Treasury Management Policy Statement for 2021/22 is based upon the Deputy Chief Finance Officer and Treasury Officers' views on interest rates supplemented by leading market forecasts. The policy statement covers:
- a) The policy for managing capital borrowing and debt rescheduling
  - b) The annual investment strategy for treasury management investments
  - c) Reporting arrangements
  - d) Training arrangements
  - e) Performance indicators
  - f) Minimum Revenue Provision (MRP) Policy
  - g) Use of treasury management advisors
- 6.6 Council of 26 February 2020 approved the Treasury Management Strategy for 2020/21, including Prudential and Treasury Indicators, the Treasury Management and Investment Strategies, and the annual Minimum Revenue Provision (MRP) Policy Statement for 2020/21. Treasury Management activities during the year have been overseen by the Governance Committee.
- 6.7 This report updates Prudential and Treasury Indicators for financial years 2021/22 to 2023/24. It presents updated Treasury Management and Investment Strategies and proposes the Minimum Revenue Provision Policy Statement for 2021/22.

## **7. TREASURY MANAGEMENT STRATEGY 2021/22**

- 7.1 The strategy for 2021/22 covers two main areas:

### **Capital issues**

- the capital plans and the Prudential Indicators;
- the Minimum Revenue Provision (MRP) policy.

### **Treasury management issues**

- the current treasury position;
- Treasury Indicators which limit the treasury risk and activities of the Council;
- prospects for interest rates;
- the borrowing strategy;
- policy on borrowing in advance of need;
- debt rescheduling;
- the investment strategy;
- creditworthiness policy; and
- the policy on use of external service providers.

7.2 These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, MHCLG MRP Guidance, the CIPFA Treasury Management Code, and MHCLG Investment Guidance.

7.3 The Statutory Guidance on Minimum Revenue Provision remains the 3<sup>rd</sup> edition, as issued by the Ministry of Housing, Communities & Local Government on 2 February 2018.

## **8. TRAINING**

8.1 The CIPFA Code requires the Responsible Officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny. Training will be provided on the implications of the revised CIPFA Prudential and Treasury Management Codes, and the revised MHCLG Investment Guidance and MRP Guidance.

8.2 The training needs of treasury management officers are reviewed periodically. Both CIPFA and Link Asset Services provide workshops and seminars.

## 9. TREASURY MANAGEMENT CONSULTANTS

9.1 The Council uses Link Asset Services, Treasury Solutions as its external treasury management advisors. The advisors provide access to specialist skills and resources including

- Technical support on treasury matters and capital finance issues.
- Economic and interest rate analysis.
- Debt services, which includes advice on the timing of borrowing.
- Debt rescheduling advice surrounding the existing portfolio.
- Generic investment advice on interest rates, timing and investment instruments.
- Credit ratings/market information service comprising the three main credit rating agencies.

9.2 The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

9.3 The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed, documented and subjected to regular review.

## 10. CAPITAL PRUDENTIAL INDICATORS 2020/21 – 2023/24 AND MRP POLICY STATEMENT

10.1 The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

### 10.2 Capital expenditure

This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle.

Table 1 - Capital Expenditure	2020/21	2021/22	2022/23	2023/24
	Estimate £000	Estimate £000	Estimate £000	Estimate £000
Good homes, green spaces and healthy places	3,461	10,338	12,290	23,880
A fair economy that works for everyone	845	2,200	2,000	0
Thriving communities	240	350	750	0
An exemplary council	2,056	2,926	940	504
<b>Capital Expenditure Total</b>	<b>6,602</b>	<b>15,814</b>	<b>15,980</b>	<b>24,384</b>

The table below summarises the above capital expenditure plans identified in the Capital & Investment Strategy and the Capital Programme and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a borrowing requirement.

Table 2 - Capital Financing	2020/21	2021/22	2022/23	2023/24
	Revised £000	Estimate £000	Estimate £000	Estimate £000
Capital expenditure from Table 1	6,602	15,814	15,980	24,384
Grants & Contributions	(1,899)	(1,270)	(3,757)	(682)
S106/CIL	(1,945)	(2,205)	(2,527)	0
Revenue and Reserves	(2,758)	(3,417)	(600)	0
<b>Net financing needed for year</b>	<b>0</b>	<b>8,922</b>	<b>9,096</b>	<b>23,702</b>

### The Council's borrowing need (the Capital Financing Requirement)

The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's indebtedness and so its underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

The CFR does not increase indefinitely, as the Minimum Revenue Provision (MRP) is a statutory annual revenue charge which broadly reduces the indebtedness in line with each assets life, and so charges the economic consumption of capital assets as they are used.

The CFR includes any other long-term liabilities (finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility by the lease provider and so the Council is not required to separately borrow for these schemes:

Table 3 - Capital Financing Requirement	2020/21	2021/22	2022/23	2023/24
	Revised £000	Estimate £000	Estimate £000	Estimate £000
Opening CFR	2,999	2,380	11,003	19,599
Net financing need for the year (Table 2)	0	8,922	9,096	23,702
Less MRP/VRP	(619)	(299)	(500)	(531)
<b>Closing CFR</b>	<b>2,380</b>	<b>11,003</b>	<b>19,599</b>	<b>42,770</b>

### 10.3 Minimum Revenue Provision (MRP)

The Council has a statutory requirement to set aside each year part of their revenues as a provision for the repayment of debt, called the Minimum Revenue Provision (MRP). The provision is in respect of capital expenditure incurred in previous years and which has been financed by borrowing.

The statutory requirement per the Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 [SI 2008/414] is for each local authority to determine an amount of MRP which it considers to be “prudent”.

As “prudence” is not defined in the regulations, the MHCLG had issued accompanying statutory guidance which explains that the broad aim of a “prudent provision” is to ensure that the debt is repaid over a period that is either, reasonably commensurate with the period over which the capital expenditure provides benefit, or, in the case of borrowing supported by formula grant, reasonably commensurate with the period implicit in the determination of that grant. Each authority must determine what they consider is a prudent amount while having regard to the guidance.

The guidance also recommends that each local authority prepare an annual statement of its strategic policy on making MRP, to be approved by the full Council. A variety of options are provided to councils in the regulations, so long as there is a prudent provision.

For capital expenditure incurred before 1 April 2008 Option 1 is applied.

This provides for local authorities to continue to calculate MRP in line with the minimum existing statutory charge of 4% of outstanding debt related to supported borrowing only, less an adjustment that ensures consistency with previous capital regulatory regimes no longer in force.

From 1 April 2008 for all unsupported borrowing (including finance leases) the MRP policy will be Option 3 – Asset Life Method

This method is appropriate for calculating MRP in relation to debt incurred as unsupported borrowing (also known as prudential borrowing), and must be used for revenue expenditure capitalised by direction or regulation. Under this option there are two methods available:

- (Equal instalment method. This generates a series of equal annual amounts over the life of each asset that is financed by borrowing, with the life determined upon acquisition. This means that the charge to revenue closely matches the period of economic benefit of the asset.
- Annuity method. This method links the MRP to the flow of benefits from an asset where the benefit is expected to increase in later years.

Under this option, authorities should consider the type of assets that they finance through prudential borrowing, as the type of asset and its useful life may have a significant impact on the level of MRP charged. Where expenditure is capitalised by direction or regulation, the guidance specifies certain maximum lives to be used in the calculation.

#### Finance Leases and PFI

The guidance indicates that for finance leases and on-balance sheet PFI contracts, the MRP requirement could be met by making a charge equal to the element of the finance lease rental that goes to write down the balance sheet liability under proper accounting practices.

### 10.4 Affordability prudential indicators

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council’s overall finances. The Council is asked to approve the following indicator:

## Ratio of financing costs to net revenue stream

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

<b>Table 4 - Ratio of Financing Costs to Net Revenue Stream</b>	<b>2020/21 Estimate</b>	<b>2020/21 Revised</b>	<b>2021/22 Estimate</b>	<b>2022/23 Estimate</b>	<b>2023/24 Estimate</b>
	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>
Ratio	5.03	3.81	1.72	5.77	9.94

The estimates of financing costs include current capital commitments and the proposals in the Budget and Capital and Capital Strategy reports. The increasing ratio for the remainder of the budget period reflects the additional level of borrowing required to finance the Council's planned Capital Programme. However, the intention for schemes funded through borrowing is that they will, where possible, deliver a financial return and therefore contribute to the sustainability of the Council's debt financing costs.

### 10.5 Core funds and expected investment balances

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.).

<b>Table 5 - Year-End Resources</b>	<b>2020/21 Estimate</b>	<b>2020/21 Revised</b>	<b>2021/22 Estimate</b>	<b>2022/23 Estimate</b>	<b>2023/24 Estimate</b>
	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>
Core Funds/Working Balances	(40,369)	(46,944)	(43,378)	(37,221)	(36,131)
Under/(over) borrowing (Table 6)	4,173	2,350	6,448	10,468	21,746
<b>Expected investments</b>	<b>(36,196)</b>	<b>(44,594)</b>	<b>(36,930)</b>	<b>(26,754)</b>	<b>(14,386)</b>

## 11. BORROWING

11.1 The capital expenditure plans set out in paragraph 10.2 above provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional codes, so that sufficient cash is available to meet this service activity and the Council's capital strategy. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant Treasury / Prudential Indicators, the current and projected debt positions and the annual Investment Strategy.

### 11.2 Current portfolio position

11.3 The Council's treasury portfolio position at 31 March 2021, with forward projections, is summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

<b>Table 6 - Portfolio Position</b>	<b>2020/21 Estimate £000</b>	<b>2020/21 Revised £000</b>	<b>2021/22 Estimate £000</b>	<b>2022/23 Estimate £000</b>	<b>2023/24 Estimate £000</b>
Debt at 1 April	0	0	0	4,461	9,186
Other long-term liabilities (OLTL)	322	390	0	0	0
<b>Total gross debt 1 April</b>	<b>322</b>	<b>390</b>	<b>0</b>	<b>4,461</b>	<b>9,186</b>
Expected change in Debt	743	0	4,461	4,725	12,151
Expected change in OLTL	(322)	(390)	0	0	0
<b>Expected change in gross debt</b>	<b>421</b>	<b>(390)</b>	<b>4,461</b>	<b>4,725</b>	<b>12,151</b>
Gross debt 31 March	743	0	4,461	9,186	21,337
Capital Financing Requirement (Table 3)	4,916	2,350	10,909	19,653	43,082
<b>Under / (over) borrowing</b>	<b>4,173</b>	<b>2,350</b>	<b>6,448</b>	<b>10,468</b>	<b>21,746</b>

11.4 Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2021/22 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue or speculative purposes.

11.5 The Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

#### 11.6 Treasury Indicators: limits to borrowing activity

**The Operational Boundary.** This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt and the ability to fund under-borrowing by other cash resources.

<b>Table 7 - Operational Boundary</b>	<b>2020/21 Estimate £000</b>	<b>2020/21 Revised £000</b>	<b>2021/22 Estimate £000</b>	<b>2022/23 Estimate £000</b>	<b>2023/24 Estimate £000</b>
Debt	750	0	4,500	9,200	21,400
Other long-term liabilities	0	0	0	0	0
<b>Operational Boundary</b>	<b>750</b>	<b>0</b>	<b>4,500</b>	<b>9,200</b>	<b>21,400</b>



**The Authorised Limit for external debt.** A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

- This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

Table 8 - Authorised Limit	2020/21	2020/21	2021/22	2022/23	2023/24
	Estimate £000	Revised £000	Estimate £000	Estimate £000	Estimate £000
Debt	3,750	3,000	7,500	12,200	24,400
Other long-term liabilities	0	0	0	0	0
<b>Authorised Limit</b>	<b>3,750</b>	<b>3,000</b>	<b>7,500</b>	<b>12,200</b>	<b>24,400</b>

#### 11.7 Maturity structure of borrowing

These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

Table 9 - Maturity Structure of Borrowing		
Maturity structure of fixed interest rate borrowing 2021/22		
	Lower	Upper
Under 12 months	0%	20%
12 months to 2 years	0%	20%
2 years to 5 years	0%	30%
5 years to 10 years	0%	50%
Over 10 years	0%	100%

It is not anticipated that any borrowing will be taken at variable interest rates.

#### 11.8 Control of interest rate exposure

Please see paragraphs 11.9, 12.4 and Appendices I1-3.

Appendix I3 compares the forecast of a year ago with that prepared for the mid-year review, and the current forecast.

## 11.9 Prospects for borrowing interest rates

Borrowing interest rates fell to historically very low levels as a result of the Covid-19 pandemic and the associated quantitative easing operations of the Bank of England, and have remained low since. The unexpected increase of 1% in PWLB rates in October 2019 had a major impact on local authority borrowing plans. However, in March 2020, the Government began a consultation process for reviewing the rates for PWLB borrowing for different types of local authority capital expenditure. The outcomes of this review were announced on 25 November 2020, with the principal results being the reversal of the previous 1% increase in rates, but with the introduction of an exclusion on the use of PWLB borrowing where a local authority's three-year capital programme includes the purchase of assets for yield.

With PWLB rates remaining at low levels and forecast to do so for some time then, where there is a financing requirement, borrowing from the PWLB should be actively considered, as should the relative merits of borrowing across different maturity periods. If it appears that greater value can be obtained in borrowing for shorter maturity periods, the Council will assess its risk appetite in conjunction with budgetary pressures to reduce total interest costs. This will be balanced by also considering longer-term borrowing for the purpose of certainty.

While it is likely, based upon the capital plans set out above, that the Council will need to enter into long-term external borrowing during the term of this strategy, this will be balanced against ongoing consideration of the use of internal cash balances as an alternative.

## 11.10 Borrowing strategy

The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is still an issue that needs to be considered.

Against this background and the risks within the economic forecast, caution will be adopted with the 2021/22 treasury operations. The Section 151 Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

- *if it was felt that there was a significant risk of a sharp FALL in borrowing rates, (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then borrowing will be postponed.*
- *if it was felt that there was a significant risk of a much sharper RISE in borrowing rates than that currently forecast, perhaps arising from an acceleration in the rate of increase in central rates in the USA and UK, an increase in world economic activity, or a sudden increase in inflation risks, then the portfolio position will be re-appraised. Most likely, fixed rate funding will be drawn whilst interest rates are lower than they are projected to be in the next few years.*

Any decisions will be reported at the next available opportunity.

## 11.11 Policy on borrowing in advance of need

The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.

## 12. ANNUAL INVESTMENT STRATEGY

### 12.1 Investment Policy

The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the CIPFA Treasury Management in the Public Services: Guidance Notes for Local Authorities incl Police and Fire Authorities (2018) ("the CIPFA TM Code"). The Council's investment priorities will be **Security** first, portfolio **Liquidity** second, and only then return (**Yield**).

In accordance with the above guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.

Ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To achieve this consideration the Council will engage with its advisors to maintain a monitor on market pricing such as "credit default swaps" and overlay that information on top of the credit ratings.

Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

**Treasury Management Practice 1 (TMP1)** deals with credit and counterparty risk management. In applying this practice, the following limits are relevant:

**SPECIFIED INVESTMENTS:** All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' quality criteria where applicable.

**NON-SPECIFIED INVESTMENTS:** These are any investments which do not meet the specified investment criteria. A maximum of £6m will be held in aggregate in non-specified investments, specifically term deposits with UK local authorities.

### 12.2 Creditworthiness policy

The Council applies the creditworthiness service provided by Link Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard & Poor's. The credit ratings of counterparties are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies;
- CDS spreads to give early warning of likely changes in credit ratings;
- sovereign ratings to select counterparties from only the most creditworthy countries.

This modelling approach combines credit ratings, credit Watches and credit Outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments. The Council will therefore use counterparties within the following durational bands:

<b>Yellow</b>	5 years
<b>Purple</b>	2 years
<b>Blue</b>	1 year (only applies to nationalised or semi nationalised UK Banks)
<b>Orange</b>	1 year
<b>Red</b>	6 months
<b>Green</b>	100 days
<b>No colour</b>	Not to be used

The yellow colour category is for UK Government debt, or its equivalent, money market funds and collateralised deposits where the collateral is UK Government debt.

The Link Asset Services' creditworthiness service uses a wider array of information other than just primary ratings. Furthermore, by using a risk weighted scoring system, it does not give undue preponderance to just one agency's ratings.

Typically, the minimum credit ratings criteria the Council use will be a Short-Term rating (Fitch or equivalents) of F1 and a LongTerm rating of A-. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances, consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

All credit ratings will be monitored weekly and will be checked at the time of placing investments. The Council is alerted to changes to ratings of all three agencies through its use of the Link Asset Services' creditworthiness service, and has access to the websites of Fitch, Moody's and Standard & Poor's.

- if a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of credit ratings the Council will be advised of information in movements in credit default swap spreads against the iTraxx benchmark and other market data on a daily basis via its Passport website, provided exclusively to it by Link Asset Services. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

Sole reliance will not be placed on the use of this external service. In addition, this Council will also use market data and market information, information on any external support for banks to help support its decision-making process.

## Investment Counterparties 2021/22

Category	Institutions	LAS Colour Code	Maximum Period	Limit per Institution
<b>Banks &amp; Building Societies: Call Accounts /Term Deposits / Certificates of Deposit (CDs)</b>				
Government related/guaranteed	DMADF (DMO) UK Local Authority	Yellow Yellow	6 months 2 years	Unlimited £6m per LA
UK part-nationalised institutions	Royal Bank of Scotland group	Blue	1 year	£6m per group
UK-incorporated Institutions	UK banks and building societies of high credit quality	Orange Red Green	1 year 6 months 3 months	£6m per group (or independent institution)
Non-UK Banks	Non-UK banks of high credit quality	Orange Red Green	1 year 6 months 3 months	£4m per group (or independent institution); £8m in total for this category
<b>Money Market Funds</b>				
Money Market Funds	MMFs of high credit quality - AAA rated		Instant access	£5m per fund

### 12.3 Country limits

In addition to the detailed UK counterparties, the above list includes non-UK banks from countries which have a minimum sovereign credit rating of AA- from Fitch. To this are added the requirement for the individual institution to itself have a high credit rating and a limit of £4m per institution/group and £8m in total in this category of investment.

The list of eligible countries at the date of this report would then be as shown below. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

The only non-UK counterparty used in the last three years is the German bank Landesbank Hessen-Thüringen Girozentrale (Helaba). The Council currently has the maximum amount of £4m invested with this counterparty.

## APPROVED COUNTRIES FOR INVESTMENTS – United Kingdom plus the following:

### AAA

Australia  
Denmark  
Germany  
Luxembourg  
Netherlands  
Norway  
Singapore  
Sweden  
Switzerland

### AA+

Canada  
Finland  
U.S.A.

### AA

Abu Dhabi (UAE)  
France

### AA-

Belgium  
Hong Kong  
Qatar

## 12.4 Investment strategy

### **In-house funds**

Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

### **Investment returns expectations**

Bank Rate is forecast to remain unchanged at 0.10% across the whole of the period covered by this strategy report. Current Bank Rate forecasts for financial year ends (March) are shown below, compared to those from twelve months ago:

- 2020/21 0.10% Was 0.75% in 2020/21 Treasury Strategy report
- 2021/22 0.10% Was 1.00%
- 2022/23 0.10% Was 1.25%
- 2023/24 0.10%

With the Bank Rate unlikely to rise from 0.10% for a considerable period, it is very difficult to say when it may start rising, so it needs to be assumed that investment earnings from money market-related instruments will remain below 0.50% for the foreseeable future.

The suggested budgeted investment earnings rates for returns on investments placed for periods up to about three months during each financial year are as follows. The long term forecast is for periods over 10 years in the future):

The suggested budgeted investment earnings rates for returns on investments placed for periods up to about three months during each financial year are as follows:

	<b>Now</b>	<b>2020/21 report</b>
2020/21	0.10%	0.75%
2021/22	0.10%	1.00%
2022/23	0.10%	1.25%
2023/24	0.10%	1.50%
2024/25	0.20%	1.75%
Long-term later years	2.00%	2.25%

The overall balance of risks to economic growth in the UK is probably now skewed to the upside, but remains subject to major uncertainty due to the virus and how quickly successful vaccines may become available and widely administered to the population. It may also be affected by ongoing developments resulting from Brexit.

There is relatively little UK domestic risk of either increases or decreases in Bank Rate or significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away, given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, or a return of investor confidence in equities, could impact gilt yields, (and so PWLB rates), in the UK.

On negative investment rates, while the Bank of England said in August / September 2020 that it is unlikely to introduce a negative Bank Rate, at least in the next 6 -12 months, and in November omitted any mention of negative rates in the minutes of the meeting of the Monetary Policy Committee, some deposit accounts are already offering negative rates for shorter periods. As part of the response to the pandemic and lockdown, the Bank and the Government have provided financial markets and businesses with plentiful access to credit, either directly or through commercial banks. In addition, the Government has provided large sums of grants to local authorities to help deal with the COVID crisis. This has caused some local authorities to have sudden large increases in cash balances searching for an investment home, some of which was only very short term until those sums were able to be passed on.

For money market funds (MMFs), yields have continued to drift lower. Some managers have already reduced fee levels to ensure that net yields for investors remain positive, wherever possible and practical. Investor cash flow uncertainty, and the need to maintain liquidity in what are unprecedented circumstances, has meant there is a surfeit of money available at the very short end of the market. This has seen a number of market operators, now including the DMADF, offer nil or negative rates for very short term maturities. This is not universal, and MMFs are still offering a marginally positive return, as are a number of financial institutions for investments at the very short end of the yield curve.

Inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash seeking a short-term home, at a time when many local authorities are probably having difficulties over accurately forecasting when funds will be received or when further large receipts may be received from the Government.



**Investment Treasury Indicator and limit** - total principal funds invested for greater than 365 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment and are based on the availability of funds after each year-end.

<b>Table 10 - Maximum Principal Sums Invested &gt; 365 Days</b>	<b>2020/21</b>	<b>2020/21</b>	<b>2021/22</b>	<b>2022/23</b>	<b>2022/24</b>
	<b>Estimate</b>	<b>Revised</b>	<b>Estimate</b>	<b>Estimate</b>	<b>Estimate</b>
	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>
UK Government	0	0	0	0	0
UK Local Authorities	6,000	6,000	6,000	6,000	6,000
UK Banks & Building Societies	0	0	0	0	0
Non-UK Banks	0	0	0	0	0
<b>Total</b>	<b>6,000</b>	<b>6,000</b>	<b>6,000</b>	<b>6,000</b>	<b>6,000</b>

For its cash flow generated balances, the Council will seek to utilise its business reserve instant access and notice accounts, money market funds and short-dated deposits (overnight to 100 days) in order to benefit from the compounding of interest.

#### 12.5 Investment Risk Benchmarking

This Council will use an investment benchmark to assess the investment performance of its investment portfolio of 7 day LIBID compounded. However, it is recognised that the provision of LIBOR and associated LIBID rates is currently expected to cease at the end of 2021. Officers will work with the Council's treasury management advisors to determine a suitable replacement investment benchmark ahead of this and will report back to members accordingly.

#### 12.6 End of Year Investment Report

At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

#### 12.7 Accounting treatment of investments

The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by this Council. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, officers will review the accounting implications of new transactions before they are undertaken.

#### 13. Risk

The financial risks are outlined throughout the report as well as the appendices to the report.

#### 14. Equality and diversity

None

#### 15. Air quality implications

None

#### COMMENTS OF THE STATUTORY FINANCE OFFICER

These are contained in the report.

## **COMMENTS OF THE MONITORING OFFICER**

The recommendations are appropriate as explained in the body of the report.

### **16. BACKGROUND DOCUMENTS**

CIPFA Treasury Management in the Public Services: Code of Practice & Cross-Sectoral Guidance Notes (December 2017 edition)

CIPFA Treasury Management in the Public Services: Guidance Notes for Local Authorities (July 2018 edition)

CIPFA Prudential Code for Capital Finance in Local Authorities (December 2017 edition)

CIPFA Standards of Professional Practice: Treasury Management

MHCLG Guidance on Local Government Investments

MHCLG Guidance on Minimum Revenue Provision

APPENDIX I1 – Economic Background

APPENDIX I2 – Interest Rate Forecasts

APPENDIX I3 – Comparison of Interest Rate Forecasts

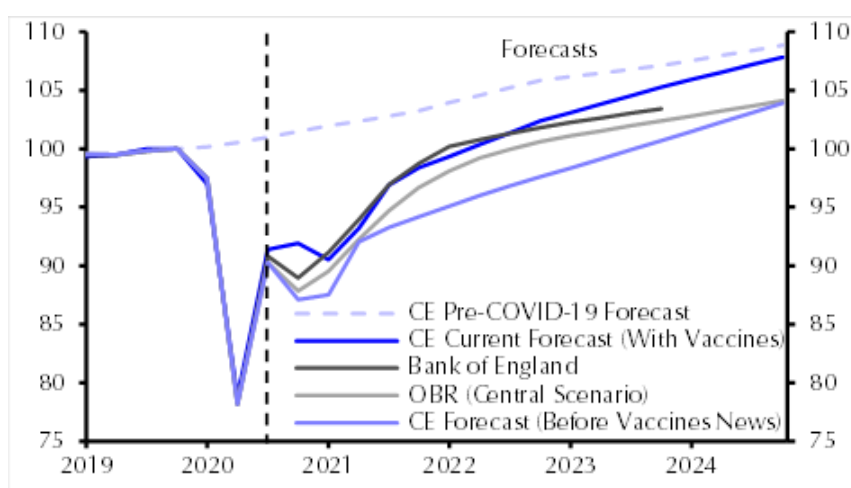
## ECONOMIC BACKGROUND

Advice from Link Asset Services:

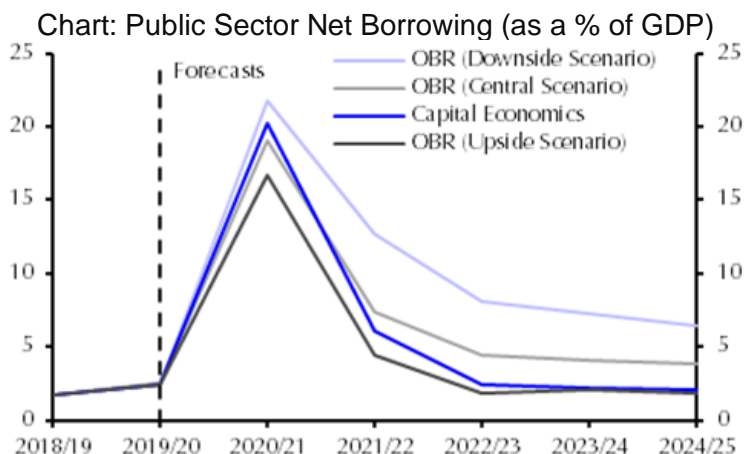
- **UK.** The Bank of England Monetary Policy Committee has continued to keep the Bank Rate unchanged at 0.10%. However, it has revised its economic forecasts to take account of the renewed national lockdowns, which are inevitably going to put back economic recovery and do further damage to the economy. It therefore decided to do a further tranche of quantitative easing (QE) of £150bn, to start in January when the current programme of £300bn, announced in March to June, runs out. It did this so that “announcing further asset purchases now should support the economy and help to ensure the unavoidable near-term slowdown in activity was not amplified by a tightening in monetary conditions that could slow the return of inflation to the target”.
- Its forecasts had appeared, at that time, to be rather optimistic in terms of three areas:
  - The economy would recover to reach its pre-pandemic level in Q1 2022
  - An expectation that there would be excess demand in the economy by Q4 2022.
  - CPI inflation was therefore projected to be a little above its 2% target by the start of 2023 and the “inflation risks were judged to be balanced”.
- Significantly, there has been no mention of negative interest rates in the minutes or Monetary Policy Report, suggesting that the MPC remains some way from being persuaded of the case for such a policy, at least for the next 6 -12 months. However, rather than saying that it “stands ready to adjust monetary policy”, the MPC has now said that it will take “whatever additional action was necessary to achieve its remit”. The latter seems stronger and wider and may indicate the Bank’s willingness to embrace new tools.
- One key addition to the Bank’s forward guidance in August was a new phrase in the policy statement, namely that “it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably”. That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years’ time, do not expect any action from the MPC to raise the Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate. Our Bank Rate forecast currently shows no increase (or decrease), through to quarter 1 2024 but there could well be no increase during the next five years as it will take some years to eliminate spare capacity in the economy, and therefore for inflationary pressures to rise to cause the MPC concern. Inflation is expected to briefly peak at just over 2% towards the end of 2021, but this is a temporary short lived factor due to base effects from twelve months ago falling out of the calculation, and so is not a concern. Looking further ahead, it is also unlikely to be a problem for some years as it will take a prolonged time for spare capacity in the economy, created by this downturn, to be used up.
- **Public borrowing** was forecast in November by the Office for Budget Responsibility (the OBR) to reach £394bn in the current financial year, the highest ever peace time deficit and equivalent to 19% of GDP. In normal times, such an increase in total gilt issuance would lead to a rise in gilt yields, and so PWLB rates. However, the QE done by the Bank of England has depressed gilt yields to historic low levels (as has similarly occurred with QE and debt issued in the US, the EU and Japan). This means that new UK debt being issued, and this is being done across the whole yield curve in all maturities, is locking in those historic low levels through until maturity. In addition, the UK has one of the longest average maturities for its entire debt portfolio, of any country in the world. Overall, this means that the total interest bill paid by the Government is manageable despite the huge increase in the total amount of debt. The OBR was also forecasting that the government will still be running a budget deficit of £102bn (3.9% of GDP) by 2025/26. However, initial impressions are that they have taken a pessimistic view of the impact that vaccines could make in the speed of economic recovery.

- Overall, the **pace of recovery** was not expected to be in the form of a rapid V shape, but a more elongated and prolonged one. The initial recovery was sharp after quarter 1 saw growth at -3.0% followed by -18.8% in quarter 2 and then an upswing of +16.0% in quarter 3. This still left the economy 8.6% smaller than in Q4 2019. While the one month second national lockdown that started on 5<sup>th</sup> November caused a further contraction of 5.7% m/m in November, this was much better than had been feared and showed that the economy is adapting to new ways of working. This left the economy 'only' 8.6% below the pre-crisis level.
- **Vaccines – the game changer.** The Pfizer announcement on 9<sup>th</sup> November 2020 of a successful vaccine was followed by approval of the Oxford University/AstraZeneca and Moderna vaccines. The Government has set a target to vaccinate 14 million people in the most at risk sectors of the population by 15<sup>th</sup> February. As of mid-January, it has made good and accelerating progress in hitting that target. The aim is to vaccinate all adults by September. This means that the national lockdown which started in early January could be replaced by regional tiers of lighter restrictions, beginning possibly in Q2. At that point, there would be less reason to fear that hospitals could become overwhelmed any more. Effective vaccines have radically improved the economic outlook, so that it may now be possible for GDP to recover to its pre-virus level as early as Q1 2022. These vaccines have enormously boosted confidence that life could largely return to normal during the second half of 2021. With the household saving rate having been exceptionally high since the first lockdown in March, there is plenty of pent-up demand and purchasing power stored up for when life returns to normal.
- Provided that both monetary and fiscal policy are kept loose for a few years yet, then it is still possible that in the second half of this decade, the economy may be no smaller than it would have been if COVID-19 never happened. The significant risk is if another mutation of COVID-19 appears that defeats the current batch of vaccines. However, now that science and technology have caught up with understanding this virus, new vaccines ought to be able to be developed more quickly to counter such a development, and vaccine production facilities are being ramped up around the world.

Chart: Level of real GDP (Q4 2019 = 100)



This recovery of growth, which eliminates the effects of the pandemic by about the middle of the decade, would have major repercussions for public finances as it would be consistent with the government deficit falling to around 2.5% of GDP without any tax increases. This would be in line with the OBR's most optimistic forecast in the graph below, rather than their current central scenario which predicts a 4% deficit due to assuming much slower growth. However, Capital Economics forecasts assumed that politicians do not raise taxes or embark on major austerity measures and so (perversely!) depress economic growth and recovery.



- There will still be some painful longer-term adjustments as e.g. office space and travel by planes, trains and buses may not recover to their previous level of use for several years, or possibly ever, even if vaccines are fully successful in overcoming the current virus. There is also likely to be a reversal of globalisation as this crisis has exposed how vulnerable long-distance supply chains are. On the other hand, digital services are one area that has already seen huge growth.
- **Brexit.** The final agreement of a trade deal on 24<sup>th</sup> December 2020 has eliminated a significant downside risk for the UK economy. The initial agreement only covers 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. This now needs to be formalised on a permanent basis. As the forecasts in this report were based on an assumption of a Brexit agreement being reached, there is no need to amend these forecasts.
- **Monetary Policy Committee meeting of 17 December.** All nine Committee members voted to keep interest rates on hold at +0.10% and the Quantitative Easing (QE) target at £895bn. The MPC commented that the successful rollout of vaccines had reduced the downsides risks to the economy that it had highlighted in November. But this was caveated by it saying, “Although all members agreed that this would reduce downside risks, they placed different weights on the degree to which this was also expected to lead to stronger GDP growth in the central case.” So, while vaccines are a positive development, in the eyes of the MPC at least, the economy is far from out of the woods in the shorter term. The MPC, therefore, voted to extend the availability of the Term Funding Scheme, (cheap borrowing), with additional incentives for small and medium size enterprises for six months from 30<sup>th</sup> April 2021 until 31<sup>st</sup> October 2021. (The MPC had assumed that a Brexit deal would be agreed.)
- **Fiscal policy.** In the same week as the MPC meeting, the Chancellor made a series of announcements to provide further support to the economy: -
  - An extension of the COVID-19 loan schemes from the end of January 2021 to the end of March 2021.
  - The furlough scheme was lengthened from the end of March 2021 to the end of April 2021.
  - The Budget on 3<sup>rd</sup> March 2021 will lay out the “next phase of the plan to tackle the virus and protect jobs”. This does not sound like tax rises (which could hold back the speed of economic recovery) are imminent.
- The **Financial Policy Committee (FPC)** report on 6<sup>th</sup> August 2020 revised down their expected credit losses for the banking sector to “somewhat less than £80bn”. It stated that in its assessment, “banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC’s central projection”. The FPC stated that for real stress in the

sector, the economic output would need to be twice as bad as the MPC's projection, with unemployment rising to above 15%.

- **US.** The Democrats gained the presidency and a majority in the House of Representatives in the November elections: After winning two key Senate seats in Georgia in elections in early January, they now also have a very slim majority in the Senate due to the vice president's casting vote. President Biden will consequently have a much easier path to implement his election manifesto. However, he will not have a completely free hand as more radical Democrat plans may not be supported by all Democrat senators. His initial radical plan for a fiscal stimulus of \$1.9trn, (9% of GDP), is therefore likely to be toned down in order to get through both houses.
- **The economy** had been recovering quite strongly from its contraction in 2020 of 10.2% due to the pandemic, with GDP only 3.5% below its pre-pandemic level and the unemployment rate dropping below 7%. However, the rise in new cases during quarter 4, to the highest level since mid-August, suggests that the US could be in the early stages of a fourth wave. The latest upturn poses a threat that the recovery in the economy could stall. This is the single biggest downside risk to the shorter term outlook – a more widespread and severe wave of infections over the winter months, which is compounded by the impact of the regular flu season and, as a consequence, threatens to overwhelm health care facilities. Under those circumstances, individual states might feel it necessary to return to more draconian lockdowns.
- The restrictions imposed to control the spread of the virus are once again weighing on the economy with employment growth slowing sharply in November and declining in December, and retail sales dropping back. The economy is set for further weakness into the spring. GDP growth is expected to rebound markedly from the second quarter of 2021 onwards as vaccines are rolled out on a widespread basis and restrictions are loosened.
- 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 and long-term bond yields duly rose after the meeting. The Federal Open Market Committee's updated economic and rate projections in mid-September showed that officials expect to leave the fed funds rate at near-zero until at least end-2023 and probably for another year or two beyond that. There is now some expectation that where the Fed has led in changing its inflation target, other major central banks will follow. The increase in tension over the last year between the US and China is likely to lead to a lack of momentum in progressing the initial positive moves to agree a phase one trade deal.
- The Fed's meeting on 5 November was unremarkable - but at a politically sensitive time around the elections. At its 16 December meeting the Fed tweaked the guidance for its monthly asset quantitative easing purchases, with the new language implying those purchases could continue for longer than previously believed. Nevertheless, with officials still projecting that inflation will only get back to 2.0% in 2023, the vast majority expect the Fed funds rate to be still at near-zero until 2024 or later. Furthermore, officials think the balance of risks surrounding that median inflation forecast is firmly skewed to the downside. 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 low – which will also have an influence on gilt yields in this country.

- **EU.** In early December, the figures for Q3 GDP confirmed that the economy staged a rapid rebound from the first lockdowns. This provides grounds for optimism about growth prospects for next year. In Q2, GDP was 15% below its pre-pandemic level. But in Q3 the economy grew by 12.5% q/q leaving GDP down by “only” 4.4%. That was much better than had been expected earlier in the year. However, growth is likely to stagnate during Q4 and in Q1 of 2021, as a second wave of the virus has seriously affected many countries. The €750bn fiscal support package, eventually agreed by the EU after prolonged disagreement between various countries, is unlikely to provide significant support, and quickly enough, to make an appreciable difference in the countries most affected by the first wave.
- With inflation expected to be unlikely to get much above 1% over the next two years, the ECB has been struggling to get inflation up to its 2% target. 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 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 Bank’s forecast for a return to pre-virus activity levels was pushed back to the end of 2021, but stronger growth is projected in 2022. 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. However, as in the UK and the US, the advent of highly effective vaccines will be a game changer, although growth will struggle before later in quarter 2 of 2021.
- **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 that occurred 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. At the same time, China’s economy has benefited from the shift towards online spending by consumers in developed markets. These factors help to explain its comparative outperformance compared to western economies. However, this was achieved by major central government funding of yet more infrastructure spending. After years of growth having been focused on this same area, any further spending in this area is likely to lead to increasingly weaker economic returns in the longer term. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.
- **Japan.** A third round of fiscal stimulus in early December took total fresh fiscal spending this year in response to the virus close to 12% of pre-virus GDP. That’s huge by past standards, and one of the largest national fiscal responses. The budget deficit is now likely to reach 16% of GDP this year. Coupled with Japan’s relative success in containing the virus without draconian measures so far, and the likelihood of effective vaccines being available in the coming months, the government’s latest fiscal effort should help 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 has been in recession in 2020 and this is likely to continue into the first half of 2021 before recovery in the second half. Inflation is unlikely to be a problem for

some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

- 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, 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 thirty years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. The Chinese government has targeted achieving major world positions in specific key sectors and products, especially high-tech areas and production of rare earth minerals used in high-tech products. It is achieving this by massive financial support (i.e. subsidies) to state owned firms, government directions to other firms, technology theft, restrictions on market access by foreign firms and informal targets for the domestic market share of Chinese producers in the selected sectors. This is regarded as being unfair competition that is putting western firms at an unfair disadvantage or even putting some out of business. It is also regarded with suspicion on the political front as China is an authoritarian country that is not averse to using economic and military power for political advantage. The current trade war between the US and China therefore needs to be seen against that backdrop. 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. This is likely to produce a backdrop in the coming years of weak global growth and so weak inflation.

## Summary

**Central banks are, therefore, likely to support growth by maintaining loose monetary policy through keeping rates very low for longer. Governments could also help a quicker recovery by providing more fiscal support for their economies at a time when total debt is affordable due to the very low rates of interest. They will also need to avoid significant increases in taxation or austerity measures that depress demand and the pace of recovery in their economies.**

**If there is a huge surge in investor confidence as a result of successful vaccines, which leads to a major switch out of government bonds into equities, which, in turn, causes government debt yields to rise, then there will be pressure on central banks to actively manage debt yields by further QE purchases of government debt; this would help to suppress the rise in debt yields and so keep the total interest bill on greatly expanded government debt portfolios within manageable parameters. It is also the main alternative to a programme of austerity.**



## INTEREST RATE FORECASTS

**Brexit.** The interest rate forecasts provided by Link Asset Services and shown at Appendix I3 below were predicated on an assumption of a reasonable agreement being reached on trade negotiations between the UK and the EU by 31.12.20. There is therefore no need to revise these forecasts now that a trade deal has been agreed. There is still the possibility that Brexit may reduce the economy's potential growth rate in the long run. However, much of that potential drag is now likely to be offset by an acceleration of productivity growth triggered by the digital revolution brought about by the COVID crisis.

### The balance of risks to the UK

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

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

- **UK government** takes too much action, too quickly, to raise taxation or introduce austerity measures that depress demand and the pace of recovery of the economy.
- **Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis**. The ECB has taken monetary policy action to support the bonds of EU states, with the positive impact most likely for "weaker" countries. In addition, the EU agreed a €750bn fiscal support package for the impacts of the COVID pandemic. These actions will help shield weaker economic regions for the next two or three years. However, in the case of Italy, the cost of the virus crisis has added to its already huge debt mountain and its slow economic growth will leave it vulnerable to markets returning to taking the view that its level of debt is insupportable. There remains a sharp divide between northern EU countries, favouring low debt to GDP and annual balanced budgets, and southern countries who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come.
- Weak capitalisation of some **European banks**, which could be undermined further depending on extent of credit losses resulting from the pandemic.
- **German minority government & general election in 2021**. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Angela Merkel has stepped down from being the CDU party leader, but she will remain as Chancellor until the general election in 2021. This then leaves a major question mark over who will be the major guiding hand and driver of EU unity when she steps down.
- **Other minority EU governments**. Italy, Spain, Austria, Sweden, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU, and they had threatened to derail the 7-year EU budget until a compromise was thrashed out in late 2020. There has also been a rise in anti-immigration sentiment in Germany and France.
- **Geopolitical risks**, for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe haven flows.

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

- **UK** - a significant rise in inflationary pressures e.g. caused by a stronger than currently expected recovery in the UK economy after effective vaccines are administered quickly to the UK population, leading to a rapid resumption of normal life and return to full economic activity across all sectors of the economy.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a rapid series of increases in the Bank Rate to stifle inflation.

**Comparison of Interest Rate Forecasts – Treasury Strategy 2020/21 – 2022/23 (Jan 2020), and Treasury Strategy 2021/22 – 2023/24 (Feb 2021)**

	Bank Rate %			PWLB Borrowing Rates % (including 0.20% certainty rate adjustment)											
				5 year			10 year			25 year			50 year		
	Feb 21	Nov 20	Jan 20	Feb 21	Nov 20	Jan 20	Feb 21	Nov 20	Jan 20	Feb 21	Nov 20	Jan 20	Jan 21	Nov 20	Jan 20
Mar-21	0.10	0.10	0.75	0.90	1.80	2.50	1.30	2.10	2.70	1.90	2.50	3.30	1.70	2.30	3.20
Jun-21	0.10	0.10	1.00	0.90	1.80	2.60	1.30	2.10	2.80	1.90	2.60	3.40	1.70	2.40	3.30
Sep-21	0.10	0.10	1.00	0.90	1.80	2.70	1.30	2.10	2.90	1.90	2.60	3.50	1.70	2.40	3.40
Dec-21	0.10	0.10	1.00	0.90	1.80	2.80	1.30	2.20	3.00	1.90	2.60	3.60	1.70	2.40	3.50
Mar-22	0.10	0.10	1.00	1.00	1.90	2.90	1.40	2.20	3.10	2.00	2.60	3.70	1.80	2.40	3.60
Jun-22	0.10	0.10	1.25	1.00	1.90	2.90	1.40	2.20	3.10	2.00	2.70	3.80	1.80	2.50	3.70
Sep-22	0.10	0.10	1.25	1.10	1.90	3.00	1.50	2.30	3.20	2.10	2.70	3.80	1.90	2.50	3.70
Dec-22	0.10	0.10	1.25	1.10	1.90	3.00	1.50	2.30	3.20	2.10	2.70	3.90	1.90	2.50	3.80
Mar-23	0.10	0.10	1.25	1.10	1.90	3.10	1.50	2.30	3.30	2.10	2.70	4.00	1.90	2.50	3.80
Jun-23	0.10			1.20			1.60			2.20			2.00		
Sep-23	0.10			1.20			1.60			2.20			2.00		
Dec-23	0.10			1.20			1.60			2.20			2.00		
Mar-24	0.10			1.20			1.60			2.20			2.00		

The January 2020 forecasts were included in Treasury Strategy 2020/21 to 2022/23.  
Link Asset Services provided an updated forecast in February 2021.