Report No: 144/2021
PUBLIC REPORT

CABINET

16 November 2021

MID YEAR REPORT ON TREASURY MANAGEMENT AND PRUDENTIAL INDICATORS 2021/22

Report of the Portfolio Holder for Finance, Governance and Performance, Change and Transformation

Strategic Aim:	Customer-focussed services	
Key Decision: No	Forward Plan Reference: FP/151021	
Exempt Information	No	
Cabinet Member(s) Responsible:	Cllr K Payne, Portfolio Holder for Finance, Governance and Performance, Change and Transformation	
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Ward Councillors	N/A	

DECISION RECOMMENDATIONS
That Cabinet notes the contents of the report.

1 PURPOSE OF THE REPORT

1.1 This report updates Members with the progress against the Treasury Management Strategy, prudential indicators and highlights whether any policies require revision.

1.2 The underlying purpose of this report supports the objective in the CIPFA Code of Practice on Treasury Management (revised 2017) and the Ministry of Housing, Communities and Local Government (MHCLG) Investment Guidance which requires that Members receive reports on and adequately scrutinise the treasury management service.

2 BACKGROUND AND MAIN CONSIDERATIONS

2.1 The Council's mid-year treasury report is included in Appendix A and includes information on the performance of the treasury management service. The key points to note for the six months to 30 September 2021 are:

- The Council has invested with institutions as determined by the creditworthiness criteria approved by the Section 151 Officer;

- The Council has made a return on investment of 0.19% compared to the LIBOR rate of 0.16%. The Council is underperforming on its investment income budget by c£135k due to the reduction in the Base Rate to 0.10% as a reaction to the Coronavirus pandemic. The returns achieved are still positive in light of challenging economic conditions. It is unlikely that investment return performance will return to pre Covid levels by 22/23 and this has been noted in the Council's Medium Term Financial Plan (MTFP) as per Appendix A para 3.1.4;

- The Council has not undertaken any external borrowing in the six months to 30 September 2021. The Council is still below its authorised limit for borrowing of £33m (Appendix A para 2.2.3);

- No external debt was repaid early as there was not a financial business case to do so. The total premium (i.e. the charge for repaying early) for the Council's debt portfolio was £19.43m as at 30th September 2021 (Appendix A para 2.3.2);

- CIPFA have released two consultations setting out the proposed changes to the current versions of the Treasury Management Code and Prudential Code. The Council is working through any impact these changes may have but the main headline relates to Council's not borrowing to invest. The Council supports this direction of travel and has not followed the line of other Council's that have commercial investments for purely financial gain and are now experiencing difficulties (Appendix A para 2.4); and

- No commercial investments were made in the first 6 months as no suitable opportunities for investment arose. In light of the emerging guidance (noted above) and the ongoing financial position (as set out in the Mid Year Update) then the Council's previous decision to set aside a notional £10m (via borrowing) for investments will be reviewed as part the budget for 22/23.

3 CONSULTATION

3.1 No formal consultation is required.

4 ALTERNATIVE OPTIONS

4.1 The report is for noting, there are no alternative options.

5 FINANCIAL IMPLICATIONS

5.1 There are no financial implications arising from this report.

6 LEGAL AND GOVERNANCE CONSIDERATIONS

6.1 The report meets the requirements of both the CIPFA Code of Practice on Treasury Management, the CIPFA Prudential Code for Capital Finance in Local Authorities and the Council's Financial Procedure Rules. The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003.

6.2 The Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance:

- The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity;
- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken;
- Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act;
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities;
- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services;
- Under the Act the CLG has issued Investment Guidance to structure and regulate the Council's investment activities; and
- Under Section 238(2) of the Local Government and Public Involvement in Health Act 2007 the Secretary of State has taken powers to issue guidance on accounting practices.

6.3 The Council's Treasury Management Strategy explains how it complies with this legal framework.

7 DATA PROTECTION IMPLICATIONS

7.1 A data protection impact assessment has not been completed as there are no data protection implications.

8 EQUALITY IMPACT ASSESSMENT

8.1 An Equality Impact Assessment (EqIA) has not been completed because the report does not represent the introduction of a new policy or service or a change / to an existing policy or service that has an impact on any particular group.

9 COMMUNITY SAFETY IMPLICATIONS

9.1 There are no community safety implications.

10 HEALTH AND WELLBEING IMPLICATIONS

10.1 There are no health and wellbeing implications.

11 CONCLUSION AND SUMMARY OF REASONS FOR THE RECOMMENDATIONS

11.1 The report summarises treasury management performance in the year to date and meets the requirements set out in Section 6.

12 BACKGROUND PAPERS

12.1 Statement of Accounts 2020/21

13 APPENDICES

13.1 Appendix A - Treasury Management Mid-Year Report

13.2 Appendix B - Link Commentary on the six months to 30 September 2021

13.3 Appendix C – Glossary

A Large Print or Braille Version of this Report is available upon request – Contact 01572 722577.

APPENDIX A - TREASURY MANAGEMENT MID-YEAR REPORT

1 THE CAPITAL PRUDENTIAL INDICATORS 2021/22

1.1 Capital Expenditure

1.1.1 The Council's capital expenditure plans as set out in the budget 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.

1.1.2 The capital expenditure prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. As at 30 September 2021 the Council estimates that it will have capital projects approved of £28.289m. The details of this are shown in the Mid-Year Capital Programme Update (Report No: 144/2021)

1.1.3 The Council's forecast capital expenditure for 2021/22 is £12.23m. The Council does not anticipate making any commercial investments hence the forecast reduction in commercial activities investments. The Mid-Year Capital Programme Update (144/2021) contains detailed analysis of the revised capital programme and financing. The £12.23m was financed as per the table below. The financing need represents an increase in borrowing requirements.

	2021/22 Treasury Strategy Estimate*	**2021/22 Original Estimate ****	**2021/22 Revised Estimate**
	£000	**£000**	**£000**
Total Projects	449	10,718	12,230
Total Commercial Activities/ non-financial investments	10,000	10,044	0
Total ring fenced grants- unallocated	3,379	0	0
Capital Expenditure	**13,828**	**20,762**	**12,230**
Financed by:			
Capital Receipts	0	61	61
Capital Grants & Contributions	3,628	10,188	11,741
Revenue	0	77	77
Total Financing	**3,628**	**10,326**	**11,879**
Net financing need for the year	**10,200**	**10,426**	**351**
Net financing need relating to commercial investments	10,000	10,000	0

Percentage of total net financing need	98%	96%	0%

* The Treasury Management Strategy report was presented to Cabinet on 12 January 2021, before the Capital Programme was approved.
** The 2020/21 Outturn Report 66/2021 updated the Capital Programme with 2021/22 carry forwards and additional capital schemes.

1.2 The Council's Borrowing Need (the Capital Financing Requirement)

1.2.1 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 its underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

1.2.2 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.

1.2.3 The Council's CFR forecast for 2021/22 is shown below; both the overall CFR and with the commercial activities CFR separately identified and represents a key prudential indicator.

	2020/21 Actual	**2021/22 Treasury Strategy Estimate**	**2021/22 Revised Estimate**
	£000	**£000**	**£000**
CFR – 1 April	**20,630**	**20,703**	**20,038**
Movement in Year -			
Net financing need for the year (from table at para 1.1.3)	22	10,200	351
MRP	(614)	(641)	(614)
Total Movement in Year	(592)	9,559	(263)
CFR – 31 March	**20,038**	**30,262**	**19,775**

	2020/21 Actual	**2021/22 Treasury Strategy Estimate**	**2021/22 Revised Estimate**
	£000	**£000**	**£000**
CFR Commercial Activities – 1 April	**0**	**0**	**0**

Movement in Year -			
Net financing need for the year	0	10,000	0
MRP	0	0	0
Total Movement in Year	0	10,000	0
CFR Commercial Activities – 31 March	**0**	**10,000**	**0**

2 BORROWING

2.1 Current borrowing portfolio

2.1.1 No additional borrowing has been undertaken so far in 2021/22.

2.1.2 All PWLB loans have been borrowed on a maturity basis. Interest payments will be made every six months on equal instalments throughout the term of the loan, with the principal being re-paid on the maturity date.

2.1.3 The table below shows the actual external debt against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing. A key prudential indicator is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR.

	2020/21 Actual £000	**2021/22 TMS Estimate £000**	**2021/22 Revised Estimate £000**	**2022/23 Estimate £000**	**2023/24 Estimate £000**
Gross Debt	22,142	27,058	22,058	26,386	26,386
Capital Financing Requirement (CFR)	20,038	30,261	19,775	29,227	28,395
Under / (Over) borrowing	(2,104)	3,203	(2,283)	2,841	2,009

*Under Borrowing Position explained in Treasury Management Strategy 2021/22 (161/2020)

2.1.4 Within the above figures the level of debt and the CFR relating to commercial activities / non-financial investment are shown on the next page. This assumes the Council invests £10m in 22/23 which at this stage looks very unlikely.

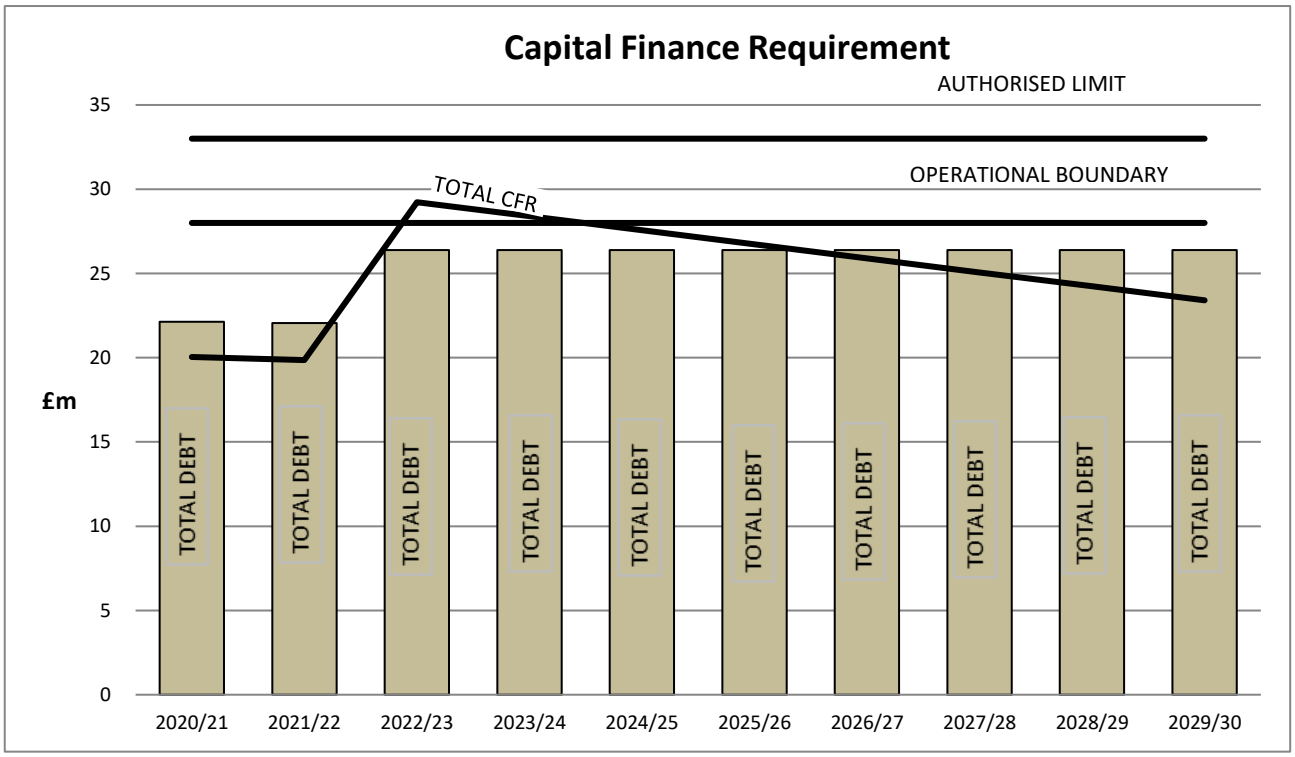
Commercial Activities	2020/21 Actual £000	2021/22 TMS Estimate £000	2021/22 Revised Estimate £000	2022/23 Estimate £000	2023/24 Estimate £000
Gross Debt	0	5,000	0	5,000	5,000
Capital Financing Requirement (CFR)	0	10,000	0	10,000	9,992
Under / (Over) borrowing	0	5,000	0	5,000	4,992

2.2 Treasury Indicators: Limits to Borrowing Activity

2.2.1 ***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.

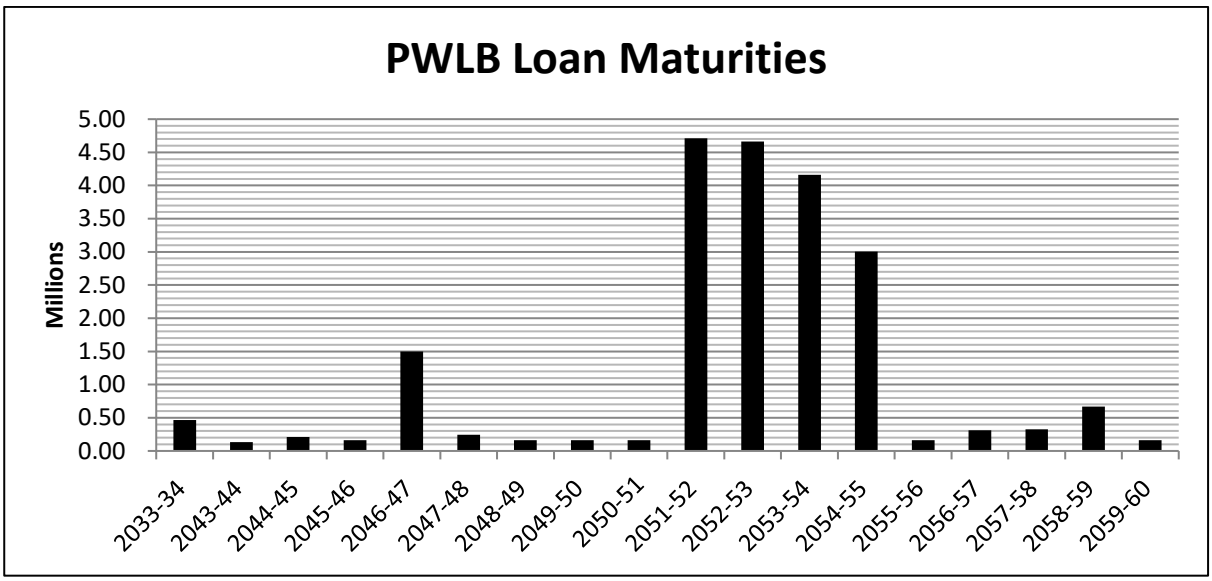
2.2.2 ***The authorised limit for external debt***. A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external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

2.2.3 The graph below shows where we currently are against all of the borrowing prudential indicators.



2.3 Debt Repayment and rescheduling

2.3.1 The table below demonstrates when PWLB debt is due to be repaid.



2.3.2 The latest advice from Link, the Council's Treasury Management Advisors, indicates that the premium at 30 September 2021 was £19.43m. This would mean it would cost £19.43m in addition to the £21.386m principal to repay the Council's PWLB loans.

2.4 CIPFA consultations on Prudential Code and Treasury Management Code

2.4.1 The Prudential Code was previously updated in 2017. The current review is being undertaken in response to the report last year of the Public Accounts Committee into local authority investment in commercial property. The current Prudential Framework places a degree of reliance on local authorities to comply with the intent and spirit of the Framework and not to actively seek ways, whatever the motivation, to diverge from its principles of prudence, affordability and sustainability. It also relies on robust local decision-making and governance. Changes are now being proposed to ensure it adapts to reflect new risks and challenges, namely borrowing for commercial investments.

2.4.2 A key plank of CIPFA's consultation is "Why shouldn't authorities borrow to invest?" This document is quite clear that authorities should not borrow to invest and goes into various reasons for this.

2.4.3 Firstly, commercial investments are generally in higher risk asset classes. This is likely to mean uncertain and volatile asset prices or income. Commercial property is also relatively illiquid compared with most financial investments, and is likely to take several months at least to realise. An urgent sale, if the authority's circumstances or if market conditions change, may not produce the best price. Such investments require expert due diligence before purchase, and careful asset monitoring and management afterwards. Local authorities do not always have these skills, and should not rely on external advice unless they understand the product and the risks themselves. If the investment goes wrong, the cost falls on public services or the local taxpayer.

2.4.4 Secondly, if authorities borrow to invest primarily for financial return, this constitutes 100% debt leverage. The intention is to earn a margin between borrowing costs and investment income, in the expectation that the income will be higher than the costs. However, the margin earned is not free money, but prices in the market's assessment of the additional risks involved. The higher the margin, the more at risk the investment is likely to be. If the investment underperforms, it may result in revenue account losses to the authority, or a capital loss on redemption.

2.4.5 Thirdly, leveraged investment considerably magnifies these risks, because it also brings borrowing risks such as interest rate risk and refinancing risk. The authority has a fixed debt repayment liability on one side of the balance sheet, but an uncertain asset value on the other side of the balance sheet. This can be expressed in terms of market values: if markets move the wrong way for the authority, the fair value of the borrowing liability may become significantly higher whilst the fair value of the investments may fall. The authority would be at a loss in its leveraged investment activity.

2.4.6 Finally, commercial investments (including commercial property) are not part of cashflow management or prudent treasury risk management, and they do not directly help deliver service outcomes. Leveraged investment is a form of speculation, which chooses to take on additional risk in order to earn a profit, much as an investment bank or property company might do.

2.4.7 The Treasury Management Code was previously updated in 2017. Since then, the landscape for public services has changed. The increasing profile of the role of treasury management as a result of the pandemic, the disciplines and skills required to meet the advances brought forward by issues such as the Markets in Financial Instruments Directive, known as MIFID II, and the increasing complexity of transactions in the sector all underline the importance of the Treasury Management Code and its guidance. In addition, the rise in commercial non-treasury investments is a contributing factor behind the need to strengthen its provisions to ensure that they are fit for the 21st century.

2.4.8 The Council is currently working through the impact these changes will have.

3 INVESTMENT STRATEGY

3.1 Investment overview

3.1.1 The Council receives substantial income from council tax, business rates and central government. The majority of council tax and business rates payments are received between April and January, with expenditure being fairly static throughout the year.

3.1.2 During the first half year investments have ranged from £44.06m to £52.72m. The table on the next page shows the level of investments held at 30 September 2021 and the forecasted balances to the end of the Financial Year.

	Investments 31-Mar-21 £000	Investments 30-Sep-21 £000	Forecast Investments 31-Mar-22 £000
UK Banks *(f)*	21,313	23,285	13,785
UK Building Societies *(f)*	5,000	12,000	5,000
UK Local Authorities	16,500	16,500	15,000
Total Fixed Interest Rates *(f)*	**42,813**	**51,785**	**33,785**
Total Variable Interest Rates *(v)*	**0**	**0**	**0**
Total Investments	**42,813**	**51,785**	**33,785**

3.1.3 Most of the Councils investments are made at fixed interest rates over 6 -12 months. For cash flow purposes, some funds are held in instant access accounts.

3.1.4 The revised budget position for investment income is:

	Original Estimate 2021/22 £000	Received to 30-Sep-21 £000	Revised Estimate 2021/22 £000
Investment Income	228	50	93
Other Interest Received *	12	0	12
Total	240	50	105

***** The Council also receives interest from sources other than investments. A Housing Association has been recharged £12k for the principal and interest of loans that the Council has made to it, the final payment will be in 2051/52.

3.2 Investment Performance

3.2.1 The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. An example of a performance indicator often used for the investment treasury function is internal returns above the 6 month LIBOR rate (the average interbank interest rate at which a selection of banks on the London money market are prepared to lend to one another). The Council monitored performance against the LIBOR rate for the first six months of 2021/22 and the results are shown below.

	2020/21	2021/22 (Q1)	2021/22 (Q2Cumulative)
RCC Returns (%)	0.50	0.23	0.19
LIBOR (%)	0.11	0.11	0.16

3.2.2 The Council is underperforming against budget by c£135k due to the Base Rate of 0.10% affecting the low interest rates offered by banks and building societies and is the main reason returns have fallen.

3.2.3 The Council is outperforming the LIBOR rate due to fixed rate investments placed that achieved a higher rate of return prior to the base rate reduction during March 2020. For example, 364 day investment traded in February 2020 achieved an interest rate of 1.05%, comparatively an investment traded in September 2021 with the same maturity achieved an interest rate of 0.18%. The gap between LIBOR and RCC's performance will continue to narrow as these investments with higher rate of return mature.

3.3 Affordability Prudential Indicators

3.3.1 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 indicators:

3.3.2 **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.

	Original Estimate 2021/22 £000	Forecast Quarter 2 2021/22 £000
Financing Costs		
Capital Financing Costs	1.646	1.646
Interest Receivable	(0.240)	(0.105)
A	1.406	1.541
Revenue Stream		
Government Grants	4.965	5.902
Retained Business Rates	5.403	5.638
Council Tax	28.456	28.425
B	38.82	39.97
Ratio (A divided by B as a percentage)	3.62%	3.86%

The estimates of financing costs include current commitments and the proposals in the budget report.

Appendix B. Link Asset Services Commentary on the Economy and Interest Rates

ECONOMICS UPDATE

- The Monetary Policy Committee (MPC) on 5.8.21 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; only one MPC member voted to stop these purchases now to leave total purchases £45bn short of the total target.

- While that was all very much unchanged from previous MPC decisions over the last year, there was a major shift from indicating no expected tightening any time soon to now flagging up that interest rate increases were now on the horizon. There was disagreement among MPC members, some of whom felt that the forward guidance that the MPC won't tighten policy until inflation "is achieving the 2% inflation target sustainably", had already been met. Although other MPC members did not agree with them, they did all agree that "some modest tightening of monetary policy over the forecast period was likely to be necessary to be consistent with meeting the inflation target sustainably in the medium term".

- The MPC was more upbeat in its new 2-3 year forecasts so whereas they had expected unemployment to peak at 5.4% in Q3, the MPC now thought that the peak had already passed. (It is to be noted though, that the recent spread of the Delta variant has damaged growth over the last couple of months and has set back recovery to the pre-pandemic level of economic activity till probably late 2021.)

- We have been waiting for the MPC to conclude a review of its monetary policy as to whether it should raise Bank Rate first before reducing its balance sheet (quantitative easing) holdings of bonds. This review has now been completed so we learnt that it will start to tighten monetary policy by: -
    1. Placing the focus on raising Bank Rate as "the active instrument in most circumstances".
    2. Raising Bank Rate to 0.50% (1.50% previously), 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.

- What the MPC did not give us was any indication on when it would start raising Bank Rate. Inflation is currently expected to peak at over 4% during 2021. The key issue then is whether this is just going to be transitory inflation or whether it will morph into inflation which will exceed the MPC's 2% target <u>on an ongoing basis</u>. In his press conference, 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's worried that labour shortages will push up wage growth by more than it expects and that, as a result, CPI inflation will stay above the 2% target for longer. Which then raises an interesting question as to whether the million or so workers who left the UK during the pandemic, will come back to the UK and help to relieve wage inflation pressures. We also have an unknown as to how trade with the EU will evolve once the pandemic distortions have dissipated now that the UK no longer has tariff free access to EU markets.

- At the current time, the MPC's forecasts are showing inflation close to, but just below, its 2% target in 2 to 3 years' time. The initial surge in inflation in 2021 and 2022 is due to a combination of base effects, one off energy price increases and a release of pent-up demand, particularly from consumers who have accumulated massive savings during the pandemic, hitting supply constraints. However, these effects will gradually subside or fall out of the calculation of inflation. The issue for the MPC will, therefore, turn into a question of when the elimination of spare capacity in the economy takes over as being the main driver to push inflation upwards and this could then mean that the MPC will not start tightening policy until 2023. Remember, the MPC has sets its policy as being wanting to see inflation coming in sustainably over 2% to counteract periods when inflation was below 2%. While financial markets have been pricing in a hike in Bank Rate to 0.25% by mid-2022, and to 0.50% by the end of 2022, they appear to be getting ahead of themselves. The first increase to 0.25% is more likely to come later; our forecast shows the first increase in Q1 of 23/24 and the second to 0.50% in Q4 of 23/24. The second increase would then open the way for the Bank to cease reinvesting maturing bonds sometime during 2024.

Gilt and treasury yields

Since the start of 2021, we have seen 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.

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 above 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. Although there are nuances between the monetary policy of all three banks, the overall common ground is allowing the inflation target to be symmetrical so that inflation averages out the dips down and surges above the target rate, over an unspecified period of time. For local authorities, this means that interest 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. 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.

Globally, our views on economies are as follows: -

- **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 of -0.3% in Q1, Q2 came in with strong growth of 2.2% which is likely to continue into Q3, though some countries more dependent on tourism may struggle. There is little sign that underlying inflationary pressures are building to cause the ECB any concern.

- **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. 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 2021. However, the pace of economic growth will fall back after this initial

surge of recovery from the pandemic. China is also now struggling to contain the spread of the Delta variant through sharp local lockdowns which will damage economic growth. There are also questions as to how effective Chinese vaccines are proving.

- **Japan.** After declaring a second state of emergency on 7th January, which depressed growth in Q1 2021, the economy was expected to make a strong recovery to pre-pandemic GDP levels in the rest of the year as the slow role out of vaccines eventually gathers momentum. However, the Delta variant has now raised questions as to whether lockdowns will be needed to contain it and to protect the health service from being overwhelmed.

- **World growth.** Further progress on vaccine rollouts, continued policy support, and the re-opening of most major economies should mean that global GDP growth in 2021 will grow at its fastest rate since 1973. The spread of the Delta variant poses the greatest risk to this view, particularly in large parts of the emerging world where vaccination coverage is typically lower than in advanced economies. Continued strong recovery will be accompanied by higher inflation. While most of the arithmetic and commodity price effects boosting inflation in recent months are behind us, goods shortages will last well into 2022 as order backlogs are worked through and inventories are replenished. What's more there is mounting evidence that rapid re-opening of economies generates labour shortages, which could exert further upward pressure on firms' costs. So, global inflation is unlikely to drop back until next year.

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

The coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings, although some forecasters had suggested that a cut into negative territory could have happened prior to more recent months when strong recovery started kicking in. However, the minutes of the Monetary Policy Committee in February 2021 made it clear that commercial banks could not implement negative rates within six months; by that time the economy would be expected to be recovering strongly and so there would be no requirement for negative rates. As shown in the forecast table above, one increase in Bank Rate from 0.10% to 0.25% has now been included in quarter 1 of 2023/24 and another increase to 0.50% in quarter 4 of 23/24, as an indication that the Bank of England will be starting monetary tightening during this year.

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

Gilt yields had, therefore, already been on a generally falling trend up until the coronavirus crisis hit western economies during March 2020 which caused gilt yields to spike up. However, yields then fell sharply in response to major western central banks taking rapid policy action to deal with excessive stress in financial markets during March and starting massive quantitative easing driven purchases of government bonds: these actions also acted to put downward pressure on government bond yields at a time when there was a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in “normal” times would have caused bond yields to rise sharply.

At the start of January 2021**,** all gilt yields from 1 to 8 years were negative: however, since then all gilt yields have become positive and rose sharply, especially in medium and longer-term periods, until starting a significant decline since May. The main driver of the increases was investors becoming progressively more concerned at the way that inflation was expected to rise sharply in major western economies during 2021 and 2022. However, repeated assurances by the Fed in the US, and by other major world central banks, that inflation would spike up after Covid restrictions were abolished, but would only be transitory, have eventually allayed those investor fears. However, there is an alternative view that the US Fed is taking a too laid-back view that inflation pressures in the US are purely transitory and that they will subside without the need for the Fed to take any action to tighten monetary policy. This could mean that US rates will end up rising faster and sharper if inflationary pressures were to escalate; the consequent increases in treasury yields could well spill over to cause (lesser) increases in gilt yields.

As the interest forecast table for PWLB certainty rates, (gilts plus 80bps), above shows, there is likely to be an unwinding of the currently depressed levels of PWLB rates and 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.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is now to the upside though there are still residual risks from Covid variants - both domestically and their potential effects worldwide, and from various shortages.

- There is relatively little domestic risk of increases in Bank Rate exceeding 0.50% in the next two to three years and, therefore, in shorter-term PWLB rates.

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

- Mutations of the virus render current vaccines ineffective, and tweaked vaccines to combat these mutations are delayed, resulting in further national lockdowns or severe regional restrictions.

- MPC acts too quickly in unwinding QE or increasing Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.

- The Government implements an austerity programme that supresses GDP growth.

- Labour and material shortages do not ease over the next few months and further stifle economic recovery.

- The lockdowns cause major long-term scarring of the economy.

- UK / EU trade arrangements – if there was a major impact on trade flows and financial services due to complications or lack of co-operation in sorting out significant remaining issues.

- 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 which has still to be disbursed. These actions will help shield weaker economic regions in the near-term. However, in the case of Italy, the cost of the virus crisis has added to its already huge debt mountain and its slow economic growth will leave it vulnerable to markets returning to taking the view that its level of debt is unsupportable. There remains a sharp divide between northern EU countries favouring low debt to GDP and annual balanced budgets and southern countries who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come.

- Weak capitalisation of some European banks, which could be undermined further depending on the extent of credit losses resulting from the pandemic.

- German minority government & general election in September 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, because of the rise in popularity of the anti-immigration AfD party. Subsequently, the CDU has done badly in state elections, but the SPD has done even worse. Angela Merkel has stepped down from being the CDU party leader but remains as Chancellor until the general election in 2021. Her appointed successor has not attracted wide support from voters and the result of the general election could well lead to some form of coalition government, though there could be a question as to whether the CDU will be part of it which, in turn, could then raise an issue over the tenure of her successor. This then leaves a question mark over who the major guiding hand and driver of EU unity will be.

- Other minority EU governments. Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile and, therein, impact market confidence/economic prospects and lead to increasing safe-haven flows.
- 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 selloffs on the general economy.
- 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: -

- Longer term US treasury yields rise strongly and pull UK gilt yields up higher than forecast.

- Vaccinations are even more successful than expected and eradicate hesitancy around a full return to normal life, which leads into a stronger than currently expected recovery in UK and/or other major developed economies.

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.

Appendix C: Treasury Management Glossary of Terms

Authorised Limit (Also known as the Affordable Limit): A statutory limit that sets the maximum level of external borrowing on a gross basis (i.e. not net of investments) for the Council. It is measured on a daily basis against all external borrowing items on the Balance Sheet (i.e. long and short term borrowing, overdrawn bank balances and long term liabilities).
Balances and Reserves: Accumulated sums that are maintained either earmarked for specific future costs or commitments or generally held to meet unforeseen or emergency expenditure.
Bank Rate: The official interest rate set by the Bank of England's Monetary Policy Committee and what is generally termed at the "base rate". This rate is also referred to as the 'repo rate'.
Basis Point: A unit of measure used in finance to describe the percentage change in the value or rate of a financial instrument. One basis point is equivalent to 0.01% (1/100th of a percent). In most cases, it refers to changes in interest rates and bond yields. For example, if interest rates rise by 25 basis points, it means that rates have risen by 0.25% percentage points. If rates were at 2.50%, and rose by 0.25%, or 25 basis points, the new interest rate would be 2.75%.
Bond: A certificate of debt issued by a company, government, or other institution. The bond holder receives interest at a rate stated at the time of issue of the bond. The price of a bond may vary during its life.
Capital Expenditure: Expenditure on the acquisition, creation or enhancement of capital assets.
Capital Financing Requirement (CFR): The Council's underlying need to borrow for capital purposes representing the cumulative capital expenditure of the local authority that has not been financed.
Capital Receipts: Money obtained on the sale of a capital asset.
Credit Rating: Formal opinion by a registered rating agency of a counterparty's future ability to meet its financial liabilities; these are opinions only and not guarantees.
Counterparty List: List of approved financial institutions with which the Council can place investments with.
Debt Management Office (DMO): The DMO is an Executive Agency of Her Majesty's Treasury and provides direct access for local authorities into a government deposit facility known as the

DMADF. All deposits are guaranteed by HM Government and therefore have the equivalent of a sovereign triple-A credit rating.
Gilts: Gilts are bonds issued by the UK Government. They take their name from 'gilt-edged'. Being issued by the UK government, they are deemed to be very secure as the investor expects to receive the full face value of the bond to be repaid on maturity.
LIBID: The London Interbank Bid Rate (LIBID) is the rate bid by banks on Eurocurrency deposits (i.e. the rate at which a bank is willing to borrow from other banks).
LIBOR: The London Interbank Offered Rate (LIBOR) is the rate of interest that banks charge to lend money to each other. The British Bankers' Association (BBA) work with a small group of large banks to set the LIBOR rate each day. The wholesale markets allow banks who need money to be more fluid in the marketplace to borrow from those with surplus amounts. The banks with surplus amounts of money are keen to lend so that they can generate interest which it would not otherwise receive.
Maturity: The date when an investment or borrowing is repaid.
Money Market Funds (MMF): Pooled funds which invest in a range of short term assets providing high credit quality and high liquidity.
Minimum Revenue Provision (MRP): An annual provision that the Council is statutorily required to set aside and charge to the Revenue Account for the repayment of debt associated with expenditure incurred on capital assets.
Voluntary Revenue Provision (VRP): An additional contribution over and above the MRP that the Council can choose to make to reduce the CFR which in turn will reduce the MRP for future years.
Non Specified Investment: Investments which fall outside the MHCLG Guidance for Specified investments (below).
Operational Boundary: This linked directly to the Council's estimates of the CFR and estimates of other day to day cash flow requirements. This indicator is based on the same estimates as the Authorised Limit reflecting the most likely prudent but not worst case scenario but without the additional headroom included within the Authorised Limit.
Prudential Code: Developed by CIPFA and introduced on 01/4/2004 as a professional code of practice to support local authority capital investment planning within a clear,

affordable, prudent and sustainable framework and in accordance with good professional practice.
Prudential Indicators: Prudential indicators are a set of financial indicators and limits that are calculated in order to demonstrate that councils' capital investment plans are affordable, prudent and sustainable. They are outlined in the CIPFA Prudential Code of Practice. They are indicators that must be used to cover the categories of affordability, prudence, capital spending, external debt/borrowing and treasury management. They take the form of limits, ratios or targets which are approved by Council before 1 April each year and are monitored throughout the year on an on-going basis. A council may also choose to use additional voluntary indicators.
Public Works Loans Board (PWLB): The PWLB is a statutory body operating within the United Kingdom Debt Management Office, an Executive Agency of HM Treasury. The PWLB's function is to lend money from the National Loans Fund to local authorities and other prescribed bodies, and to collect the repayments.
Revenue Expenditure: Expenditure to meet the continuing cost of delivery of services including salaries and wages, the purchase of materials and capital financing charges.
(Short) Term Deposits: Deposits of cash with terms attached relating to maturity and rate of return (Interest).
Specified Investments: Term used in the MHCLG Guidance and Welsh Assembly Guidance for Local Authority Investments. Investments that offer high security and high liquidity, in sterling and for no more than one year. UK government, local authorities and bodies that have a high credit rating.
Supported Borrowing: Borrowing for which the costs are supported by the government or third party.
Temporary Borrowing: Borrowing to cover peaks and troughs of cash flow, not to fund capital spending.
Unsupported Borrowing: Borrowing which is self-financed by the local authority. This is also sometimes referred to as Prudential Borrowing.
Yield: The measure of the return on an investment.