APPENDIX I

| Report of | Meeting | Date |
|---|---|---|
| Deputy Chief Finance Officer & Section 151 Officer | Special Council | 23 February 2021 |

# TREASURY STRATEGY 2021/22 TO 2023/24

## PURPOSE OF REPORT

1. To present the Prudential and Treasury Indicators and Treasury Management and Investment Strategies for 2021/22 to 2023/24, and the Minimum Revenue Provision (MRP) Policy Statement for 2021/22.

## RECOMMENDATION(S)

2. 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 34.
   - 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 65.

## EXECUTIVE SUMMARY OF REPORT

3. This report incorporates the implications for treasury management of both financial and non-financial (income generating assets) investments. The wider approach to non-financial investments and to the capital expenditure as a whole is set out in more detail in the Capital Strategy report, which appears as Appendix H to the Budget report.

4. The report presents the Prudential Indicators in respect of capital expenditure and financing, the forecast levels of external borrowing and investments.

5. The proposed MRP Policy for 2021/22 is unchanged from that for 2020/21 and continues to be based on the Statutory Guidance issued in February 2019 and effective from 1 April 2019.

6. The proposed list of investment counterparties for 2021/22 contains two changes, compared to that approved by Council for 2020/21 on 25 February 2020, with the limits per institution for UK incorporated institutions and for Money Market Funds being increased from £3m to £5m. This is in response to the cash flow variations resulting from the impacts of the Covid-19 pandemic. Whether, or for how long, these same cash flow patterns will continue into 2021/22 is of course not yet known. If appropriate, proposals will be brought to Council, during the year, to return the limits to their original level.

| | | |
|---|---|---|
| **Confidential report**<br>Please bold as appropriate | Yes | **No** |

| | | |
|---|---|---|
| **Key Decision?**<br>Please bold as appropriate | Yes | **No** |

## REASONS FOR RECOMMENDATIONS

7. Approval of the Prudential Indicators, Treasury Management Strategy, Treasury Indicators, Annual Investment Strategy, and Annual MRP Policy Statement is necessary to comply with statutory requirements.

## ALTERNATIVE OPTIONS CONSIDERED AND REJECTED

8. None.

## CORPORATE PRIORITIES

9. This report relates to the following Strategic Objectives:

| | | | |
|---|---|---|---|
| Involving residents in improving their local area and equality of access for all | | A strong local economy | |
| Clean, safe and healthy homes and communities | | An ambitious council that does more to meet the needs of residents and the local area | ✓ |

## BACKGROUND

10. At its meeting on 26 February 2019, Council approved the Treasury Management Strategy for 2019/20, including Prudential and Treasury Indicators, the Treasury Management and Investment Strategies, and the annual Minimum Revenue Provision (MRP) Policy Statement for 2019/20. A revised set of indicators and a temporary variation to the Investment Counterparties list was then approved by Council on 23 July 2019. Treasury Management activities during the year have been overseen by the Governance Committee.

11. This report updates the Prudential and Treasury Indicators for financial years 2019/20 to 2021/22, and introduces provisional indicators for the financial year 2022/23. It presents updated Treasury Management and Investment Strategies, including a revised list of Investment Counterparties, and proposes the Minimum Revenue Provision (MRP) Policy Statement for 2021/22.

12. The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments, commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

13. The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer-term cash flow planning, to ensure that the Council can meet its capital

spending obligations. This management of longer-term cash may involve arranging long or short-term loans, or using longer-term cash flow surpluses.

14. The Chartered Institute of Public Finance and Accountancy (CIPFA) defines treasury management as *"The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."*

15. The Treasury Management Policy Statement for 2021/22 is based upon the Deputy Chief Finance Officer (s151 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

16. Council of 25 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.

17. This report updates Prudential and Treasury Indicators for financial years 2020/21 to 2023/24. It presents updated Treasury Management and Investment Strategies and proposes the Minimum Revenue Provision Policy Statement for 2021/22.

## CAPITAL STRATEGY

18. Under the latest Prudential and Treasury Management Codes, in addition to the Treasury Management Strategy, all local authorities are now required to prepare an additional report, a Capital Strategy report, which is intended to provide the following:
    - a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services
    - an overview of how the associated risk is managed
    - the implications for future financial sustainability

19. The aim of this report is to ensure that all elected members on the full council fully understand the overall strategy, governance procedures and risk appetite entailed by this Strategy. The Strategy both complements and supplements the Treasury Management Strategy and the two documents should be read in conjunction.

20. The Capital Strategy for 2021/22 appears at Appendix H to the 2021/22 budget report.

## TREASURY MANAGEMENT STRATEGY 2021/22

21. The strategy for 2021/22 covers two main areas:

**Capital issues**

- the capital plans and the associated 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.

22. 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.

## TRAINING

23. 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.

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

## TREASURY MANAGEMENT CONSULTANTS

25. 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.

26. 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.

27. It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure

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

**CAPITAL PRUDENTIAL INDICATORS 2021/22 – 2023/24 AND MRP STATEMENT**

28. 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.

**Capital expenditure**

29. 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 Revised £000 | 2021/22 Estimate £000 | 2022/23 Estimate £000 | 2023/24 Estimate £000 |
|---|---|---|---|---|
| Customer & Digital | 222 | 0 | 0 | 0 |
| Early Intervention & Support | 6,117 | 7,891 | 875 | 875 |
| Policy & Governance | 1,144 | 1,003 | 0 | 0 |
| Commercial Services | 7,119 | 29,221 | 2,300 | 300 |
| **Capital Expenditure Total** | **14,602** | **38,115** | **3,175** | **1,175** |

30. The table below summarises the above capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need.

| Table 2 - Capital Financing | 2020/21 Revised £000 | 2021/22 Estimate £000 | 2022/23 Estimate £000 | 2023/24 Estimate £000 |
|---|---|---|---|---|
| Capital expenditure from Table 1 | 14,602 | 38,115 | 3,175 | 1,175 |
| Capital Receipts | (505) | (5,166) | 0 | 0 |
| Grants & Contributions | (5,803) | (15,830) | (775) | (775) |
| Revenue and Reserves | (648) | (885) | 0 | 0 |
| **Net financing needed for year** | **7,646** | **16,234** | **2,400** | **400** |

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

31. 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.

32. 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.

33. The Council is asked to approve the CFR projections below:

| Table 3 - Capital Financing Requirement | 2020/21 Revised £000 | 2021/22 Estimate £000 | 2022/23 Estimate £000 | 2023/24 Estimate £000 |
|---|---|---|---|---|
| Opening CFR | 88,865 | 95,208 | 109,343 | 109,894 |
| Net financing need for the year (Table 2) | 7,646 | 16,234 | 2,400 | 400 |
| Less MRP/VRP | (1,303) | (2,099) | (1,849) | (1,939) |
| **Closing CFR** | **95,208** | **109,343** | **109,894** | **108,355** |

**Minimum Revenue Provision (MRP) Policy Statement**

34. The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the Minimum Revenue Provision - MRP), although it is also allowed to undertake additional voluntary payments if required (voluntary revenue provision - VRP).

35. MHCLG regulations have been issued which require the full Council to approve an MRP Statement in advance of each year. A variety of options are provided to councils, so long as there is a prudent provision.

36. The Council is recommended to approve the following MRP Policy Statement:

**Annual Statement of MRP Policy 2021/22**

37. The aim of the policy is to ensure that MRP is charged over a period that is reasonably commensurate with the period over which the capital expenditure which gave rise to the debt provides benefits.

38. MRP shall commence in the financial year following that in which the capital expenditure is incurred, or in the year following that in which the relevant asset becomes operational.

39. In respect of the proportion of the Capital Financing Requirement which relates to debt incurred prior to 2008/09, MRP shall be charged on this at the rate of 4% in accordance with option 1 of the guidance, otherwise known as the Regulatory Method.

40. The MRP liability on debt incurred from 2008/09 onwards shall be based on the estimated useful life of the asset. The MRP shall be calculated using the following methods, as appropriate for specific capital expenditure:

- Equal instalments: where the principal repayments made are the same in each year
- Annuity: where the principal repayments increase over the life of the asset

41. Estimated life periods shall be determined under delegated powers, with reference to the guidance and advice of appropriate professional advisers, in the year that MRP commences.

As some types of capital expenditure are not capable of being related to an individual asset, the MRP shall be assessed on a basis which most reasonably reflects the anticipated period of benefit arising from the expenditure.

**Affordability prudential indicators**

42. 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**

43. 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.

| Table 4 - Ratio of Financing Costs to Net Revenue Stream | 2020/21 Estimate % | 2021/22 Estimate % | 2022/23 Estimate % | 2023/24 Estimate % |
|---|---|---|---|---|
| Ratio | 15.64 | 16.66 | 21.24 | 22.37 |

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

45. This table now includes within the Net Revenue Stream not only income from taxation (Council Tax and Business Rates) and general government grants such as New Homes Bonus, but also that from income-generating assets. The Financing Costs also include the debt repayment and interest in respect of such assets. Table 4A below compares the income derived from these assets against the total financing cost incurred by the Council. It is emphasised that the comparison is against the total financing cost and not only that which relates to the assets themselves. Further detail is contained in the Capital Strategy.

| Table 4A - Investment Income in Excess of Borrowing | 2020/21 Estimate % | 2021/22 Estimate % | 2022/23 Estimate % | 2023/24 Estimate % |
|---|---|---|---|---|
| Total Borrowing Costs | 2,838 | 3,047 | 3,604 | 3,661 |
| Net Income From Non-Financial Investments | (4,780) | (4,081) | (4,716) | (5,086) |
| Investment Income in Excess of Borrowing Costs | (1,942) | (1,034) | (1,112) | (1,425) |

**Core funds and expected investment balances**

46. 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.).

| Table 5 - Year-End Resources | 2019/20 Revised £000 | 2020/21 Estimate £000 | 2021/22 Estimate £000 | 2022/23 Estimate £000 |
|---|---|---|---|---|
| Core Funds/Working Balances | (32,157) | (28,435) | (26,431) | (26,386) |
| Under/(over) borrowing (Table 6) | 31,157 | 27,435 | 25,431 | 25,386 |
| **Expected investments** | **(1,000)** | **(1,000)** | **(1,000)** | **(1,000)** |

**BORROWING**

47. The capital expenditure plans set out in paragraph 29 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.

**Current portfolio position**

48. The Council's projected treasury portfolio position 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.

| Table 6 - Portfolio Position | 2019/20 Actual £000 | 2020/21 Revised £000 | 2021/22 Estimate £000 | 2022/23 Estimate £000 | 2023/24 Estimate £000 |
|---|---|---|---|---|---|
| Debt at 1 April | 19,990 | 64,026 | 69,777 | 86,043 | 88,880 |
| Other long-term liabilities (OLTL) | 15 | 15 | 15 | 15 | 15 |
| Total gross debt 1 April | 20,005 | 64,041 | 69,792 | 86,058 | 88,895 |
| Expected change in Debt | 44,036 | 5,751 | 16,266 | 2,837 | (665) |
| Expected change in OLTL | 0 | 0 | 0 | 0 | 0 |
| Expected change in gross debt | 44,036 | 5,751 | 16,266 | 2,837 | (665) |
| Gross debt 31 March | 64,041 | 69,792 | 86,058 | 88,895 | 88,230 |
| Capital Financing Requirement (Table 3) | 88,865 | 95,208 | 109,344 | 109,895 | 108,356 |
| **Under / (over) borrowing** | **24,824** | **25,416** | **23,286** | **21,000** | **20,126** |

49. 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.

50. The S151 Officer reports that 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.

**Treasury Indicators: limits to borrowing activity**

51. **The Operational Boundary.** This is the limit 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.

| Table 7 - Operational Boundary | 2020/21 Revised £000 | 2021/22 Estimate £000 | 2022/23 Estimate £000 | 2023/24 Estimate £000 |
|---|---|---|---|---|
| Debt | 73,700 | 90,400 | 93,500 | 92,800 |
| Other long-term liabilities | 15 | 15 | 15 | 15 |
| **Operational Boundary** | **73,715** | **90,415** | **93,515** | **92,815** |

52. **The Authorised Limit for external debt.** This 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 a level of external debt which, while not desired, could be afforded in the short term, but which is not demonstrably prudential 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.

- The Council is asked to approve the following Authorised Limit:

| Table 8 - Authorised Limit | 2020/21 Revised £000 | 2021/22 Estimate £000 | 2022/23 Estimate £000 | 2023/24 Estimate £000 |
|---|---|---|---|---|
| Debt | 79,300 | 97,200 | 100,600 | 99,800 |
| Other long-term liabilities | 15 | 15 | 15 | 15 |
| **Authorised Limit** | **79,315** | **97,215** | **100,615** | **99,815** |

**Maturity structure of borrowing**

53. 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.

The Council is asked to approve the following treasury indicators and limits:

| Table 9 - Maturity Structure of Borrowing | | | |
|---|---|---|---|
| **Maturity structure of fixed interest rate borrowing 2020/21** | | | |
| | **31/3/21** | **Lower** | **Upper** |
| Under 12 months | 3% | 0% | 30% |
| 12 months to 2 years | 3% | 0% | 30% |
| 2 years to 5 years | 9% | 0% | 40% |
| 5 years to 10 years | 14% | 0% | 50% |
| Over 10 years | 71% | 0% | 80% |

54. The column headed 31/3/21 is the forecast split of borrowing as at the end of the current **financial** year and includes estimated temporary borrowing. The column for the Upper limit is in respect of borrowing in 2021/22. It indicates that borrowing is likely to be for a range of maturities.

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

**Control of interest rate exposure**

55. Please see the summary in this report and the advice of Link Assets Services on prospects for interest rates in Appendix I1.

56. The table in Appendix I1 compares the forecast of a year ago with that prepared for the mid-year review, and the current forecast.

**Prospects for borrowing interest rates**

57. 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.

58. 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.

59. Based upon the capital plans set out above, the Council will need to enter into further long-term external borrowing during the term of this strategy.

**Borrowing strategy**

60. 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.

61. 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.

62. Any decisions will be reported at the next available opportunity.

**Policy on borrowing in advance of need**

63. 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.

64. 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.

## ANNUAL INVESTMENT STRATEGY

### Investment Policy – management of risk

65. The MHCLG and CIPFA have extended the meaning of 'investments' to include both financial and non-financial investments. This report deals solely with financial investments, (as managed by the treasury management team). Non-financial investments, essentially the purchase of income yielding assets, are covered in the Capital Strategy at Appendix H to the Budget report.

    The Council's investment policy has regard to

    - the MHCLG's Guidance on Local Government Investments ("the Guidance"),
    - CIPFA's Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 ("the CIPFA TM Code"), and
    - CIPFA Treasury Management Guidance Notes 2018.

66. The Council's investment priorities will be **S**ecurity first, portfolio **L**iquidity second, and only then return (**Y**ield).

67. The above guidance from the MHCLG and CIPFA places a high priority on the management of risk. This authority has adopted a prudent approach to managing risk and defines its risk appetite by the following means:

    - Minimum acceptable **credit criteria** are applied in order to generate a list of highly creditworthy counterparties. This also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the short term and long-term ratings.

    - **Other information:** 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.

    - This Council has defined the list of **types of investment instruments** that the treasury management team are authorised to use.

        - **Specified investments** are those with a high level of credit quality and subject to a maturity limit of one year.
        - **Non-specified investments** are those with less high credit quality, may be for periods in excess of one year, and/or are more complex instruments which require greater consideration by members and officers before being authorised for use.

- **Non-specified investments limit.** The Council has determined that it will limit the maximum total exposure to non-specified investments as being £4 million. See Table 10 below.

- **Lending limits**, (amounts and maturity), for each counterparty will be set through applying the matrix table in paragraph 78.

- **Transaction limits** are set for each type of investment in paragraph 78.

- This authority will set a limit for the amount of its investments which are invested for **longer than 365 days**, (see Table 10).

- Investments will only be placed with UK counterparties.

- This authority has engaged **external consultants** to provide expert advice on how to optimise an appropriate balance of security, liquidity and yield, given the risk appetite of this authority in the context of the expected level of cash balances and need for liquidity throughout the year.

- All investments will be denominated in **sterling**.

**Creditworthiness policy**

68. 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.

69. 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:

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

70. 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.

71. 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.

72. Typically the minimum credit ratings criteria the Council use will be a Short Term rating (Fitch or equivalents) of F1 and a Long Term 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.

73. 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.

74. 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.

**UK banks – ring fencing**

75. The largest UK banks, (those with more than £25bn of retail / Small and Medium-sized Enterprise (SME) deposits), are required, by UK law, to separate core retail banking services from their investment and international banking activities by 1st January 2019. This is known as "ring-fencing". Whilst smaller banks with less than £25bn in deposits are exempt, they can choose to opt up. Several banks are very close to the threshold already and so may come into scope in the future regardless.

76. Ring-fencing is a regulatory initiative created in response to the global financial crisis. It mandates the separation of retail and SME deposits from investment banking, in order to improve the resilience and resolvability of banks by changing their structure. In general, simpler, activities offered from within a ring-fenced bank, (RFB), will be focused on lower risk, day-to-day core transactions, whilst more complex and "riskier" activities are required to be housed in a separate entity, a non-ring-fenced bank, (NRFB). This is intended to ensure that an entity's core activities are not adversely affected by the acts or omissions of other members of its group.

77. While the structure of the banks included within this process may have changed, the fundamentals of credit assessment have not. The Council will continue to assess the new-formed entities in the same way that it does others and those with sufficiently high ratings, (and any other metrics considered), will be considered for investment purposes.

**Counterparties and investment limits 2021/22**

78. The proposed counterparties and investment limits for 2021/22 are shown in the following table.

79. **This list contains two proposed changes, compared to that approved by Council for 2020/21 on 25 February 2020, with the limits per institution for UK incorporated institutions and for Money Market Funds being increased from £3m to £5m.** This is in response to the cash flow variations resulting from the impacts of the Covid-19 pandemic, **specifically** the periodic receipt of substantial tranches of government grant funding, as a result of which substantial amounts have at times been placed with the Debt Management Office, at minimal interest rates. The increased limits will allow a greater flexibility in the placing of funds, with the potential for higher returns. Whether, or for how long, these same cash flow patterns will continue into 2021/22 is of course not yet known. If appropriate, proposals will be brought to Council, during the year, to return the limits to their original level.

## Investment Counterparties 2021/22

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

**Investment strategy**

**In-house funds**

80. 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). Greater returns are usually obtainable by investing for longer periods. However, as Table 6 indicates, the Council is currently under-borrowed, which means that it is using its own cash balances to avoid taking external borrowing at higher rates of interest than it would achieve if it invested the cash. Cash balances are held only to manage the ups and down of cash flow, and in general they are held only in highly liquid accounts such as bank current accounts and Money Market Funds. Such accounts pay lower rates of interest than are offered for term deposits, so it is very unlikely that the rate of return on cash investments will reach the levels suggested by Link Asset Services for term deposits of around three months.

**Investment returns expectations**

81. 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%

82. 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:

| | **Now** | **2020/21 report** |
|---|---|---|
| 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% |

83. 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.

84. 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.

85. 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.

86. 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.

87. 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.

88. **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.

89. The Council is asked to approve the treasury indicator and limit:

| Table 10 - Maximum Principal Sums Invested > 365 Days | 2020/21 Revised £000 | 2021/22 Estimate £000 | 2022/23 Estimate £000 | 2023/24 Estimate £000 |
|---|---|---|---|---|
| UK Government | 0 | 0 | 0 | 0 |
| UK Local Authorities ** | 4,000 | 4,000 | 4,000 | 4,000 |
| UK Banks & Building Societies | 0 | 0 | 0 | 0 |
| Non-UK Banks | 0 | 0 | 0 | 0 |
| **Total** | **4,000** | **4,000** | **4,000** | **4,000** |

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.

**Investment Risk Benchmarking**

90. 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.

**End of Year Investment Report**

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

**IMPLICATIONS OF REPORT**

92. This report has implications in the following areas and the relevant Directors' comments are included:

| | | | |
|---|---|---|---|
| Finance | ✓ | Customer Services | |
| Human Resources | | Equality and Diversity | |
| Legal | ✓ | Integrated Impact Assessment required? | |

| | | | |
|---|---|---|---|
| No significant implications in this area | | Policy and Communications | |

**COMMENTS OF THE STATUTORY FINANCE OFFICER**

93. These are contained in the report.

**COMMENTS OF THE MONITORING OFFICER**

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

JAMES THOMSON
DEPUTY CHIEF FINANCE OFFICER AND SECTION 151 OFFICER

| **Background Papers** | | | |
|---|---|---|---|
| **Document** | **Date** | **File** | **Place of Inspection** |
| CIPFA Treasury Management in the Public Services: Code of Practice & Guidance Notes (2017) | | | Town Hall |
| CIPFA Prudential Code for Capital Finance in Local Authorities (2017) | | | Town Hall |
| CIPFA Treasury Management in the Public Services: Guidance Notes for Local Authorities (2018) | | | Town Hall |
| CIPFA Standards of Professional Practice: Treasury Management | | | Town Hall |
| MHCLG Guidance on Local Government Investments | | | Town Hall |
| MHCLG Guidance on Minimum Revenue Provision | | | Town Hall |

| **Report Author** | **Ext** | **Date** | **Doc ID** |
|---|---|---|---|
| Tony Furber | 5027 | 11th February 2021 | |

## 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.

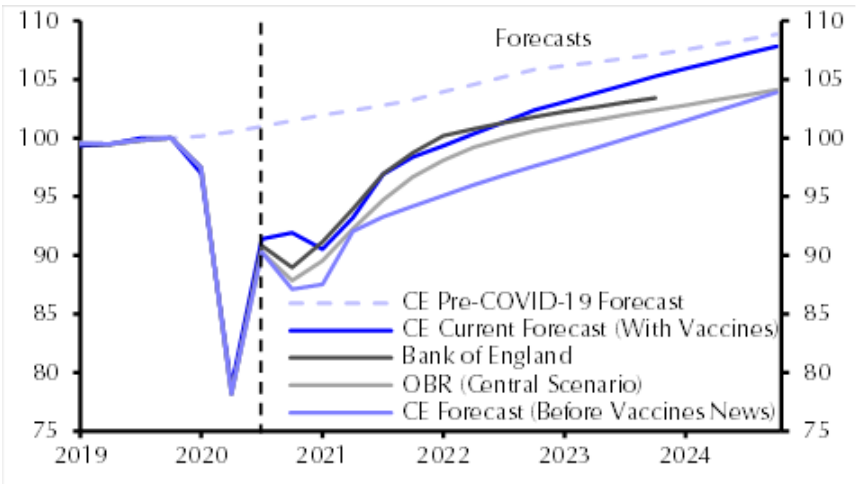
- **Public borrowing** was forecast in November by the Office for Budget Responsibility (the OBR) to reach £394bn in the current financial year, the highest ever peace time deficit and equivalent to 19% of GDP. In normal times, such an increase in total gilt issuance would lead to a rise in gilt yields, 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 5th 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 9th November 2020 of a successful vaccine was followed by approval of the Oxford University/AstraZeneca and Moderna vaccines. The Government has a set a target to vaccinate 14 million people in the most at risk sectors of the population by 15th 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.

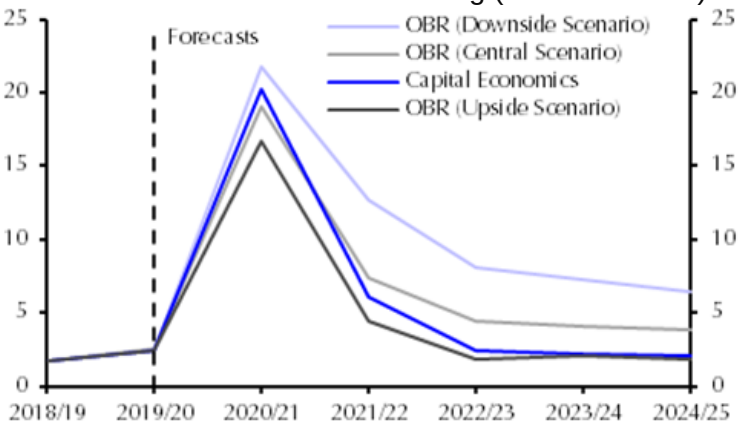
- Provided that both monetary and fiscal policy are kept loose for a few years yet, then it is still possible that in the second half of this decade, the economy may be no smaller than it would have been if COVID-19 never happened. The significant risk is if another mutation of COVID-19 appears that 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.

Chart: Public Sector Net Borrowing (as a % of GDP)




- 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 24th 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 30th April 2021 until 31st 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 3rd 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 6th 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 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 2021/22 – 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.