Governance, Audit, Risk Management and Standards Committee Supplemental Agenda

Date: **Tuesday 26 January 2021**

Agenda - Part I

10. **Treasury Management Strategy Statement and Annual Investment Strategy: Treasury Management Outturn 2019/20 and Mid-year Review 2020/21** (Pages 3 - 36)
Report of the Director of Finance

Agenda - Part II

Nil

Note: In accordance with the Local Government (Access to Information) Act 1985, the following agenda item has been admitted late to the agenda by virtue of the special circumstances and urgency detailed below:-

Agenda item	Special Circumstances/Grounds for Urgency
10. Treasury Management Strategy Statement and Annual Investment Strategy: Treasury Management Outturn 2019/20 and Mid-year Review 2020/21	The report was not available at the time the agenda was published as it was necessary to commission external help to produce the report due to the existing vacancy of the Treasury Manager. Due to the challenges of recruiting to Treasury Management roles, the Council is exploring the option of signing up to the GLA's Treasury Management Service from 1st April 2021. Members are requested to consider the report as a matter of urgency as so that the Treasury Management reports are adequately scrutinised, with this role being undertaken by the Governance, Audit, Risk Management and Standards Committee (GARMS). The Council needs to ensure this scrutiny takes place in order to comply with the CIPFA Treasury Management Code of Practice and therefore the report needs to be considered at the January GARMs meeting.

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Report for:	**Governance, Audit, Risk Management and Standards Committee (GARMS)**
Date of Meeting:	26 January 2021
Subject:	Treasury Management Strategy Statement and Annual Investment Strategy: Treasury Management Outturn 2019/20 and Mid-year Review 2020/21
Responsible Officer:	Dawn Calvert, Director of Finance and Assurance
Exempt:	No
Wards affected:	All
Enclosures:	Report to Cabinet on 21 January 2021 - Treasury Management Strategy Statement and Annual Investment Strategy: Treasury Management Outturn 2019/20 and Mid-year Review 2020/21

Section 1 – Summary and Recommendations

This report sets out the mid-year review of Treasury Management activities for 2020/21 and the 2019/20 Outturn position.

Cabinet considered this report on Treasury Management activities on 21 January 2021 and referred it to the Governance, Audit, Risk Management and Standards Committee for review.

Recommendations:
The Committee is asked to review the mid-year position for treasury management activities for 2020/21 and the 2019/20 Outturn position.

Section 2 – Report

Background

1. The enclosed report sets out the mid-year position for treasury management activities for 2020/21 and the 2019/20 Outturn position. The report on the Outturn would usually go to cabinet in June, with the midyear position going to Cabinet in either December or January. This year the 2 reports have been combined but will revert back to separate reports next year.

2. In addition to consideration of the January cabinet report, Committee are also being advised of a proposed change in the management of the Council's Treasury Management activities to take effect from the 1st April 2021. Due to the challenges of recruiting to Treasury Management roles, the Council is exploring the option of signing up to the GLA's Treasury Management Service. In terms of timing it would be easier to sign up to any new service from the start of the financial year, hence the current process is to update the Chair and Vice Chair of the GARMS Committee in February and then report the arrangement to Cabinet in March and GARMS in April.

Legal Implications

3. See attached cabinet report.

Financial Implications

4. See attached Cabinet Report.

Risk Management Implications

5. See attached cabinet report.

Equalities implications / Public Sector Equality Duty

6. See attached cabinet report.

Council Priorities

7. See attached cabinet report.

Section 3 - Statutory Officer Clearance

Statutory Officer: Dawn Calvert
Signed on by the Chief Financial Officer

Date: 18 January 2021

Statutory Officer: Chris Cuckney
Signed on behalf of the Monitoring Officer

Date: 18 January 2021

Chief Officer: Charlie Stewart
Signed by the Corporate Director

Date: 18 January 2021

Mandatory Checks

Ward Councillors notified: NO, as it impacts on all Wards

Section 4 - Contact Details and Background Papers

Contact: Dawn Calvert, Director of Finance and Assurance
E-mail: dawn.calvert@harrow.gov.uk

Background Papers: None

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Harrow COUNCIL LONDON

Report for:	**Cabinet**
Date of Meeting:	21 January 2021
Subject:	Treasury Management Strategy Statement and Annual Investment Strategy: Treasury Management Outturn 2019/20 and Mid-year Review 2020/21
Key Decision:	No
Responsible Officer:	Dawn Calvert, Director of Finance and Assurance
Portfolio Holder:	Councillor Adam Swersky - Portfolio Holder for Finance and Resources
Exempt:	No
Decision subject to Call-in:	No
Wards affected:	All
Enclosures:	Appendix 1: Economic update and current interest rate forecast from Link Asset Services

Section 1 – Summary and Recommendations

This report sets out the Treasury Management Outturn position for 2019/20 and the Mid-Year Review of Treasury Management activities for 2020/21 and is for noting only.

Recommendations:
Cabinet is requested to:

a) note the Treasury Management Outturn for 2019/20 and Mid-Year Review for 2020/21;

b) refer this report to the Governance, Audit, Risk Management and Standards Committee for review.

Reason: (for recommendations)

a) to promote effective financial management and comply with the Local Authorities (Capital Finance and Accounting) Regulations 2003, other relevant guidance and the Council's Financial Regulations.

b) to keep Members informed of Treasury Management activities and performance.

Section 2 – Report

1. Background

1.1 The purpose of this report is to present the Council's Annual Treasury Management outurn position for 2019/20 and update members with the Mid-Year Report for 2019/20 in accordance with the Council's Treasury Management Practices and in compliance with the Chartered Institute of Public Finance and Accountancy's (CIPFA) Treasury Management Code of Practice. The Council has complied with all elements of the Treasury Management Strategy Statement (TMSS) as the treasury management function.

1.2 Additional finance lease liabilities entered into during 2019/20 in respect of vehicles and machinery has resulted in the Operational Boundary for other long-term liabilities being exceeded. This element of the Operational Boundary will be revised as part of the 2021/22 Treasury Management Strategy development process. The Operational Boundary is based on the expected debt position of the Authority (and Periods where the actual position is either below or over the boundary are acceptable subject to the *A*uthorised Limit not being breached. The Authority remained well within its Authorised Limit and apart from this element of the Operational Boundary, the Authority has operated within the Treasury Limits and Prudential Indicators as set out in the both the 2019/20 and 2020/21 TMSS documents which are confirmed in the individual sections of this report.

1.3 Treasury management comprises:

- Managing the Council's borrowing to ensure funding of the Council's current and future Capital Programme is at optimal cost;
- Investing surplus cash balances arising from the day-to-day operations of the Council to obtain an optimal return while ensuring security of capital and liquidity.

1.4 The annual revenue budget includes the revenue costs that flow from capital financing decisions. Under the CIPFA Treasury Management Code of Practice and the CIPFA Prudential Code, increases in capital expenditure should be limited to levels whereby increases in interest charges and running costs are affordable within the Council's revenue account.

1.5 The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation to ensure the security and liquidity of the Council's treasury investments.

1.6 The Council recognises that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of the CIPFA Treasury Management Code of Practice.

2. Reporting Requirements

2.1 The Council and/or Cabinet are required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals.

2.2 **Treasury Management Strategy Statement Report** - The first, and most important report is presented to the Council in February and covers:

- The Treasury Management Strategy Statement (TMSS), which details how the investments and borrowings for capital expenditure are to be organised, including Treasury Limits and Prudential Indicators.
- The Annual Investment Strategy which forms part of the TMSS, (the parameters on how investments are to be managed).
- the MRP Policy (how capital expenditure is charged to revenue over time).

2.3 **Mid-Year Review Report** – This is presented to Cabinet in December/January and updates Members on the progress of the Capital Programme, reporting on Prudential Indicators to give assurance that the treasury management function is operating within the Treasury Limits and Prudential Indicators set out in the TMSS.

2.4 **Treasury Management Outturn Report** – This is typically presented to Cabinet in June and provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the TMSS.

This report will fulfill the requirements of the Treasury Management Outturn Report for 2019/20 and the Mid-Year Review Report for 2020/21. It is accepted that the information in this report would normally have come to Cabinet earlier in the year. However due to the challenge of filing staff vacancies during the pandemic and that no treasury activity, in the form of borrowing, has been undertaken since treasury management was reported to Cabinet in February 2020, this report is presented at this time.

2.5 **Scrutiny -** The above reports are required to be adequately scrutinised, normally before being recommended to Cabinet / Council, with the role being undertaken by the Governance, Audit, Risk Management and Standards Committee (GARMS). The Council has complied with the CIPFA Treasury Management Code of Practice to the extent that all Treasury Management reports have been scrutinised though the efficient conduct of the Council's business may require consideration by GARMS subsequent to consideration by Cabinet/Council.

2.6 The Council has delegated responsibility for the implementation and regular monitoring of its treasury management policies and practices to the Section 151 Officer. The Section 151 Officer chairs the Treasury Management Group (TMG), which monitors the treasury management activity and market conditions monthly.

3. Matters covered in report

3.1 This report covers the following:

- Treasury Management Outturn Report for 2019/20
  - Capital Expenditure, Financing and Limits
  - Treasury Position as at 31st March 2020
  - Summary of 2019/20 Strategy
- Mid-Year Review Report 2020/21
  - Treasury Position as at 30 September 2019
  - Compliance with Treasury Limits and Prudential Indicators
  - Economic update and Interest Rate Forecast for 2020/21 (Appendix 1).

4. Options considered

4.1 The report is in accordance with the reporting requirements of the CIPFA Treasury Management Code of Practice.

5. Treasury Management Outturn Report 2019/20

5.1 The Treasury Management Strategy Statement, (TMSS), for 2019/20 was approved by Council on 28 February 2019. It stated that for the next three years the Capital Programme would continue to be funded from grants and revenue resources, but that substantial borrowing would also be required.

6. The Council's Capital Expenditure and Financing

6.1 The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or

- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

6.2 The actual capital expenditure forms one of the required prudential indicators. The tables below show the actual capital expenditure for 2019/20 against that budgeted and how this was financed.

Table 1: Capital Expenditure

Capital expenditure £'000	2018/19 Actual	2019/20 Budget	2019/20 Actual	2019/20 Variance	Variance Analysis Slippage to 2020/21	Underspend
- Resources and Commercial	9,802	143,434	36,269	107,165	106,268	897
- People's	5,690	29,049	4,464	24,585	24,034	551
- Community	35,198	114,021	40,369	73,652	70,082	3,570
General Fund	**50,690**	**286,504**	**81,102**	**205,402**	**200,384**	**5,018**
HRA	**7,091**	**32,565**	**9,483**	**23,082**	**15,347**	**7,735**
Total	**57,781**	**319,069**	**90,585**	**228,484**	**215,731**	**12,753**

Table 2: Financing of Capital Expenditure

Financing of capital expenditure £'000	2018/19 Actual	2019/20 Actual
Capital Receipts	1,120	2,530
Grants	13,063	13,170
S106/S20 Contributions	337	0
Revenue	6,191	8,770
External Funding	**20,711**	**24,470**
Net Financing need for the year (Borrowing)	**37,070**	**66,115**

6.3 Further details of the capital expenditure position are included within the Revenue and Capital Outturn Report 2019/20.

6.4 In light of the impact of the pandemic the Capital Programme for 2020/21 has been revisited and a large amount of the figures identified as slippage to 2020/21 above are expected to be removed from the programme altogether. Revised estimates for 2020/21 provided as part of the Mid-Year Report later in this document reflect the updated capital programme for 2020/21.

7. The Council's Overall Borrowing Need

7.1 The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR). The CFR increases within any net financing need for the year and reduces through the application of resources, including an annual charge to the revenue budget, the Minimum Revenue Provision (MRP).

7.2 **Gross Debt and the CFR**

In order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external debt (borrowing plus other long term liabilities such as PFI and Finance Leases) does not, except in the short term, exceed the total CFR in the preceding year (2019/20) plus the estimates of any additional borrowing requirement for the current (2020/21) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. The table below highlights the Council's gross debt position against the CFR in 2019/20. The Council has complied with this prudential indicator.

Table 3: Gross Debt and CFR

CFR £'000	**2018/19 Actual**	**2019/20 Actual**
General Fund	366,849	410,978
HRA	150,683	150,683
Total CFR	517,532	561,661
Gross Debt	361,762	440,781
Under/(Over) Borrowing	155,770	120,880

7.3 <u>**The Authorised Limit**</u>

The Authorised Limit is the "Affordable Borrowing Limit" required by S3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2019/20 the Council has maintained gross borrowing within its Authorised Limit.

Table 4: Authorised Limit

Authorised limit £'000	**2019/20**
Debt & Other long term liabilities	587,820

7.4 **The Operational Boundary**

The Operational Boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary are acceptable subject to the Authorised Limit not being breached. The Council entered into new finance leases of vehicles and machinery in 2019/20 with a liability of £3.6m. Together with the existing PFI liabilities this resulted in total long-term liabilities of £18.5m, in excess of the Operational Boundary for this category of debt. This limit will be increased as part of the 2021/22 TMSS process to accommodate these additional liabilities to the Council.

Table 5: Operational Boundary

Operational boundary £'000	2019/20
Debt	432,771
Other long term liabilities	15,501
Total	448,272

8. Treasury Position as at 31 March 2020

8.1 Borrowing Outturn (excluding borrowing by PFI and finance leases)

The Council has maintained an internal borrowing strategy for a number of years, forgoing lost investment income on investments to use its cash balances to temporarily fund capital expenditure and avoid external borrowing costs. This has proved efficient given the differential between short term investment returns and borrowing costs.

8.2 During 2019/20 the Council took £100m of new PWLB loans and a further £20m market loan. As detailed in the 2019/20 mid-year treasury report £100m of new PWLB borrowing was taken in April 2019 in the form of two 50-year maturity loans at interest rates of 2.2% and 2.31%. In December 2019, a 30-year maturity loan was taken from the market at an interest rate of 2.55%. This new borrowing partially refinanced temporary borrowing and market debt in place at the 1st April 2019 that matured in 2019/20 and was also used to fund the Authority’s underlying need to borrow, represented by the CFR.

8.3 As the new loans are at lower interest rates than the average rate of the borrowing portfolio as at 1st April 2019, this average rate reduced over the year from 3.7% to 3.34% as at 31st March 2020. The long-term nature of the PWLB loans resulted in the average life of the borrowing portfolio increasing from 31 years to 38 years as at 31st March 2020.

Table 6: Borrowing Portfolio

Borrowing Portfolio £'000	31-Mar-19			31-Mar-20		
	Principal	Average Rate (%)	Average Life (yrs)	Principal	Average Rate (%)	Average Life (yrs)
- PWLB	248,461	3.93%	33.21	348,461	3.45%	37.04
- Market	65,800	4.19%	39.68	73,800	2.84%	42.69
- Temporary	32,000	0.97%	0.37			
Total borrowing	346,261	3.70%	31.41	422,261	3.34%	38.02

The maturity structure of the debt portfolio remained within the Prudential Indictor limits set as part of the Treasury Management Strategy:

Table 7: Maturity Structure of Borrowing

Maturity structure of borrowing	Lower	Upper	Actual 31.03.19	Actual 31.03.20
Under 12 months	0%	40%	24%	10%
12 months to 2 years	0%	30%	0%	0%
2 years to 5 years	0%	30%	1%	1%
5 years to 10 years	0%	40%	3%	5%
10 years and above	30%	100%	71%	84%

8.4 Investment Outturn

The Council made investments throughout 2019/20 in accordance with the Treasury Management Strategy approved by Full Council on 28 February 2019.

8.5 Due to the internal borrowing strategy being undertaken by the Council, cash balances continued to be held for liquidity purposes, in Money Market Funds and banks. Investment returns remained low throughout 2019/20 so while the additional borrowing taken by the Authority reduced the internal borrowing position and increased the cash available to invest in the market, a reduction in investment returns particularly for liquid investments was experienced within the portfolio, especially as the impact of the pandemic was beginning to be realised.

8.6 The investment portfolio remained highly liquid throughout 2019/20. Investments increased from £26m to £65m over the year while the average rate of interest reduced from 0.42% as at 31st March 2019 to 0.19% as at 31st March 2020.

Table 8: Investment Portfolio

Investment Portfolio £'000	31-Mar-19			31-Mar-20		
	Principal	Average Rate (%)	Average Life (days)	Principal	Average Rate (%)	Average Life (days)
- MMFs	1,604	0.72%	1	1,615	0.35%	1
- Banks	24,724	0.40%	2	62,917	0.18%	4
Total Investments	26,328	0.42%	2	64,532	0.19%	4

9. The strategy for 2019/20

9.1 Investment strategy and control of interest rate risk

Investment returns remained low during 2019/20. The expectation for interest rates within the treasury management strategy for 2019/20 was that Bank Rate would stay at 0.75% during 2019/20 as it was not expected that the MPC would be able to deliver on an increase in Bank Rate until the Brexit issue was finally settled. However, there was an expectation that Bank Rate would rise after that issue was settled, but only to 1.0% during 2020. Shorter term investment interest rates were fairly flat during most of the year until the two cuts in Bank Rate in March 2020 as part of the emergency response to the pandemic caused investment rates to fall sharply.

Investment balances continued to remain relatively low through the agreed strategy of using reserves and balances to support internal borrowing, despite the additional external borrowing taken in 2019/20. Further external borrowing would have incurred an additional cost, due to the continued differential between borrowing and investment rates. Maintaining an internal borrowing strategy provides additional benefits in terms of reducing the counterparty risk exposure, by having fewer investments placed in the financial markets than would be the case if the Authority had borrowed up to its CFR.

9.2 Borrowing strategy and control of interest rate risk

During 2019-20 the Council maintained an internal borrowing position. Additional borrowing of £120m was taken during the year, £44m of which related to refinancing temporary and market debt maturing in year. The Authority's CFR increased by £44m during 2019/20. The cumulative impact of the new borrowing, additional finance lease liabilities and movement in the CFR was a reduction in the internal borrowing position from £156m to £121m as at 31st March 2020.

9.3 This means that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure.

9.4 The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this has been kept under review to avoid incurring higher borrowing costs in the future when the Authority may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt. The new borrowing decisions taken in 2019/20 were made within this context given the relatively low levels of investments in place as at 31st March 2019 and the anticipated increase in the CFR required to fund the capital programme.

9.5 Interest rate forecasts expected only gradual rises in medium- and longer-term fixed borrowing rates during 2019/20 and the two subsequent financial years. The impact of the pandemic and continued Brexit discussions up to the recent agreement at the end of 2020 has resulted in lower interest rate expectations throughout 2020/21. Link Asset Services latest Economic commentary and interest rate forecast is contained in Appendix 1.

10. Mid-Year Review Report 2020/21

10.1 The Treasury Management Strategy Statement, (TMSS), for 2020/21 was approved by Council on 27 February 2020. It stated that for the next three years the Capital Programme would continue to be funded from grants and revenue resources, but that substantial borrowing would also be required, demonstrated by the projected increase in the Authority's CFR.

10.2 As part of the capital planning for 2021/22, service directorates were asked to carry out a review of the capital programme inclusive of the requirements for 2020/21 due to the impact of the pandemic which halted or delayed many capital projects for several months. This review is reflected in the revised estimates for 2020/21 within this report.

11. Treasury Position as at 30 September 2020

11.1 <u>Investments</u>
In accordance with the CIPFA Treasury Management Code of Practice and MHCLG Investment Guidance, the TMSS sets out the Council's investment priorities as being:
•Security of capital
•Liquidity
•Yield

11.2 It is now impossible to earn the level of interest rates commonly seen in previous decades as all investment rates are barely above zero now that Bank Rate is at 0.10%, while some entities, including more recently the Debt Management Account Deposit Facility (DMADF), are offering negative rates of return in some shorter time periods. This has been exacerbated by high levels of liquidity in the market in light of the uncertainty caused by the pandemic and Brexit negotiations. Given this risk environment and the fact that increases in Bank Rate are unlikely to occur before the end of the current forecast horizon of 31st March 2023, investment returns are expected to remain low for the foreseeable future.

Table 9: Investment Portfolio

Investment Portfolio £'000	31-Mar-20			30-Sep-20		
	Principal	Average Rate (%)	Average Life (days)	Principal	Average Rate (%)	Average Life (days)
- MMFs	1,615	0.35%	1	1,616	0.01%	1
- Banks	62,917	0.18%	4	82,865	0.02%	4
Total Investments	64,532	0.19%	4	84,481	0.02%	4

11.3 The Council held £84.5m of investments as at 30 September 2019 compared with £64.5m at 31 March 2020. The portfolio remains highly liquid with the yield reflecting the current market for liquid investments. Cashflow forecasting has been challenging during 2020/21 due to the response to the pandemic and the impact this has had on the Authority along with the Authority's role within that response. The internal borrowing strategy of the Authority focusing on minimising the net cost of borrowing also prevents longer term investment with a consequent impact on investment return.

11.4 The Council's investment income budget is £1.4m and the forecast outturn is £1.14m. This includes the loan income from the £15m loan to the West London Waste Authority which the Council approved in July 2013 to finance the cost of a new energy from waste plant. The term of the loan is 25 years at an interest rate of 7.604% on a reducing balance. The loan balance at the 31 March 2020 was £16.1m which includes interest accrued to date. For the financial year 2020/21, the outturn forecast on the interest accrued is £1.2m which is included as part of the investment income budget.

11.5 During the period cash investments have been held with Deutsche and Fidelity Money Market Funds, Lloyds, Royal Bank of Scotland PLC, and Svenska Handelsbanken. Counterparty use has been with consistent with previous years and in accordance with the credit criteria set out in the TMSS. Officers can confirm that the approved limits within the Annual Investment Strategy have not been breached to the period of 31st December 2020.

11.6 Borrowing
The Authority took £120m of new borrowing in 2019/20 and continues to run an internal borrowing strategy with a borrowing portfolio of £422m (excluding £18.5m of PFI and Finance Lease Liabilities) below the actual CFR of £562m as at 31st March 2020 and the revised estimate of the CFR for the 31st March 2021 of £592m.

11.7 The Authority's current borrowing portfolio remains unchanged from 31st March 2020, with no new borrowing undertaken in 2020/21 up to 31st December 2020.

11.8 The forecast outturn on borrowing costs is £8.29m, a favourable variance of £2.4m on the budget of £10.7m, reflecting slippage on the Capital Programme.

Table 10: Borrowing Portfolio

Borrowing Portfolio £'000	31-Mar-20			30-Sep-20		
	Principal	Average Rate (%)	Average Life (yrs)	Principal	Average Rate (%)	Average Life (yrs)
- PWLB	348,461	3.45%	37.04	348,461	3.45%	36.53
- Market	73,800	2.84%	42.69	73,800	2.84%	42.19
Total borrowing	422,261	3.34%	38.02	422,261	3.34%	37.52

11.9 The Director of Finance will continue to keep borrowing decisions under review.

11.10 The Authority's maturity structure of borrowing remains within the lower and upper limits of the Prudential Indicator set as part of the 2020/21 TMSS. While the portfolio remains unchanged in 2020/21, a PWLB loan within the portfolio has moved between categories as it comes closer to maturity in September 2022.

Table 11: Maturity Structure of Borrowing

Maturity structure of borrowing	Lower	Upper	Actual 31/03/20	Actual 30/09/20
Under 12 months	0%	40%	10%	10%
12 months to 2 years	0%	30%	0%	1%
2 years to 5 years	0%	30%	1%	0%
5 years to 10 years	0%	40%	5%	5%
10 years and above	30%	100%	84%	84%

11.11 PWLB Consultation

In response to concerns about commercial activity being undertaken by local authorities supported through borrowing from the PWLB HM Treasury increase the margin over the Gilt applied to all PWLB borrowing on the 9th October 2019 from 0.8% to 1.8% above the Gilt.

11.12 In March 2020 HM Treasury reversed this for HRA borrowing (with reference to the HRA CFR) and announced a consultation on the future lending terms of the PWLB. The Governments response to the consultation was published in November 2020, and reversed the additional 1% margin imposed on General Fund borrowing subject to local authority's confirming that they have no purely commercial activity within their three year capital programme, which will come from data submissions of the capital programme accompanied by an assurance from the s151 officer. Subject to this criteria being met borrowing for both the General Fund and HRA is now back at a margin of 80bps above the Gilt.

12. Economic and Interest Rates Updates

12.1 The coronavirus outbreak has done huge economic damage to the UK and economies around the world. After the Bank of England took emergency action in March to cut Bank Rate to first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its subsequent meetings to 16th December, although some forecasters had suggested that a cut into negative territory could happen. However, the Governor of the Bank of England has made it clear that he currently thinks that such a move would do more damage than good and that more quantitative easing is the favoured tool if further action becomes necessary. No increase in Bank Rate is expected in the near-term as economic recovery is expected to be only gradual and, therefore, prolonged.

12.2 A full economic update along with the interest rate forecast and commentary provided by Link Treasury Services is included as Appendix 1.

13. Compliance with Prudential Indicators

13.1 It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. With the exception of the issue regarding the Operational Boundary and additional finance leases referred to earlier in the report and carried over from 2019/20, the Council has operated within the Treasury and Prudential Indicators set out in the Council's Treasury Management Strategy Statement for 2020/21 during the half year ended 30 September 2020 (and given the timing of this report the period up to 31 December 2020).

13.2 The other long-term liabilities element of the Operational Boundary will be revised as part of the 2021/22 Treasury Management Strategy development process which will also take into account the revised capital programme due to be presented to Council.

13.3 All treasury management operations have been conducted in full compliance with the Council's Treasury Management Practices.

13.4 Capital Expenditure and Funding

The Council's Capital Programme is the key driver of Treasury Management activity. The output of the Capital Programme is reflected in the statutory prudential indicators, which are designed to assist Members' overview and confirm the capital expenditure programme. The tables below summarise the capital expenditure and funding for the current financial year.

Table 12: Capital Expenditure

Capital expenditure £'000	2019/20 Actual	2020/21 Budget	2020/21 Estimate
- Resources and Commercial	36,269	6,200	12,362
- People's	4,464	1,746	4,990
- Community	40,369	34,827	51,849
General Fund	**81,102**	**42,773**	**69,201**
HRA	**9,483**	**36,297**	**24,150**
Total	**90,585**	**79,070**	**93,351**

13.5 The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Table 13: Financing of Capital Expenditure

Financing of capital expenditure £'000	2019/20 Actual	2020/21 Budget	2020/21 Estimate
Capital Receipts	2,530	5,113	4,283
Capital Grants	13,170	21,626	17,691
Section 106/Section 20/CIL		7,493	6,113
Revenue	8,770	7,089	12,946
External Funding	**24,470**	**41,321**	**41,033**
Net Financing need for the year (Borrowing)	**66,115**	**37,749**	**52,318**
Slippage from 2019/20		186,136	
Net Financing need inc Slippage (Borrowing)	**66,115**	**223,885**	**52,318**

	2018/19	2019/20	2019/20
	Actual	Estimate	Forecast
	£'000	£'000	£'000
Capital Expenditure			
Non - HRA	47,690	97,674	117,800
HRA	7,091	26,586	21,471
TOTAL	**54,781**	**124,260**	**139,271**
Funding:-			
Grants	9,011	20,845	18,399
Capital receipts	4,820	1,277	4,783
Revenue financing	6,386	6,135	11,988
Section 106 / Section 20	337	200	5,825
TOTAL	**20,554**	**28,457**	**40,995**
Net financing need for the year	**34,227**	**95,803**	**98,276**

13.6 **Capital Financing Requirement (CFR)**

The CFR as set out in Table 5, is 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 underlying borrowing need. Any new capital expenditure, which has not immediately been paid for, will increase the CFR.

13.7 The original estimate for 2020/21 included £186m of slippage from previous years capital programmes, which increased to £216m based on the 2019/20 Capital Outturn Report. As part of the capital planning for 2021/22, service directorates were asked to carry out a review of the capital programme using a bottom up approach to ensure programme represents capital investment that is necessary up to financial year 2023/24. The current financial year was also included as part of the review, so that services could better set out the likely spend for the 2020/21 due to the impact of the pandemic which halted or delayed many capital projects for several months. This is reflected in the revised estimates below:

Table 14: Capital Financing Requirement

Capital Financing Requirement £'000	**2019/20 Actual**	**2020/21 Original Estimate***	**2020/21 Revised Estimate**
CFR – General Fund	410,978	617,526	439,093
CFR – HRA	150,683	166,102	152,685
Total CFR	**561,661**	**783,628**	**591,778**
Movement in CFR	**44,129**	**201,385**	**30,117**

* Original 2020/21 Movement in CFR was based on estimated outturn for 2019/20

Movement in CFR represented by			
Net financing need for the year (above)	66,115	223,885	52,318
Less MRP/VRP/other financing movements	-21,986	-22,500	-22,201
Movement in CFR	**44,129**	**201,385**	**30,117**

13.8 **Operational Boundary and Authorised Limit**

● Operational Boundary – This limit is based on the Council's programme for capital expenditure, capital financing requirement and cash flow requirements for the year.

● Authorised Limit – This represents a limit beyond which external debt is prohibited. The Council's policy is to set this rate at the Capital Financing Requirement. The Government retains an option to control either the total of all councils' programmes, or those of a specific council, although this power has not yet been exercised.

Table 15: Operational Boundary & Authorised Limit approved as part of the 2020/21 TMSS

Operational boundary £'000	**2019/20**	**2020/21**	**2021/22**	**2022/23**
Borrowing	432,771	656,656	720,096	768,489
Other long term liabilities	15,501	14,827	14,153	13,479
Total	448,272	671,483	734,249	781,968

Authorised limit £'000	**2019/20**	**2020/21**	**2021/22**	**2022/23**
Borrowing & Other Long Term Liabilities	587,820	811,705	875,145	923,538
Total	587,820	811,705	875,145	923,538

13.9 The Council entered into new finance leases of vehicles and machinery in 2019/20 with liabilities of £3.6m. Together with the Authority's existing PFI liabilities, this resulted in long term liabilities of £18.5m, in excess of the Operational Boundary for this category of debt.

13.10 A full review of all the Authority's Treasury and Prudential Indicators will take place as part of the 2021/22 TMSS process.

14. Implications of the Recommendations

The recommendations are asking the Cabinet to note the position on treasury management activities. They do not affect the Council's staffing / workforce and have no equalities, procurement, data protection or community safety impact.

15. Procurement Implications

There are no procurement implications arising from this report.

16. Legal Implications

16.1 The Local Government Act 2003 requires the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable. These are contained within this report. The Act requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy. This sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments. This report assists the Council in fulfilling its statutory obligation under the Local Government Act 2003 to monitor its borrowing and investment activities.

17. Financial Implications

In addition to supporting the Council's revenue and capital programmes the Treasury Management interest budget is an important part of the revenue budget. Any savings achieved, or overspends incurred, have a direct impact on the financial performance of the budget.

18. Performance Issues

18.1 The Council meets the requirements of the CIPFA Code of Practice for Treasury Management and therefore is able to demonstrate best practices for the Treasury Management function.

18.2 As part of the Code the Council must agree a series of prudential indicators and measure its performance against them. These indicators and performance are detailed in the report and reported to Council

19. Environmental Impact

There are no direct environmental impacts.

20. Risk Management Implications

20.1 This report is for noting and the Cabinet are not being asked to make any decisions hence there are no direct risk management implications to this report.

21. Equalities implications / Public Sector Equality Duty

There is no direct equalities impact.

Council Priorities

This report deals with the Treasury Management Strategy which plays a significant part in supporting the delivery of all the Council's corporate priorities.

Section 3 - Statutory Officer Clearance

Statutory Officer: Dawn Calvert
Chief Financial Officer
Date: 18 January 2021

Statutory Officer: Chris Cuckney
Signed on behalf of the Monitoring Officer
Date: 18 January 2021

Chief Officer: Charlie Stewart
Signed off by the Corporate Director
Date: 18 January 2021

Head of Procurement: Nimesh Mehta
Signed by the Head of Procurement
Date: 18 January 2021

Head of Internal Audit: Susan Dixson - N/A

Mandatory Checks

Ward Councillors notified: NO, as it impacts on all Wards

EqIA carried out: NO

EqIA cleared by: N/A

Section 4 - Contact Details and Background Papers

Contact: Dawn Calvert – Director of Finance & Assurance,
dawn.calvert@harrow.gov.uk

Background Papers: None

Call-in waived by the Chair of Overview and Scrutiny Committee – NOT APPLICABLE

APPENDIX 1: Interest Rate Forecasts 2020 – 2024.

The PWLB rates below are based on the new margins over gilts announced on 26th November 2020. PWLB forecasts shown below have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012. There are no changes to these forecasts as at 5.1.21.

Link Group Interest Rate View 9.11.20 (The Capital Economics forecasts were done 11.11.20) These Link forecasts have been amended for the reduction in PWLB margins by 1.0% from 26.11.20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
5 yr PWLB	0.80	0.80	0.80	0.80	0.90	0.90	0.90	0.90	0.90	1.00	1.00	1.00	1.00
10 yr PWLB	1.10	1.10	1.10	1.10	1.20	1.20	1.20	1.20	1.20	1.30	1.30	1.30	1.30
25 yr PWLB	1.50	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.70	1.80	1.80	1.80	1.80
50 yr PWLB	1.30	1.40	1.40	1.40	1.40	1.50	1.50	1.50	1.50	1.60	1.60	1.60	1.60
Bank Rate													
Link	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Capital Economics	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	-	-	-	-	-
5yr PWLB Rate													
Link	0.80	0.80	0.80	0.80	0.90	0.90	0.90	0.90	0.90	1.00	1.00	1.00	1.00
Capital Economics	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	-	-	-	-	-
10yr PWLB Rate													
Link	1.10	1.10	1.10	1.10	1.20	1.20	1.20	1.20	1.20	1.30	1.30	1.30	1.30
Capital Economics	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	-	-	-	-	-
25yr PWLB Rate													
Link	1.50	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.70	1.80	1.80	1.80	1.80
Capital Economics	1.80	1.80	1.80	1.80	1.80	1.80	1.80	1.80	-	-	-	-	-
50yr PWLB Rate													
Link	1.30	1.40	1.40	1.40	1.40	1.50	1.50	1.50	1.50	1.60	1.60	1.60	1.60
Capital Economics	1.70	1.70	1.70	1.70	1.70	1.70	1.70	1.70	-	-	-	-	-

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ECONOMIC BACKGROUND

- **UK.** The key quarterly meeting of the Bank of England Monetary Policy Committee kept **Bank Rate** unchanged on 5.11.20. However, it revised its economic forecasts to take account of a second national lockdown from 5.11.20 to 2.12.20 which is obviously 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 of QE, 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 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
    - The Bank also expected there to be excess demand in the economy by Q4 2022.
    - CPI inflation was therefore projected to be a bit above its 2% target by the start of 2023 and the "inflation risks were judged to be balanced".
- Significantly, there was 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 this time 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 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 and so not a concern.
- However, the minutes did contain several references to **downside risks**. The MPC reiterated that the "recovery would take time, and the risks around the GDP projection were judged to be skewed to the downside". It also said "the risk of a more persistent period of elevated unemployment remained material". Downside risks could well include severe restrictions remaining in place in some form during the rest of December and most of January too. **Upside risks** included the early roll out of effective vaccines.

- **COVID-19 vaccines.** We had been waiting expectantly for news that various COVID-19 vaccines would be cleared as being safe and effective for administering to the general public. The Pfizer announcement on 9th November was very encouraging as its 90% effectiveness was much higher than the 50-60% rate of effectiveness of flu vaccines which might otherwise have been expected. However, this vaccine has demanding cold storage requirements of minus 70c that impairs the speed of application to the general population. It has therefore been particularly welcome that the Oxford

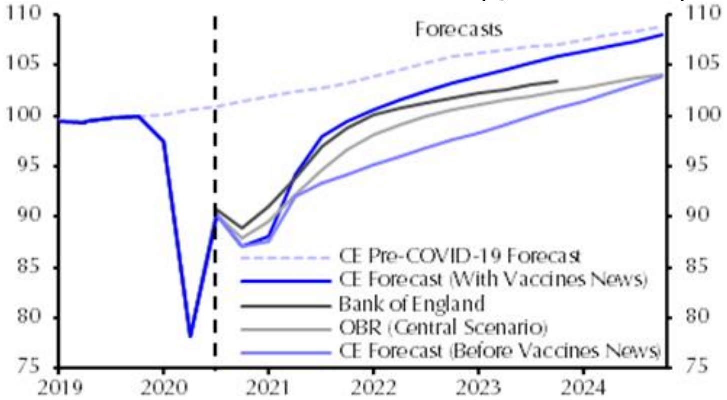
University/AstraZeneca vaccine has now also been approved which is much cheaper and only requires fridge temperatures for storage. The Government has 60m doses on order and is aiming to vaccinate at a rate of 2m people per week starting in January, though this rate is currently restricted by a bottleneck on vaccine production; (a new UK production facility is due to be completed in June).

- These announcements, plus expected further announcements that other vaccines could be approved soon, have enormously boosted confidence that **life could largely return to normal during the second half of 2021**, with activity in the still-depressed sectors like restaurants, travel and hotels returning to their pre-pandemic levels; this would help to bring the unemployment rate down. 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 these services. A comprehensive roll-out of vaccines might take into late 2021 to fully complete; but if these vaccines prove to be highly effective, then there is a possibility that restrictions could start to be eased, beginning possibly in Q2 2021 once vulnerable people and front-line workers have been vaccinated. At that point, there would be less reason to fear that hospitals could become overwhelmed any more. Effective vaccines would radically improve the economic outlook once they have been widely administered; it may allow GDP to rise to its pre-virus level a year earlier than otherwise and mean that the unemployment rate peaks at 7% in 2021 instead of 9%.

- **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. It is likely that the one month national lockdown that started on 5th November, will have caused a further contraction of 8% m/m in November so the economy may have then been 14% below its pre-crisis level.

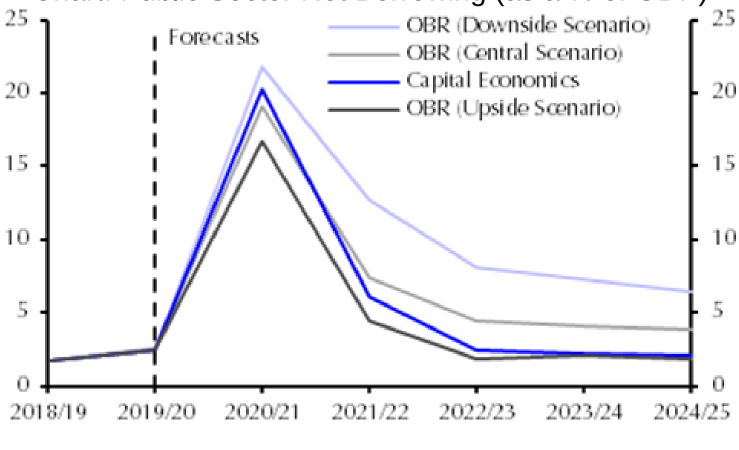
- **December 2020 / January 2021**. Since then, there has been rapid back-tracking on easing restrictions due to the spread of a new mutation of the virus, and severe restrictions were imposed across all four nations. These restrictions were changed on 5.1.21 to national lockdowns of various initial lengths in each of the four nations as the NHS was under extreme pressure. It is now likely that wide swathes of the UK will remain under these new restrictions for some months; this means that the near-term outlook for the economy is grim. However, the distribution of vaccines and the expected consequent removal of COVID-19 restrictions, should allow GDP to rebound rapidly in the second half of 2021 so that the economy could climb back to its pre-pandemic peak as soon as late in 2022. 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 caveat 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 there is a reasonable Brexit deal and also 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.** While the UK has been gripped by the long running saga of whether or not a deal would be made by 31.12.20, the final agreement on 24.12.20, followed by ratification by Parliament and all 27 EU countries in the following week, 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; that 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.

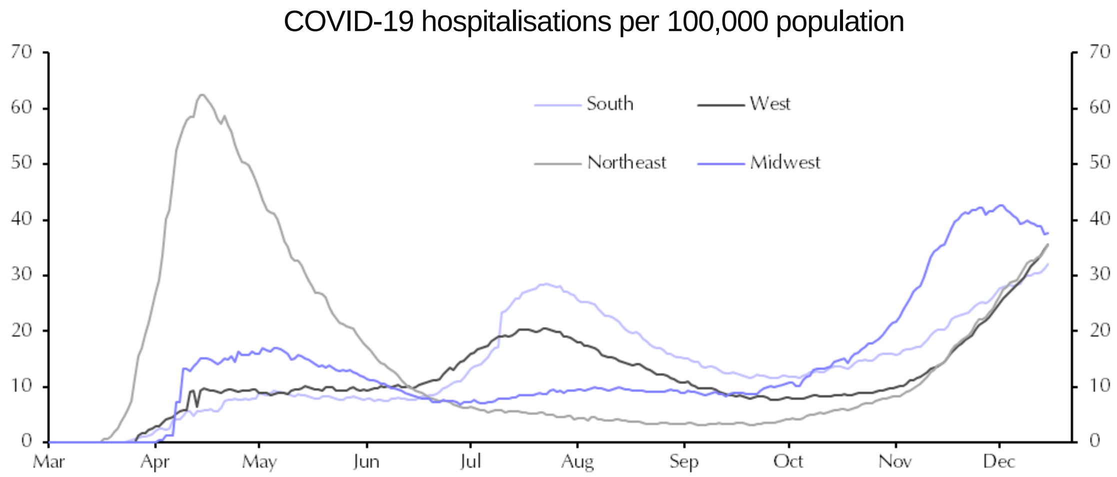
- **Monetary Policy Committee meeting of 17 December.** All nine Committee members voted to keep interest rates on hold at +0.10% and the Quantitative Easing (QE) target at £895bn. The MPC commented that the successful rollout of vaccines had reduced the downsides risks to the economy that it had highlighted 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 the vaccine is a positive development, in the eyes of the MPC at least, the economy is far from out of the woods. As a result of these continued concerns, the MPC voted to extend the availability of the Term Funding Scheme, (cheap borrowing), with additional incentives for small and medium size enterprises for six months from 30.4.21 until 31.10.21. (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.
  - The furlough scheme was lengthened from the end of March to the end of April.
  - The Budget on 3.3.21 will lay out the "next phase of the plan to tackle the virus and protect jobs". This does not sound like tax rises are imminent, (which could hold back the speed of economic recovery).

- The **Financial Policy Committee** (FPC) report on 6.8.20 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 result of **the November elections** meant that while the Democrats gained the presidency and a majority in the House of Representatives, it looks as if the Republicans could retain their slim majority in the Senate provided they keep hold of two key seats in Georgia in elections in early January. If those two seats do swing to the Democrats, they will then control both Houses and President Biden will consequently have a free hand to determine policy and to implement his election manifesto.

- **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. While the first wave in March and April was concentrated in the Northeast, and the second wave in the South and West, the third wave in the Midwest looks as if it now abating. However, it also looks as if the virus is rising again in the rest of the country. 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, 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 retail sales dropping back. The economy is set for further weakness in December and into the spring. However, a $900bn fiscal stimulus deal passed by Congress in late December will limit the downside through measures which included a second round of direct payments to households worth $600 per person and a three-month extension of enhanced unemployment insurance (including a $300 weekly top-up payment for all claimants). 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; long-term bond yields duly rose after the meeting. The FOMC’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 are 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 affected many countries: it is likely to hit hardest those countries more dependent on tourism. 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 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 will have been in recession in 2020. 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 and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last 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 in their economies.

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

INTEREST RATE FORECASTS

Brexit. The interest rate forecasts provided by Link 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. Brexit may reduce the economy's potential growth rate in the long run. However, much of that 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 in the economy.
- **UK - 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. 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 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 extent of credit losses resultant of 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. The CDU has done badly in subsequent state elections but the SPD has done particularly badly. 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.** Austria, Sweden, Spain, 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 Bank Rate to stifle inflation.

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