Report to: **Policy and Resources Committee, 16th November 2021**

Report of: **Head of Finance**

Subject: TREASURY MANAGEMENT MID-YEAR REPORT 2021/22

Recommendation

That the Committee notes the contents of the Mid-Year Report in accordance with the CIPFA Code of Practice on Treasury Management in the Public Services, and the Prudential Code for Capital Finance.

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1. Introduction

The Council has adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires it to approve treasury management semi-annual and annual reports.

The Council's treasury management strategy for 2021/22 was approved at a full Council meeting on 23rd February 2021. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk is therefore central to the Council's treasury management strategy.

The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Council's Capital Strategy, complying with CIPFA's requirement, was also approved by full Council on 23rd February 2021.

2. External Context

2.1 Economic background

The economic recovery from coronavirus pandemic continued to dominate the first half of the financial year. By the end of the period over 48 million people in the UK had received their first dose of a COVID-19 vaccine and almost 45 million their second dose.

The Bank of England (BoE) held Bank Rate at 0.1% throughout the period and maintained its Quantitative Easing programme at £895 billion, unchanged since the November 2020 meeting. In its September 2021 policy announcement, the BoE noted it now expected the UK economy to grow at a slower pace than was predicted in August, as the pace of the global recovery had shown signs of slowing and there were concerns inflationary pressures may be more persistent. Within the announcement, Bank expectations for GDP growth for the third (calendar) quarter were revised down to 2.1% (from 2.9%), in part reflecting tighter supply conditions. The path of CPI inflation is now expected to rise slightly above 4% in the last three months of 2021, due to higher energy prices and core goods inflation. While the Monetary Policy Committee meeting ended with policy rates unchanged, the tone was more hawkish.

Government initiatives continued to support the economy over the quarter but came to an end on 30th September 2021, with businesses required to either take back the 1.6 million workers on the furlough scheme or make them redundant.

The latest labour market data showed that in the three months to July 2021 the unemployment rate fell to 4.6%. The employment rate increased, and economic activity rates decreased, suggesting an improving labour market picture. Latest data showed growth in average total pay (including bonuses) and regular pay (excluding bonuses) among employees was 8.3% and 6.3% respectively over the period. However, part of the robust growth figures is due to a base effect from a decline in average pay in the spring of last year associated with the furlough scheme.

Annual CPI inflation rose to 3.2% in August, exceeding expectations for 2.9%, with the largest upward contribution coming from restaurants and hotels. The Bank of England now expects inflation to exceed 4% by the end of the calendar year owing largely to developments in energy and goods prices. The Office of National Statistics' (ONS') preferred measure of CPIH which includes owner-occupied housing was 3.0% year/year, marginally higher than expectations for 2.7%.

The easing of restrictions boosted activity in the second quarter of calendar year, helping push GDP up by 5.5% q/q (final estimate vs 4.8% q/q initial estimate). Household consumption was the largest contributor. Within the sector breakdown production contributed 1.0% q/q, construction 3.8% q/q and services 6.5% q/q, taking all of these close to their pre-pandemic levels.

2.2 Financial markets

Monetary and fiscal stimulus together with rising economic growth and the ongoing vaccine rollout programmes continued to support equity markets over most of the period, albeit with a bumpy ride towards the end. The Dow Jones hit another record high while the UK-focused FTSE 250 index continued making gains over pre-pandemic levels. The more internationally focused FTSE 100 saw more modest gains over the period and remains below its pre-crisis peak.

Inflation worries continued during the period. Declines in bond yields in the first quarter of the financial year suggested bond markets were expecting any general price increases to be less severe, or more transitory, that was previously thought. However, an increase in gas prices in the UK and EU, supply shortages and a dearth of HGV and lorry drivers with companies willing to pay more to secure their services, has caused problems for a range of industries and, in some instance, lead to higher prices.

2.3 Credit Review

Over the period Fitch and Moody's upwardly revised to stable the outlook on a number of UK banks and building societies on our counterparty list, recognising their improved capital positions compared to last year and better economic growth prospects in the UK.

Fitch also revised the outlooks for Nordea, Svenska Handelsbanken and Handelsbanken plc to stable from negative. The rating agency considered the improved economic prospects in the Nordic region to have reduced the baseline downside risks it previously assigned to the lenders.

The successful vaccine rollout programme is credit positive for the financial services sector in general and the improved economic outlook has meant some institutions have been able to reduce provisions for bad loans. While there is still uncertainty around the full extent of the losses banks and building societies will suffer due to the pandemic-related economic slowdown, the sector is in a generally better position now compared to earlier this year and 2020.

At the end of the period Arlingclose had completed its full review of its credit advice on unsecured deposits. The outcome of this review included the addition of NatWest Markets plc to the counterparty list together with the removal of the suspension of Handelsbanken plc. In addition, the maximum duration for all recommended counterparties was extended to 100 days.

As ever, the institutions and durations on the Council's counterparty list recommended by treasury management advisors Arlingclose remain under constant review.

3. Local Context

On 31st March 2021, the Council had total investments of £16.8m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1 Balance Sheet Summary	**31.03.21 Actual £m**
General Fund CFR	**28.2**
External borrowing	(20.1)
Internal / (over) borrowing	**8.1**
Less: Usable reserves	(29.5)
Less: Working capital	4.6
Total investments	**16.8**

Lower official interest rates have lowered the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

The treasury management position at 30th September 2021 and the change during the period is shown in Table 2 below.

Table 2 Treasury Management Summary	**31.03.21 Balance £m**	**Movement £m**	**30.09.21 Balance £m**
Long-term borrowing	20.1	(0.6)	19.5
Short-term borrowing	0	0	0
Total borrowing	**20.1**	**(0.6)**	**19.5**
Long-term investments	2.7	0	2.7
Short-term investments	15.0	13.6	28.6
Cash and cash equivalents	(0.9)	1.0	0.1
Total investments	**16.8**	**14.6**	**31.4**
Net (borrowing)/investments	**(3.3)**	**15.2**	**11.9**

Please note investment balances are typically at their lowest levels at the end of each financial year and rise significantly during the middle of the year due to cashflow movements.

4. Borrowing Update

Local authorities can borrow from the PWLB provided they can confirm they are not planning to purchase 'investment assets primarily for yield' in the current or next two financial years, with confirmation of the purpose of capital expenditure from the Section 151 Officer. Authorities that are purchasing or intending to purchase investment assets primarily for yield will not be able to access the PWLB except to refinance existing loans or externalise internal borrowing.

Acceptable use of PWLB borrowing includes service delivery, housing, regeneration, preventative action, refinancing and treasury management.

Competitive market alternatives may be available for authorities with or without access to the PWLB. However, the financial strength of the individual authority and borrowing purpose will be scrutinised by commercial lenders. Further changes to the CIPFA Prudential Code expected in December 2021 are likely to prohibit borrowing for the primary purpose of commercial return even where the source of borrowing is not the PWLB.

The Council is not planning to purchase any investment assets primarily for yield within the next three years and so is able to fully access the PWLB.

Revised PWLB Guidance:

HM Treasury published further guidance on PWLB borrowing in August 2021 providing additional detail and clarifications predominantly around the definition of an 'investment asset primarily for yield'. The principal aspects of the new guidance are:

- Capital expenditure incurred or committed to before 26th November 2020 is allowable even for an 'investment asset primarily for yield'.
- Capital plans should be submitted by local authorities via a DELTA return. These open for the new financial year on 1st March and remain open all year. Returns must be updated if there is a change of more than 10%.
- An asset held primarily to generate yield that serves no direct policy purpose should not be categorised as service delivery.
- Further detail on how local authorities purchasing investment assets primarily for yield can access the PWLB for the purposes of refinancing existing loans or externalising internal borrowing.
- Additional detail on the sanctions can be imposed for inappropriate use of the PWLB loan. These can include a request to cancel projects, restrictions to accessing the PLWB and requests for information on further plans.

Changes to PWLB Terms and Conditions from 8th September 2021:

The settlement time for a PWLB loan has been extended from two workings days (T+2) to five working days (T+5). In a move to protect the PWLB against negative interest rates, the minimum interest rate for PWLB loans has also been set at 0.01% and the interest charged on late repayments will be the higher of Bank of England Base Rate or 0.1%.

Municipal Bonds Agency (MBA):

The MBA is working to deliver a new short-term loan solution, available in the first instance to principal local authorities in England, allowing them access to short-dated, low rate, flexible debt. The minimum loan size is expected to be £25 million. Importantly, local authorities will borrow in their own name and will not cross guarantee any other authorities.

If the Authority intends future borrowing through the MBA, it will first ensure that it has thoroughly scrutinised the legal terms and conditions of the arrangement and is satisfied with them.

UK Infastructure Bank:

£4bn has been earmarked for of lending to local authorities by the UK Infrastructure Bank which is wholly owned and backed by HM Treasury. The availability of this lending to local authorities, for which there will be a bidding process, is yet to commence. Loans will be available for qualifying projects at gilt yields plus 0.6%, which is 0.2% lower than the PWLB certainty rate.

5. Borrowing Strategy

As at 30th September 2021 the Council held £19.5m of external loans, a reduction of £0.6m from 31st March 2021, as part of its strategy for funding previous years' capital programmes. Outstanding loans on 30th September 2021 are summarised in Table 3 below.

Table 3 Borrowing Position	**31.03.21 Balance £m**	**Net Movement £m**	**30.09.21 Balance £m**	**Weighted Average Rate %**
6 x PWLB (Maturity)	2.2	0	2.2	4.6
2 x PWLB (Annuity)	12.9	(0.6)	12.3	1.5
1 x LOBO Loan	5.0	0	5.0	4.5
Local Authorities (Short-term)	0	0	0	N/A
Total borrowing	**20.1**	**(0.6)**	**19.5**	**2.7**

The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

In keeping with these objectives, no new borrowing has been undertaken since the start of the financial year, while £606k of principal on the Councils two Annuity loans has been paid down. This strategy enabled the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

With short-term interest rates remaining much lower than long-term rates and with surplus of liquidity continuing to feature in the LA to LA market, the Council considers it to be more cost effective in the near term to use internal resources or borrow rolling temporary / short-term loans from Local Authorities for the remainder of the financial year if required.

The Council has an increasing CFR due to the capital programme and an estimated future borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital. However current cashflow projections for 2021/22 suggest further borrowing will not be necessary.

PWLB funding margins have lurched quite substantially and there remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields plus 0.80%. The Council will evaluate all available options at the point of need with its advisors.

LOBO loans: The Council continues to hold a £5m LOBO (Lender's Option Borrowers Option) loan where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. The lender did not exercise their option during the period and remains unlikely to do so going forward due to the current economic conditions.

6. Treasury Investment Activity

The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the six-month period, the Council's principal investment balances ranged between £10.0m and £41.5m due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4 Treasury Investment Position	**31.03.21 Balance £m**	**Net Movement £m**	**30.09.21 Balance £m**	**30.09.21 Average Rate of Return %**
Banks (unsecured)	(0.9)	1.0	0.1	N/A
Covered bonds (secured)	0	0	0	N/A
DMO (Central Government)	15.0	4.6	19.6	0.01
Local Authorities	0	0	0	N/A
Corporate Bonds	0	0	0	N/A
Money Market Funds	0	9.0	9.0	0.01
Property Funds	2.7	0	2.7	3.70
Total investments	**16.8**	**14.6**	**31.4**	

Both the CIPFA code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

Ultra-low short-dated cash rates which have been a feature since March 2020 when Bank Rate was cut to 0.1% have resulted in the return on sterling low volatility net asset value money market funds (LVNAV MMFs) being close to zero even after some managers have temporarily waived or lowered their fees. At this stage net negative returns are not the central case of most MMF managers over the short-term, and fee cuts or waivers should result in MMF net yields having a floor of zero, but the possibility cannot be ruled out.

Deposit rates with the Debt Management Account Deposit Facility (DMADF) are also largely around zero.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

Table 5 Investment Benchmarking	**Credit Score**	**Credit Rating**	**Bank Bail-in exposure**	**Weighted Average Maturity (days)**	**Total Average Rate of Return %**
Worcester City					
31.03.2021	3.67	AA-	0%	9	0.55
30.09.2021	4.00	AA-	31%	1	0.42
Similar Las 30.09.2021	4.66	A+	69%	32	1.20
All LAs 30.09.2021	4.69	A+	69%	10	0.78

Externally Managed Pooled Funds: £3m of the Council's investments are held in an externally managed pooled property fund (CCLA) where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. This fund is currently generating an average income return of 3.70% which is used to support services in year. The investment has incurred an unrealised capital loss of £0.3m since inception.

The improved market sentiment in the past 6 months is reflected in equity, property and multi-asset fund valuations and, in turn, in the capital values of the Council's portfolio.

Because the Council's externally managed funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's medium to long-term investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three- to five-year period total returns will exceed cash interest rates.

The Council has budgeted £120,000 of income from this investment in 2021/22, which is based on an assumed return of 4%.

7. <u>Non-Treasury Investments</u>

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council hold primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

The Council currently holds investments in directly owned property as follows:

Offices	£13,120,000
Industrial Units	£4,318,650
Perdiswell Bowling Centre	£420,000
Shambles Market Hall	£406,000
Miscellaneous/Other Land	£137,300
	£18,401,950

After taking into account direct costs (repair and maintenance costs, management costs and current costs of borrowing) these investments will generate the following amounts of investment income for 2021-22:

Offices	£432,130
Industrial Units	£183,100
Perdiswell Bowling Centre	£14,500
Shambles Market Hall	£31,554
Miscellaneous/Other Land	£9,850
	£671,134

The estimated overall rate of return for 2021-22 is 3.65%.

Please note the Council made a £10.2m property acquisition in early April 2019. It is currently being partly funded from the Council's internal resources (generally referred to as internal borrowing) and partly by £7m of PWLB borrowing which was taken out in March 2021. If the Council's overall levels of reserves and working capital position begin to reduce, it may be required to externalise borrowing further, therefore rates of return are likely to reduce in future years.

In addition, the Council made a second £5.8m property acquisition in April 2020 which is currently being funded entirely from internal borrowing. Again, as the Council is likely to not be in a position to fund the acquisition indefinitely from internal resources it may need to externalise this at some point in the future.

8. Interest Performance

The Council measures the financial performance of its treasury management activities in terms of its impact on the revenue budget, as shown in table 6 below.

Table 6 Interest Performance	**2021/22 Budget £000**	**2021/22 Forecast Year End Position £000**	**2021/22 Forecast Year End Variance £000**
LOBO loan	225	225	0
PWLB Maturity loans	100	100	0
PWLB Annuity loans	361	193	(168)
Total interest (borrowing)	**686**	**518**	**(168)**
LT Investments (CCLA Property Fund)	(120)	(120)	0
Short-term Investments	(50)	(2)	48
Total interest (investments)	**(170)**	**(122)**	**48**
Total net interest	**516**	**396**	**(120)**

The interest payable budget incorporated external borrowing of £16.0m relating to the Property Development Fund, however increasing levels of reserves have dictated that only £7.0m has been required so far to date. This new PWLB loan was taken out in March 2021. This temporary reduction in borrowing requirement has produced the £168,000 surplus above. No further external borrowing is predicted this financial year however once levels of reserves begin to fall this situation is subject to change.

Interest earned from short-dated investments will be lower than predicted due to the on-going Covid pandemic and current market conditions. This has resulted in a predicted shortfall of £48,000. Base rate is predicted to remain at 0.10% throughout 2021/22 however returns on almost all types of short-dated investments are currently yielding only 0.01%.

9. Compliance

The Head of Finance reports that all treasury management activities undertaken during the first two quarters of the financial year complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below.

Table 7 Debt Limits	**Maximum Q1 & Q2 £m**	**30.09.21 Actual £m**	**2021/22 Operational Boundary £m**	**2021/22 Authorised Limit £m**	**Complied**
Borrowing	20.1	19.5	43.5	49.0	Yes
PFI and Finance Leases	0	0	0	0	N/A
Total debt	**20.1**	**19.5**	**43.5**	**49.0**	**Yes**

Since the operational boundary is a management tool for in-year monitoring, it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure. However total debt did not rise above the operational boundary during the six-month period.

Compliance with specific investment limits is demonstrated in table 8 below.

Table 8 Investment Limits	**Maximum Actual up to 30.09.21 £m**	**2021/22 Limit £m**	**Complied**
Any single organisation, except UK Government	2.0	2.0	Yes
UK Central Government	29.5	Unlimited	Yes
UK Local Government	0	3.0	Yes
Any group of organisations under the same ownership	3.0	3.0	Yes
Any group of pooled funds under the same management	3.0	3.0	Yes

Negotiable instruments held in a broker's account	0	6.0	Yes
Limit per non-UK country	0	3.0	Yes
Registered Providers	0	3.0	Yes
Unsecured investments with building societies	0	N/A	Yes
Loans to unrated corporates	0	N/A	Yes
Money Market Funds (including Property Funds)	12.0	12.0	Yes
Real Estate Investment Trusts	0	3.0	Yes

10. Treasury Management Indicators

The Council measures and manages its exposures to treasury management risks using the following indicators.

10.1 Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2 etc.) and taking arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	30.09.21 Actual	**2021/22 Target**	**Complied**
Portfolio average credit rating	AA-	AA-	Yes

10.2 Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing.

	30.09.21 Actual £m	**2021/22 Target £m**	**Complied**
Total cash available within 3 months	28.6	5.0	Yes

10.3 Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	30.09.21 Actual	**Upper Limit**	**Lower Limit**	**Complied**
Under 12 months	33%	100%	0%	Yes

12 months and within 24 months	7%	100%	0%	Yes
24 months and within 5 years	18%	100%	0%	Yes
5 years and within 10 years	42%	100%	0%	Yes
10 years and above	0%	100%	0%	Yes

Time periods start in the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender could demand payment. LOBO option dates are treated as potential repayment dates, the next being 3rd December 2021.

10.4 Principal Sums Invested for Periods Longer than 365 days: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2021/22	**2022/23**	**2023/24**
Actual principal invested beyond year end	£3m	£3m	£3m
Limit on principal invested beyond year end	£6m	£6m	£6m
Complied	Yes	Yes	Yes

<u>Revisions to CIPFA Codes:</u>

In February 2021 CIPFA launched two consultations on changes to its Prudential Code and Treasury Management Code of Practice. These followed the Public Accounts Committee's recommendation that the prudential framework should be further tightened following continued borrowing by some authorities for investment purposes. In June, CIPFA provided feedback from this consultation.

In September CIPFA issued the revised Codes and Guidance Notes in draft form and opened the latest consultation process on their proposed changes. The changes include:

- Clarification that (a) local authorities must not borrow to invest primarily for financial return (b) it is not prudent for authorities to make any investment or spending decision that will increase the Capital Financing Requirement, and so may lead to new borrowing, unless directly and primarily related to the functions of the authority.
- Categorising investments as those (a) for treasury management purposes, (b) for service purposes and (c) for commercial purposes.
- Defining acceptable reasons to borrow money: (i) financing capital expenditure primarily related to delivering a local authority's functions, (ii) temporary management of cash flow within the context of a balanced budget, (iii) securing affordability by removing exposure to future interest rate rises and (iv) refinancing current borrowing, including replacing internal borrowing.
- For service and commercial investments, in addition to assessments of affordability and prudence, an assessment of proportionality in respect of the authority's overall

financial capacity (i.e. whether plausible losses could be absorbed in budgets or reserves without unmanageable detriment to local services).

Prudential Indicators:

- New indicator for net income from commercial and service investments to the budgeted net revenue stream.
- Inclusion of the liability benchmark as a mandatory treasury management prudential indicator. CIPFA recommends this is presented as a chart of four balances – existing loan debt outstanding; loans CFR, net loans requirement, liability benchmark – over at least 10 years and ideally cover the authority's full debt maturity profile.
- Excluding investment income from the definition of financing costs.
- Incorporating ESG issues as a consideration within TMP 1 Risk Management.
- Additional focus on the knowledge and skills of officers and elected members involved in decision making

MHCLG Improvements to the Capital Finance Framework:

MHCLG published a brief policy paper in July outlining the ways it feels that the current framework is failing and potential changes that could be made. The paper found that "while many authorities are compliant with the framework, there remain some authorities that continue to engage in practices that push the bounds of compliance and expose themselves to excessive risk".

The actions announced include greater scrutiny of local authorities and particularly those engaged in commercial practices; an assessment of governance and training; a consideration of statutory caps on borrowing; further regulations around Minimum Revenue Provision (MRP) and ensuring that MHCLG regulations enforce guidance from CIPFA and the new PWLB lending arrangements.

A further consultation on these matters is expected soon.

11. Outlook for the remainder of 2021/22

Arlingclose expects Bank Rate to rise in Q2 2022. We believe this is driven as much by the Bank of England's desire to move from emergency levels as by fears of inflationary pressure.

Investors have priced in multiple rises in Bank Rate to 1% by 2024. While Arlingclose believes Bank Rate will rise, it is by a lesser extent than expected by markets.

The global economy continues to recover from the pandemic but has entered a more challenging phase. The resurgence of demand has led to the expected rise in inflationary pressure, but disrupted factors of supply are amplifying the effects, increasing the likelihood of lower growth rates ahead. This is particularly apparent in the UK due to the impact of Brexit.

While Q2 UK GDP expanded more quickly than initially thought, the 'pingdemic' and more latterly supply disruption will leave Q3 GDP broadly stagnant. The outlook also appears weaker. Household spending, the driver of the recovery to date, is under pressure from a combination of retail energy price rises, the end of government support programmes and soon, tax rises. Government spending, the other driver of recovery, will slow considerably as the economy is taken off life support.

Inflation rose to 3.2% in August. A combination of factors will drive this to over 4% in the near term. While the transitory factors affecting inflation, including the low base effect of 2020, are expected to unwind over time, the MPC has recently communicated fears that these transitory factors will feed longer-term inflation expectations that require tighter monetary policy to control. This has driven interest rate expectations substantially higher. The supply imbalances are apparent in the labour market. While wage growth is currently elevated due to compositional and base factors, stories abound of higher wages for certain sectors, driving inflation expectations. It is uncertain whether a broad-based increased in wages is possible given the pressures on businesses.

Government bond yields increased sharply following the September FOMC and MPC minutes, in which both central banks communicated a lower tolerance for higher inflation than previously thought. The MPC in particular has doubled down on these signals in spite of softer economic data. Bond investors expect higher near-term interest rates but are also clearly uncertain about central bank policy.

The MPC appears to be playing both sides, but has made clear its intentions to tighten policy, possibly driven by a desire to move away from emergency levels. While the economic outlook will be challenging, the signals from policymakers suggest Bank Rate will rise unless data indicates a more severe slowdown.

Latest Bank Rate Forecast:

	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Official Bank Rate													
Upside risk	0.00	0.15	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Case	0.10	0.10	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk	0.00	0.00	0.15	0.15	0.15	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40

Ward(s): **All**
Contact Officer: **Mark Baldwin – Tel 01905 722007**
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Background Papers: **None**