Agenda Item	**10.b**
Report No	**RES/41/21**

HIGHLAND COUNCIL

Committee: Corporate Resources Committee

Date: 24 November 2021

Report Title: **Mid-Year Treasury Management Report 2021/22**

Report By: Executive Chief Officer, Resources and Finance

1. Purpose/Executive Summary

1.1 This report is the mid-year treasury management review for the financial year 2021/22 which is prepared in compliance with the Chartered Institute of Public Finance and Accountancy's (CIPFA) revised Code of Practice on Treasury Management in Local Authorities.

1.2 The report highlights the Council's treasury management activities undertaken, provides a commentary on the year to 30 September 2021 and compares activity to the expected activities contained in the annual Treasury Management Strategy Statement and Investment Statement (TMSS) which was approved by Corporate Resources Committee on 25 February 2021.

1.3 This Treasury Management Mid-Year Review 2021/22 is submitted to the Committee for consideration.

1.4 The Prudential Code also requires the Council to report the actual prudential indicators after the financial year end and these are shown as at 30 September 2021 in **Appendix 1.**

2. Recommendations

2.1 Members are asked to:

i. Consider the Treasury Management Mid-Year Review 2021/22.

3. Implications

3.1 Resource – Loan charges are forecast to be in line with the budget provision. However, this figure depends on the level of capital expenditure undertaken during the rest of the financial year and market interest rates for short-term borrowing and deposits which will continue to be monitored.

3.2 Due to high levels of economic uncertainty there is a risk that any approach the Council takes to its borrowing may not correctly anticipate future market movements. By historic standards all borrowing opportunities are at very low interest rates.

3.3 Other Treasury management risk considerations are:

- Volatility on PWLB/borrowing rates caused by economic uncertainty.
- Managing cashflows in an uncertain environment due to the impact of COVID-19 with unexpected receipts and expenditure.
- Wider funding considerations such as reductions in grants/contributions will impact budget and borrowing plans.
- Potential credit risk/uncertainty to UK Banks and interest rates. The Governor of the Bank of England has highlighted risks to economic growth due to COVID-19 and the BoE will take action to manage those risks (monetary stimulus/rate changes to support the economy).

3.4 There are no Legal, Equalities; Climate Change/Carbon Clever; Gaelic or Community (Equality, Poverty and Rural) implications relating this report.

4. Background

4.1 Treasury Management is defined as: "*The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities and the pursuit of optimum performance consistent with those risks*".

4.2 This report has been written in accordance with the requirements of the CIPFA Code of Practice on Treasury Management (revised 2017). The primary requirements of the code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the Council of an Annual Strategy Report for the year ahead, a mid–year report and an Annual Review Report of the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management policies to a specific named body, which in this Council is the Corporate Resources Committee.

4.3 This Treasury Management Mid-Year Review 2021/22 covers the following:

- An economic update for the first six months of 2021/22, provided by the Council's Treasury Advisers, Link Group
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- A review of the Council's capital expenditure (prudential indicators)
- A review of the Council's investment portfolio for 2021/22
- A review of the Council's borrowing strategy for 2021/22
- A review of any debt rescheduling undertaken during 2021/22
- A review of compliance with Treasury and Prudential Limits for 2021/22

5. Economic update (provided by Link Group)

5.1 The Council has appointed Link Group as treasury adviser to the Council and part of their service is to assist the Council to formulate a view on interest rates. **Appendix 2** provides an economic update from Link Group.

5.2 The coronavirus outbreak has caused huge economic damage to the UK and economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings. As shown in the forecast table below, an increase in Bank Rate from 0.10% to 0.25% has now been included in quarter 2 of 2022/23, a second increase to 0.50% in quarter 2 of 23/24 and a third one to 0.75% in quarter 4 of 23/24.

5.3 The Council's treasury advisor, Link Group, provided the following forecasts on 29 September 2021 (PWLB rates are certainty rates: gilt yields plus 80bps):

Link Group Interest Rate View	29.9.21								
	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
BANK RATE	0.10	0.10	0.25	0.25	0.25	0.25	0.50	0.50	0.50
3 month ave earnings	0.10	0.10	0.20	0.20	0.30	0.40	0.50	0.50	0.60
6 month ave earnings	0.20	0.20	0.30	0.30	0.40	0.50	0.60	0.60	0.70
12 month ave earnings	0.30	0.40	0.50	0.50	0.50	0.60	0.70	0.80	0.90
5 yr PWLB	1.40	1.40	1.50	1.50	1.60	1.60	1.60	1.70	1.70
10 yr PWLB	1.80	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10
25 yr PWLB	2.20	2.20	2.30	2.30	2.40	2.40	2.40	2.50	2.50
50 yr PWLB	2.00	2.00	2.10	2.20	2.20	2.20	2.20	2.30	2.30

Additional notes by Link Group on this forecast table:

- LIBOR and LIBID rates will cease from the end of 2021. Work is currently progressing to replace LIBOR with a rate based on SONIA (Sterling Overnight Index Average). In the meantime, our forecasts are based on expected average earnings by local authorities for 3 to 12 months.
- Our forecasts for average earnings are averages i.e., rates offered by individual banks may differ significantly from these averages, reflecting their different needs for borrowing short term cash at any one point in time.

5.4 Significant risks to the forecasts include the following

- COVID-19 vaccines do not work to combat new mutations and/or new vaccines take longer than anticipated to be developed for successful implementation.
- The pandemic causes major long-term damage to the economy.
- The Government implements an austerity programme that supresses GDP growth.
- The MPC tightens monetary policy too early – by raising Bank Rate or unwinding QE; or tightens monetary policy too late to ward off building inflationary pressures.
- Major stock markets e.g. in the US, become increasingly judged as being over-valued and susceptible to major price corrections. Central banks become increasingly exposed to the “moral hazard” risks of having to buy shares and corporate bonds to reduce the impact of major financial market sell-offs on the general economy.
- Geo-political risks are widespread e.g. German general election in September 2021 produces an unstable coalition or minority government and a void in high-profile leadership in the EU when Angela Merkel steps down as Chancellor of Germany; on-going global power influence struggles between Russia/China/US.

5.6 The overall balance of risks to economic growth in the UK is now to the downside, including residual risks from COVID-19 and its variants - both domestically and their potential effects worldwide.

5.7 **Forecasts for Bank Rate**

Bank Rate is not expected to go up fast after the initial rate rise as the supply potential of the economy has not generally taken a major hit during the pandemic, so should be able to cope well with meeting demand without causing inflation to remain elevated in the medium-term, or to inhibit inflation from falling back towards the MPC’s 2% target after the surge to around 4% towards the end of 2021. Three increases in Bank rate are forecast in the period to March 2024, ending at 0.75%. However, these forecasts may well need changing within a relatively short time frame for the following reasons:

- Grounds for viewing the economic recovery as running out of steam during the summer and now into the autumn. This could lead into stagflation which would create a dilemma for the MPC when deciding on Bank Rate.
- Rising gas and electricity prices in October and next April and increases in other prices caused by supply shortages and increases in taxation next April, are going to deflate consumer spending power without the MPC having to take any action on Bank Rate to cool inflation.
- On the other hand, consumers are sitting on around £200bn of excess savings which could increase demand.
- There are 1.6 million people coming off furlough at the end of September; how many of those will, be available to fill labour shortages in many sectors of the economy? It could follow that supply shortages which have been driving up both wages and costs, could reduce significantly within the next six months or so and alleviate the MPC’s current concerns.
- There is a risk that there could be further Covid-19 impacts, on top of the flu season this winter, which could depress economic activity.

In summary, with the high level of uncertainty prevailing on several different fronts, it is likely that these forecasts will need to be revised again soon - in line with what the current news is.

It also needs to be considered that Bank Rate being cut to 0.10% was an emergency measure to deal with the Covid crisis hitting the UK in March 2020. At any time, the MPC could decide to simply take away that final emergency cut from 0.25% to 0.10% on the grounds of it no longer being warranted and as a step forward in the return to normalisation. In addition, any Bank Rate under 1% is both highly unusual and highly supportive of economic growth.

6. Treasury Management Strategy Statement and Annual Investment Strategy update

6.1 The Treasury Management Strategy Statement (TMSS) for 2021/22 was approved by Corporate Resources Committee on 25 February 2021. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as security of capital, liquidity and then yield.

6.2 The investment portfolio yield for the first six months of the year was an average rate of 0.08% (2020/21 0.22%) against a benchmark (7 Day London Inter-bank Offer Rate – LIBID average) of -0.08%.

6.3 The daily average level of funds available for investment purposes in the first six months of 2021/22 was £99.4m (2020/21 £112.3m). These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of council tax payments, receipt of grants and progress of the capital programme.

6.4 In line with the investment strategy, the Council will only place deposits with counterparties with a high creditworthiness. The forecasts in section 5.3 demonstrate that it is a very difficult investment market at present. It is now impossible to earn the level of interest seen previously as all investment rates are barely above zero now that Bank Rate is at 0.10%. 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 30 June 2022, investment returns are expected to remain low.

6.5 As for money market funds (MMFs), yields have continued to drift lower. Fund managers have reduced fee levels to ensure that net yields for investors remain in positive territory where possible and practical. Investor cash flow uncertainty, and the need to maintain liquidity in these unprecedented times, has meant greater amounts at the very short end of the market. This has seen a number of market operators, offer nil or negative rates for very short-term maturities. It is still the case that some MMFs are still offering a marginally positive return, as are a number of financial institutions.

6.6 The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Council's risk appetite. In the current economic climate, it is considered appropriate to keep investments short term to cover cash flow needs with security and liquidity being the key considerations.

7. New External Borrowing

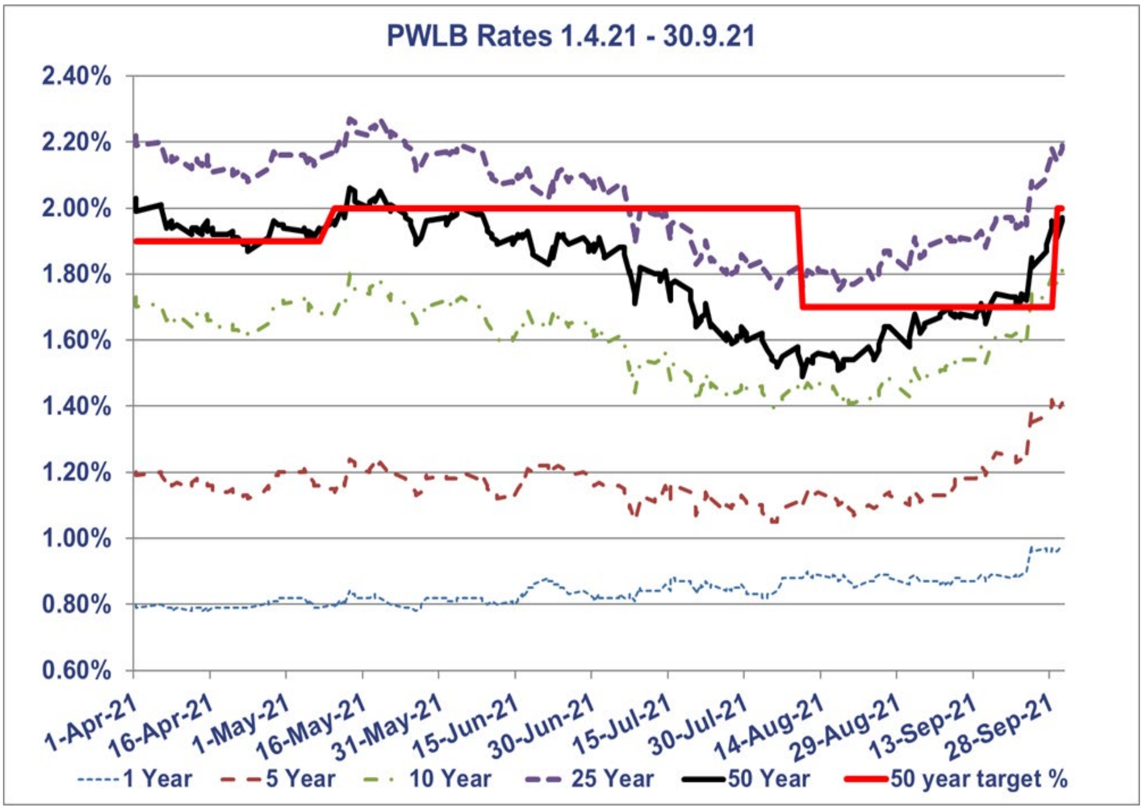
7.1 The Capital Financing Requirement (CFR) represents the accumulated net capital expenditure for the General Fund and Housing Revenue account which the Council requires to fund by way of long-term debt until the capital projects, comprising the CFR, are fully written off by way of annual loan charges to revenue accounts.

7.2 The balance of external and internal borrowing is generally driven by market conditions, and the need to take a balanced view of savings available from short term and internal borrowing, versus the mitigation of re-financing risk which can be achieved from longer-term borrowing, but at potentially higher cost.

7.3 The table below shows the estimated CFR at 31/03/22 and how it is expected to be funded by short-term borrowing and historic long-term borrowing.

	£m
Estimated Capital Financing Requirement (CFR) at 31/03/22 See appendix 1 – indicator 2	1,250.8
Less PPP/NPD	-135.7
Estimated CFR 31/03/22	**1,115.1**
Opening Long Term Debt 01/04/21	832.5
Long term maturities (PWLB)	-7.3
New PWLB loans	60.0
Market Loan repays	-9.0
Estimated Long Term Debt 31/03/22	**876.2**
Opening short term borrowing 01/04/21	131.0
Raised and repaid to 30 Sept 2021	-54.0
Add estimated net borrowing for new capital expenditure and replace maturities in 2021/22 (November to March)	125.9
Estimated Short Term Debt at 31/03/22	**202.9**
Estimated total long term and short-term debt 31/03/22	**1,079.1**
Difference between CFR and borrowing = Funding from internal balances and cash flow	36.0

7.4 The graph and table below show the movement in PWLB rates from 1 April until 30 September incorporating the certainty rate (0.20% discount on rates for local authorities who have applied for rate).



The 50 year PWLB target certainty rate for new long-term borrowing started 2021/22 at 1.90%, rose to 2.00% in May, fell to 1.70% in August and returned to 2.00% at the end of September after the MPC meeting of 23 September.

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.78%	1.05%	1.39%	1.75%	1.49%
Date	08/04/21	08/07/21	05/08/21	17/08/21	10/08/21
High	0.98%	1.42%	1.81%	2.27%	2.06%
Date	24/09/21	28/09/21	28/09/21	13/05/21	13/05/21
Average	0.84%	1.16%	1.60%	2.02%	1.81%

7.5 There was £5m of PWLB borrowing undertaken (rate 1.91%, term 50 years) in June 2021 to finance the capital programme. Borrowing requirements are also currently being funded using short term borrowing.

7.6 It is anticipated that over the remainder of the financial year, there will be further new long-term borrowing to fund the capital programme but this will depend on long-term rates. Decisions will be made using rates and other available market information to achieve optimum value and risk exposure in the long-term. Markets remain volatile, and favourable short-term borrowing opportunities are also likely to continue to be available to the Council. The strategy remains flexible and consideration will be given to the appropriate mix of long and short term borrowing based on prevailing market conditions.

7.7 In consultation with Link Group, the market situation is constantly monitored and borrowing strategies reviewed on a regular basis.

8. Debt rescheduling

8.1 No debt rescheduling was undertaken during the first six months of 2021/22 as there were no cost-effective opportunities.

9. Compliance with Treasury and Prudential Limits

9.1 It is a statutory duty for the Council to determine and keep under review the "Affordable Capital Expenditure Limits". The Council's approved Treasury and Prudential Indicators (affordability limits) are outlined in the approved Treasury Management Strategy Statement (TMSS) agreed on 12 March 2020.

9.2 During the financial year to date the Council has operated within the treasury limits and Prudential Indicators set out in the Council's TMSS and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators are shown in **Appendix 1**, comparing the initial limits agreed for the year, and updated year-end forecasts.

Designation: Executive Chief Officer, Finance and Corporate Resources

Date: 10 November 2021

Author: Edward Foster, Head of Corporate Finance and Commercialism

Background Papers: Treasury Live System and Integra financial ledger

https://www.highland.gov.uk/download/meetings/id/77829/8b_treasury_manag

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Appendix 1

Estimated Treasury Position and Prudential Indicators
Figures are for financial year unless otherwise titled in italics

Prudential Indicator		2021/22 Original £m	2021/22 Revised £m
1.	**Capital expenditure**		
	Gross capital expenditure		
	General Fund including PPP	132.2	103.9
	Housing Revenue Account	48.5	66.7
	Total gross capital expenditure	**180.7**	**170.6**
	Income - General Fund	(51.2)	(24.1)
	Income - HRA	(19.5)	(18.7)
	Total income	**(70.7)**	**(42.8)**
	Net capital expenditure		
	General Fund	81.0	79.8
	HRA	29.0	48.0
	Total net capital expenditure	**110.0**	**127.8**
	Loan charge instalments General Fund	(30.9)	(30.1)
	Loan charge instalments HRA	(11.2)	(11.0)
	Total instalments	**(42.1)**	**(41.1)**
	Net borrowing for new capital expenditure		
	General Fund	50.1	49.7
	HRA	17.8	37.0
	Total net borrowing for new capital expenditure	**67.9**	**86.7**
2.	**Capital Financing Requirement (CFR) at 31 March**		
	General Fund excluding PPP/NPD	773.6	759.8
	Housing Revenue Account	322.7	339.2
	Joint Boards	16.1	16.1
	PPP	135.7	135.7
	Total	**1,248.1**	**1,250.8**

Prudential Indicator		2021/22 Original £m	2021/22 Revised £m
	Treasury Position at 31 March		
	Borrowing – Long term	806.2	876.2
	Borrowing – Short term	270.2	202.9
	Other Long Term Liabilities (PPP/NPD)	135.7	135.7
	Total Debt	**1,212.1**	**1,214.8**
	Investments	50.0	50.0
	Net Borrowing	**1,162.1**	**1,164.8**
3.	**Ratio of financing costs to net revenue stream**		
	General Fund including PPP/NPD	13.1%	13.1%
	Housing Revenue Account	40.7%	40.7%

Prudential Indicator		2021/22 Maximum £m	2021/22 Actual £m
4.	**Authorised Limit for Borrowing**	1,129.4	959.5 (April 2021)
5.	**Operational Boundary for Borrowing**	1,093.4	959.5 (April 2021)
6.	**Interest rate exposures of debt net of investments**		
	Upper Limit (Fixed)	1,112.4	890.0 (June 2021)
	Upper Limit (Variable)	389.3	-39.6* (Sept 2021)
7.	**Maturity structure of fixed rate borrowing (against maximum position)**		
	Under 12 months	30.0%	12.7% (Sept 2021)
	12 months to 2 years	30.0%	3.6% (June 2021)
	2 years to 5 years	40.0%	4.7% (Sept 2021)
	5 years to 10 years	50.0%	14.6% (Sept 2021)
	10 years and above	100.0%	67.7% (Sept 2021)
8.	**Upper limit for the maturing of investments made for periods longer than 364 days**	20.0	Nil
9.	**Short term borrowing as a % of outstanding long-term debt (maximum position)**	25.0%	11.8% (April 2021)
10.	**Variable interest debt as a % of outstanding long-term debt (maximum position)**	35.0%	4.1% (Sept 2021)

*Negative as higher level of investments than variable borrowing

Appendix 2

Economic update (provided by Link Group)

MPC meeting 24/09/2021

- The Monetary Policy Committee (MPC) voted unanimously to leave Bank Rate unchanged at 0.10% and made no changes to its programme of quantitative easing purchases due to finish by the end of this year at a total of £895bn; two MPC members voted to stop the last £35bn of purchases as they were concerned that this would add to inflationary pressures.

- There was a major shift in the tone of the MPC's minutes at this meeting from the previous meeting in August which had majored on indicating that some tightening in monetary policy was now on the horizon, but also not wanting to stifle economic recovery by too early an increase in Bank Rate. In his press conference after the August MPC meeting, Governor Andrew Bailey said, "the challenge of avoiding a steep rise in unemployment has been replaced by that of ensuring a flow of labour into jobs" and that "the Committee will be monitoring closely the incoming evidence regarding developments in the labour market, and particularly unemployment, wider measures of slack, and underlying wage pressures." In other words, it was flagging up a potential danger that labour shortages could push up wage growth by more than it expects and that, as a result, CPI inflation would stay above the 2% target for longer. It also discounted sharp increases in monthly inflation figures in the pipeline in late 2021 which were largely propelled by events a year ago e.g., the cut in VAT in August 2020 for the hospitality industry, and by temporary shortages which would eventually work their way out of the system: in other words, **the MPC had been prepared to look through a temporary spike in inflation.**

- So, in August the country was just put on alert. However, this time the MPC's words indicated there had been a marked increase in concern that more recent increases in prices, particularly the increases in gas and electricity prices in October and due again next April, are, indeed, likely to lead to **faster and higher inflation expectations and underlying wage growth, which would in turn increase the risk that price pressures would prove more persistent next year than previously expected. Indeed, to emphasise its concern about inflationary pressures, the MPC pointedly chose to reaffirm its commitment to the 2% inflation target in its statement;** this suggested that it was now willing to look through the flagging economic recovery during the summer to prioritise bringing inflation down next year. This is a reversal of its priorities in August and a long way from words at earlier MPC meetings which indicated a willingness to look through inflation overshooting the target for limited periods to ensure that inflation was 'sustainably over 2%'. Indeed, whereas in August the MPC's focus was on getting through a winter of temporarily high energy prices and supply shortages, believing that inflation would return to just under the 2% target after reaching a high around 4% in late 2021, now its primary concern is that underlying price pressures in the economy are likely to get embedded over the next year and elevate future inflation to stay significantly above its 2% target and for longer.

- Financial markets are now pricing in a first increase in Bank Rate from 0.10% to 0.25% in February 2022, but this looks ambitious as the MPC has stated that it wants to see what happens to the economy, and particularly to employment once furlough ends at the end of September. At the MPC's meeting in February it will only have available the employment figures for November: to get a clearer picture of employment trends, it would need to wait until the May meeting when it would have data up until February. At its May meeting, it will also have a clearer understanding of the likely peak of inflation.

  - **The MPC's forward guidance on its intended monetary policy** on raising Bank Rate versus selling (quantitative easing) holdings of bonds is as follows: -
    1. Placing the focus on raising Bank Rate as "the active instrument in most circumstances".
    2. Raising Bank Rate to 0.50% before starting on reducing its holdings.
    3. Once Bank Rate is at 0.50% it would stop reinvesting maturing gilts.
    4. Once Bank Rate had risen to at least 1%, it would start selling its holdings.

  - **COVID-19 vaccines.** These have been the game changer which have enormously boosted confidence that **life in the UK could largely return to normal during the summer** after a third wave of the virus threatened to overwhelm hospitals in the spring. With the household saving rate having been exceptionally high since the first lockdown in March 2020, there is plenty of pent-up demand and purchasing power stored up for services in hard hit sectors like restaurants, travel and hotels. The big question is whether mutations of the virus could develop which render current vaccines ineffective, as opposed to how quickly vaccines can be modified to deal with them and enhanced testing programmes be implemented to contain their spread.

Globally, our views are as follows

EU. The slow role out of vaccines initially delayed economic recovery in early 2021 but the vaccination rate has picked up sharply since then. After a contraction in GDP of -0.3% in Q1, Q2 came in with strong growth of 2%, which is likely to continue into Q3, though some countries more dependent on tourism may struggle. Recent sharp increases in gas and electricity prices have increased overall inflationary pressures but the ECB is likely to see these as being only transitory after an initial burst through to around 4%, so is unlikely to be raising rates for a considerable time.
German general election. With the CDU/CSU and SDP both having won around 24-26% of the vote in the September general election, the composition of Germany's next coalition government may not be agreed by the end of 2021. An SDP-led coalition would probably pursue a slightly less restrictive fiscal policy, but any change of direction from a CDU/CSU led coalition government is likely to be small. However, with Angela Merkel standing down as Chancellor as soon as a coalition is formed, there will be a hole in overall EU leadership which will be difficult to fill.

China. After a concerted effort to get on top of the virus outbreak in Q1 2020, economic recovery was strong in the rest of the year; this enabled China to recover all the initial contraction. During 2020, policy makers both quashed the virus and implemented a programme of monetary and fiscal support that was particularly effective at stimulating short-term growth. At the same time, China's economy benefited from the shift towards online spending by consumers in developed markets. These factors helped to explain its comparative outperformance compared to western economies during 2020 and earlier in 2021. However, the pace of economic growth has now fallen back after this initial surge of recovery from the pandemic and China is now struggling to contain the spread of the Delta variant through sharp local lockdowns - which will also depress economic growth. There are also questions as to how effective Chinese vaccines are proving. In addition, recent regulatory actions motivated by a political agenda to channel activities into officially approved directions, are also likely to reduce the dynamism and long-term growth of the Chinese economy.

Japan. 2021 has been a patchy year in combating COVID-19. However, after a slow start, nearly 50% of the population are now vaccinated and COVID-19 case numbers are falling. After a weak Q3 there is likely to be a strong recovery in Q4. The Bank of Japan is continuing its very loose monetary policy but with little prospect of getting inflation back above 1% towards its target of 2%, any time soon: indeed, inflation was negative in July. New Prime Minister Kishida has promised a large fiscal stimulus package after the November general election – which his party is likely to win.

World growth. World growth was in recession in 2020 but recovered during 2021 until starting to lose momentum more recently. Inflation has been rising due to increases in gas and electricity prices, shipping costs and supply shortages, although these should subside during 2022. It is 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, and vice versa. This is likely to reduce world growth rates from those in prior decades.

Supply shortages. The pandemic and extreme weather events have been highly disruptive of extended worldwide supply chains. At the current time there are major queues of ships unable to unload their goods at ports in New York, California and China. Such issues have led to mis-distribution of shipping containers around the world and have contributed to a huge increase in the cost of shipping. Combined with a shortage of semi-conductors, these issues have had a disruptive impact on production in many countries. Many western countries are also hitting up against a difficulty in filling job vacancies. It is expected that these issues will be gradually sorted out, but they are currently contributing to a spike upwards in inflation and shortages of materials and goods on shelves.

Forecasts for PWLB rates and gilt and treasury yields

As the interest forecast table for PWLB certainty rates on page 3 shows, there is likely to be a steady rise over the forecast period, with some degree of uplift due to rising treasury yields in the US.

There is likely to be **exceptional volatility and unpredictability in respect of gilt yields and PWLB rates** due to the following factors:

- How strongly will changes in gilt yields be correlated to changes in US treasury yields?
- Will the Fed take action to counter increasing treasury yields if they rise beyond a yet unspecified level?
- Would the MPC act to counter increasing gilt yields if they rise beyond a yet unspecified level?
- How strong will inflationary pressures turn out to be in both the US and the UK and so impact treasury and gilt yields?
- How will central banks implement their new average or sustainable level inflation monetary policies?
- How well will central banks manage the withdrawal of QE purchases of their national bonds i.e., without causing a panic reaction in financial markets as happened in the "taper tantrums" in the US in 2013?
- Will exceptional volatility be focused on the short or long-end of the yield curve, or both?

The forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU within our forecasting period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China / North Korea and Iran, which have a major impact on international trade and world GDP growth.

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Gilt and treasury yields

Since the start of 2021, there has been a lot of volatility in gilt yields, and hence PWLB rates. During the first part of the year, US President Biden's, and the Democratic party's determination to push through a $1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the COVID-19 pandemic was what unsettled financial markets. However, this was in addition to the $900bn support package already passed in December 2020 under President Trump. This was then followed by additional Democratic ambition to spend further huge sums on infrastructure and an American families plan over the next decade which are caught up in Democrat / Republican haggling. Financial markets were alarmed that all this stimulus, which is much bigger than in other western economies, was happening at a time in the US when: -

1. A fast vaccination programme has enabled a rapid opening up of the economy.
2. The economy had already been growing strongly during 2021.
3. It started from a position of little spare capacity due to less severe lockdown measures than in many other countries. A combination of shortage of labour and supply bottle necks is likely to stoke inflationary pressures more in the US than in other countries.
4. And the Fed was still providing monetary stimulus through monthly QE purchases.

These factors could cause an excess of demand in the economy which could then unleash stronger and more sustained inflationary pressures in the US than in other western countries. This could then force the Fed to take much earlier action to start tapering monthly QE purchases and/or increasing the Fed rate from near zero, despite their stated policy being to target average inflation. It is notable that some Fed members have moved forward their expectation of when the first increases in the Fed rate will occur in recent Fed meetings. In addition, more recently, shortages of workers appear to be stoking underlying wage inflationary pressures which are likely to feed through into CPI inflation. A run of strong monthly jobs growth figures could be enough to meet the threshold set by the Fed of "substantial further progress towards the goal of reaching full employment". However, the weak growth in August, (announced 3.9.21), has spiked anticipation that tapering of monthly QE purchases could start by the end of 2021. These purchases are currently acting as downward pressure on treasury yields. As the US financial markets are, by far, the biggest financial markets in the world, any trend upwards in the US will invariably impact and influence financial markets in other countries. However, during June and July, longer term yields fell sharply; even the large non-farm payroll increase in the first week of August seemed to cause the markets little concern, which is somewhat puzzling, particularly in the context of the concerns of many commentators that inflation may not be as transitory as the Fed is expecting it to be. Indeed, inflation pressures and erosion of surplus economic capacity look much stronger in the US than in the UK. **As an average since 2011, there has been a 75% correlation between movements in 10 year treasury yields and 10 year gilt yields. This is a significant UPWARD RISK exposure to our forecasts for longer term PWLB rates. However, gilt yields and treasury yields do not always move in unison.**

There are also possible **DOWNSIDE RISKS** from the huge sums of cash that the UK populace have saved during the pandemic; when savings accounts earn little interest, it is likely that some of this cash mountain could end up being invested in bonds and so push up demand for bonds and support their prices i.e., this would help to keep their yields down. How this will interplay with the Bank of England eventually getting round to not reinvesting maturing gilts and then later selling gilts, will be interesting to keep an eye on.

The balance of risks to medium to long term PWLB rates: -

- There is a balance of upside risks to forecasts for medium to long term PWLB rates.

A new era – a fundamental shift in central bank monetary policy

One of the key results of the pandemic has been a fundamental rethinking and shift in monetary policy by major central banks like the Fed, the Bank of England and the ECB, to tolerate a higher level of inflation than in the previous two decades when inflation was the prime target to bear down on so as to stop it going above a target rate. There is now also a greater emphasis on other targets for monetary policy than just inflation, especially on 'achieving broad and inclusive "maximum" employment in its entirety' in the US before consideration would be given to increasing rates.

- The Fed in America has gone furthest in adopting a monetary policy based on a clear goal of allowing the inflation target to be symmetrical, (rather than a ceiling to keep under), so that inflation averages out the dips down and surges above the target rate, over an unspecified period of time.
- The Bank of England has also amended its target for monetary policy so that inflation should be 'sustainably over 2%' and the ECB now has a similar policy.
- ***For local authorities, this means that investment interest rates and very short term PWLB rates will not be rising as quickly or as high as in previous decades when the economy recovers from a downturn and the recovery eventually runs out of spare capacity to fuel continuing expansion.***
- Labour market liberalisation since the 1970s has helped to break the wage-price spirals that fuelled high levels of inflation and has now set inflation on a lower path which makes this shift in monetary policy practicable. In addition, recent changes in flexible employment practices, the rise of the gig economy and technological changes, will all help to lower inflationary pressures.
- Governments will also be concerned to see interest rates stay lower as every rise in central rates will add to the cost of vastly expanded levels of national debt; (in the UK this is £21bn for each 1% rise in rates). On the other hand, higher levels of inflation will help to erode the real value of total public debt.