Appendix 11

Warwick District Council Financial Strategy 2018/19-2022/23

1 INTRODUCTION

"Money" is one of 3 keys strands of the Council's Fit for the Future Programme. The others are People and Services. This document supports the delivery of the Council's services and the projects within the Programme, as well as supporting all Council Strategies to deliver its aims and objectives.

It considers the major funding issues facing the Council in the Medium Term (the next 5 years). Extending the Strategy beyond this period would rely on broad estimates and many uncertainties. It would not be prudent to base the Strategy a shorter period as risks and significant issues arising in the medium term could arise before the Council has developed means of managing these. Forecast future levels of Funding are projected alongside other known constraints and opportunities.
In drawing up a Medium Term Plan, the Strategy considers the constraints and opportunities facing the Council. The Council has a Code of Financial Practice and Code of Procurement Practice which underpin the Strategy.

Monthly Budget Review Reports are considered by the Senior Management Team, with Members of the Executive being updated on a quarterly basis. Alongside this, regular updated 5 year Financial Projections are included. Full Council receive the latest 5 Year Forecast alongside this Strategy within the Budget and Council Tax Reports presented in February of each year.

2. BACKGROUND

2.1 The Economic Background, as provided by Treasury Advisors, Link Asset Services – Their Report is reproduced as Annex 1.

2.2 Recent years have seen many changes to the nature of Funding Local Authorities receive from Central Government. The new Business Rate Retention Scheme was introduced from 1st April 2013. Whilst setting the NNDR Baseline, Government then allowed Council to retain a share of any growth above this Baseline. Similarly, should actual income received be below Baseline , there was a safety net whereby the Authority would receive a top up payment should actual Business Rates collected fall more than 7.5% below their Baseline. Alongside this, the proportion of Business Rates to revenue Support Grant has increased. The 4 year settlement announced in December 2015 and January 2016 show that by 2019/20 Revenue Support Grant will be zero, having reduced significantly over the next 3 years.(The Council's other main income source is its local Council Tax Payers)

	2016/17 £'000'	2017/18 £'000's	2018/19 £'000's	2019/20 £'000's	2020/21 £'000's	2021/22 £'000's	2021/22 £'000's
Revenue Support Grant	1,597	793.6754	306.7363	0	0	0	**0**
Tariff Adjustment				-237	-237	-237	-237
Business Rate Retention	877	3,523	6,976	4,545	3,436	3,528	3,623
Total	2,473	4,317	7,283	4,308	3,199	3,291	3,386
Revenue Support Grant %	64.56%	18.39%	4.21%	0.00%	0.00%	0.00%	0.00%
Business Rates %	35.44%	81.61%	95.79%	100.00%	100.00%	100.00%	100.00%

2.3 The Government still propose to introduce a scheme to enable authorities to retain all the Business Rate Income they collect, as announced in the Autumn Statement of 2015. However, full details of the new proposals have yet to be published. The assumptions in the table above (2.2) are based upon existing arrangements until such information becomes available.

2.4 The Government announced that it intends to proceed with the expansion of the pilot programme for 100% business rates retention in 2018/19. Specifically the 2018/19 pilots are seen as an opportunity for the Government to test more technical aspects of the 100% business rates retention system, such as tier-splits and provide the opportunity to evaluate how collaboration between local authorities works in practice. The Warwickshire Authorities' bid to become a pilot was unsuccessful.

2.5 The Financial Strategy and projections have been updated in line with the 2018/19 Government Settlement Figures announced in December/January 2017/2018. The Council's Financial Strategy is based upon the 4 year Revenue Support Grant announced by the Government and its own Business Rates forecasts using the NNDR1 and NNDR3 returns and local intelligence, including support from "Analyse Local" independent Business Rates Consultants.

2.6 As referred to above, from 2013/14, the District Council retains 20% of any growth in business rates above the pre-determined Baseline. The Council's Baseline for 2018/19 is £3.316m.This is the amount the Council retains. If the actual amount collected varies to the Baseline, the Council will retain more or less income, working out at the Council retaining 20% of any increased revenues. Conversely, if there is any reduction in the new business rate receipts, the Council will bear 20% of this cost. There is a Safety Net whereby the Council will not be able to receive less than £3,067, this being within 7.5% of the Baseline retained income figure. However, this Authority has entered into Pooling arrangements. This means the Safety Net payment would be paid to the Pool rather than the actual authority falling into the Safety Net.

The Baseline is due to continue to be inflated annually originally until 2020 when there was due to be a "reset" of the system. However, in light of proposals for Authorities to retain all Business Rates collected, this may no longer be the case

The Council entered into a "pooling" arrangement with the other Warwickshire Councils. Under this arrangement the amounts due to be paid to Central Government under the Levy should greatly reduce, meaning more income will be retained locally. Whilst there are risks attached to pooling, especially if income should substantially decline, however, based on the latest projections, the Council should benefit from remaining in the pool in 2018/19.

2.7 The Council also receives Government Support by way of New Homes Bonus (NHB) for 2018/19 this is £2.482 million. A proportion of this is allocated to the Waterloo Housing Association as part of the WC Housing Joint Venture. NHB was previously funded on a 6 year rolling time limited basis. After consultation the Government reduced this to 5 years for 2017/18. For 2018/19 and subsequent years it has reduced to a 4 year rolling basis. To date the Council has not to relied upon it for revenue support and has not had to use it to support recurring expenditure on core service provision. This prudence has proved wise so far, whilst allowing the Council to support new schemes and replenish its Reserves.

2.8 In total, the District had a 2017/18 Council Tax at Band D of £1,674.52. However, the District element (including parish precepts) is only £183.66. An increase to this Council's share of £5.00 is proposed for 2018/19. The District element is just outside the lowest quarter nationally, with the District and Parish charge being well within the lowest national Quartile. The District and Parish charge remain the lowest of the 5 Warwickshire Authorities.

2.9 In March 2012 the Housing Revenue Account (HRA) borrowed £136.2m to make a one off 'buy out' payment when the Housing Subsidy system was replaced by 'Self Financing'. This debt is serviced from HRA rental income, in place of the payments previously made to the National Housing Rent Pool under the Housing Subsidy system. A 50 year Business Plan is maintained to demonstrate the viability of the HRA and the capacity to invest in the service and provide new homes.

2.10 A 'Prudential Framework' for borrowing was introduced from 2004/05. Local authorities no longer have to obtain Government approval before borrowing. Control is by prudential limits based on the authority's revenue resources. The Council can borrow if it can afford the revenue consequences.

2.11 The Council reviews its budgets on a monthly basis, amending these as changes are identified, rather than reporting upon variations and updating its current year's budgets once at part of the following year's budget setting process. The process will be constantly reviewed to identify further efficiencies so that data can be produced in the most timely and accurate manner.

3. CORPORATE STRATEGY AND FIT FOR THE FUTURE PROGRAMME

3.1 The Council's Organisational Purpose being:

"**Warwick District: a great place to live, work and visit".**

3.2 During 2010, the Council adopted its Fit For the Future programme as its Corporate Strategy to provide an organisation framework to progress these objectives. As well as focusing on delivering quality services that its customers' need, the programme and subsequent updates have set challenging savings targets to be delivered. Achieving these will assist the Council in delivering its services in the future in light of uncertainty surrounding the economic climate, and future reductions in Central Government Support.

This programme needs to stay up to date and relevant in providing the strategic framework for the Council to meet the challenges it faces. Projects within the programme will be adjusted to reflect opportunities and challenges arising from Government initiatives and legislation as well as the Council's own Local Priorities.

These include-

In June 2018 Universal Credit will be rolled out to this Council. This Authority will retain responsibility for pensioners. New working age customers will be dealt with by the DWP. Existing working age customers will transfer as and when there are changes to their circumstances

The impact of Brexit on the economy and changes in legislation as Britain leaves the European Union is still uncertain.

In his Autumn Statement 2016, the Chancellor announced that the National Living Wage rise from £7.64 to £7.83 in April 2018.

3.3 As well as these initiatives, other major issues that will affect the Council's finances over this period are:

(i) Monitoring the medium term financial forecast and this Council's progress in meeting it's various savings initiatives.
(ii) The impact of pressures to improve environmental sustainability. Alongside this, CO^2 emissions need to be reduced to meet the climate change agenda.
(iii) Energy costs are extremely volatile.

(iv) Major developments that may occur, such as, Chandos Street, Office (H.Q) Relocation, Europa Way and other potential strategic opportunities.

(vi) Major investment in multi storey car parks that will require structural renewal.

(vii) The Council completed condition surveys on its Corporate Assets. The Council continues to strive to ensure its Corporate Asset properties are maintained at a reasonable standard. So far it has been able to resources these costs. Funding for the full liabilities for the next five years of the plan have yet to be found.

(viii) The potential to work with partners and realising savings by pooling resources.

(ix) Capital receipts have reduced considerably and any for the future are extremely uncertain.

(x) The volatility of many of the Council's income budgets.

(xi) The rate of economic recovery and investment interest returns.

(xii) Trees throughout the district need replacing for which funding will need to be sought.

(xiii) Ongoing reviews on how the Council manages and delivers its services.

(xiv) Development of the Fit for the Future Programme and the Council's ability to adapt to change.

(xv) Efficient procurement to deliver quality services at minimum cost.

(xvi) Superannuation Fund and pensions changes further to the changes to the Local Government Pension Scheme introduced in April 2014.The pensions fund, in common with most others, continues to carry a projected deficit, although plans are in place to seek to ensure the fund is in surplus.

(xvii) In June 2016, the country voted to leave the European Union. The initial impact saw a reduction in interest rates and a drop in the pound against other currencies. The market has still not recovered from this initial reaction. The Council continues to monitor this situation and will amend its medium term financial forecasts to incorporate future changes including changes in legislation, such as VAT.

(xviii) Renewal of the Council's major contracts in 2021/22.

3.4 The Council will plan replacements and renewals of equipment (including ICT Resources), and repair and maintenance in a careful manner concentrating on the sustainability of services as a first priority. In addition the Council needs to continually review its reserves in the light of a very ambitious programme of change, and constant uncertain external pressures on the planning regime.

3.5 The Council continues to promote agile working, and this links to the asset management plan strategy of reducing office space needs.

3.6 On 18 November 2015 Members approved funding for work to progress to develop a £12 million investment plan for Newbold Comyn and St Nicholas Park Leisure Centres. From June 2017, the Council outsourced the management of it’s Leisure Centres. A private contractor will be able to operate in a more cost efficient way, benefitting from Mandatory Rate Relief and achieving economies of scale from operating many Leisure Centres across the country. From 2019, this Council will receive an annual concession from the Operator. There is potential to receive more income from a “Profit Share” arrangement. In the interests of prudence, none of this has been factored into the Financial Forecasts.

4. FINANCIAL PRINCIPLES

4.1 The following are the principles (for both the General Fund and the Housing Revenue Account) that underpin the Financial Strategy:

(i) Savings and developments will be based upon corporate priorities as set out in the Council’s Fit for the Future programme.

(ii) In order to achieve further savings the Council continues to explore all avenues including

- Shared services and joint working
- Outsourcing where other providers can deliver a minimum of the same standard of service more efficiently
- Efficient Procurement
- Benchmarking costs and understanding differences
- Increasing fees and paying customers where there is spare capacity and Looking for opportunities to maximize income
- Accessing grants to assist with corporate priorities
- Controlling costs
- Workforce planning
- Improved more efficient technology

(iii) The Council has ambitions to effectively manage its resources. In setting both its Council Tax and Housing Rents, the Council takes account of its budget requirement, the support it receives from Central Government, inflation and the affordability of its local tax-payers.

(iv) The Council’s base policy for Council house rent increases is currently to follow Central Government guidance. Any diversion from this policy will be requested in the annual Rent Setting report to Council, and reflected in the HRA Business Plan.

(v) Whilst the Council will aim for Fees and Charges to be increased so that income is at least maintained in real terms, it will be mindful of the reality of the current economic conditions and its competitors. The Council is committed to making good use of the ability to raise funds through charges and put them to good use for the community.

(vi) The Council still needs to develop its ability to benchmark all services across the Council.

(vii) This Council takes a positive approach to partnership working, realising the following benefits: -

a) Levering in additional external funding.
b) Ensuring improved use of sites, whether or not in the ownership of the Council.
c) Ensuring the future sustainability of projects.
d) Sharing/Reducing costs
e) Strengthening the Resilience of the Service

(viii) The Financial Strategy takes account of all revenue effects of the capital programme to ensure that the decisions taken are sustainable into the future.

(ix) The Council will hold reserves for specific purposes, as to be agreed by Executive.

(x) The Capital Investment Reserve shall be maintained with a minimum uncommitted balance of £1m.

(xi) Any unplanned windfalls of income, whether service specific or more general, will be reported to the Executive who will prioritise how such income is used as part of setting future balanced budgets and meeting the Council's priorities.

5. PROCESS & MONITORING

Preparing budgets

5.1 The budget setting process is consistent with the service area planning process and the Fit for the Future Programme with recent years focusing on reductions in budgets and efficiencies.

5.2 When the Capital Programme is approved by Council the capital schemes will still be subject to individual approval on the basis of an evaluation and Business Case that needs to be agreed by Executive. .

Monitoring and managing budgets

5.4 Under the monthly "Budget Review" Process, Budgets are amended as soon as changes are identified. The Financial Code of Practice is regularly updated to incorporate any changes. The Financial Code of Practice was reviewed and updated in 2015 to reflect changes in this process and procurement practices.

5.5 Accountants work with Service Areas to identify budget variances and changes, these are reported to the Senior Management Team on a monthly basis. Regular reports are submitted for consideration by the Executive and Scrutiny Committees. The Council continues to review and refine its current processes, putting tighter controls in place to improve the quality and accuracy of the review process.

Consultation

5.6 The Council has a track record of consulting both partner organisations and the public this is an important contribution to assist identifying options and in learning lessons.

5.7 There is extensive consultation with partners on Fit For the Future, and the Sustainable Community Strategy.

5.8 The Council takes a strategic 5 year approach to determine how budgets are set and service prioritised.

5.9 The Council has a record of consulting where appropriate on the development of individual schemes.

6 ASSUMPTIONS

6.1 The following assumptions will be used in bringing forward proposals on the budget

(i) Whilst The Council has built the indicative RSG settlements, announced as part of the four year settlement announced in January 2016, into its financial forecasts, its Business Rates forecasts are based upon its own local forecasts and out-turns.

(ii) Interest projections will continue to be based on the rates projected by Link Asset Services Treasury Solutions, the treasury management advisers.

(iii) No allowance for inflation has been applied to most budgets for 2018/19, from 2019/20 an annual increase of 2% increase is assumed. Where the Council is contractually bound to increase costs, Business Rates and uplifted fees and charges budgets will be increased.

7. HOUSING REVENUE ACCOUNT (HRA)

7.1 Housing Self Financing was implemented on 1st April 2012. A 50 year HRA Business Plan has been developed to ensure sufficient funds will be available to service the £136.2m debt taken out with the PWLB in order to 'buy' the Council out of the existing Housing Subsidy system, provide the necessary funding to maintain the stock and enable the building of new homes over the life of the Business Plan.

7.2 There is a requirement to follow Central Government National Housing Rent Policy when determining rents on HRA dwellings. With effect from April 2016, the rent charged by local authorities has had to be reduced by 1% per year for 4 years. When a new tenancy begins the Council can re-let at Target Social Rent, in time bringing all social housing rents in line with 2002 Convergence policy. From April 2020 social rents policy will change, allowing the rent charged to be increased by CPI + 1% each year. The council does have discretion over the setting of garage rents, Warwick Response charges and rents for HRA owned shops and commercial properties.

7.3 The Housing and Planning Act received Royal Assent in May 2016. It included a number of policy changes that in future could impact on the HRA Business Plan and potentially adversely affect its financial viability. These included the Right-to-Buy policy is to be extended to Housing Association properties, with the Local Housing Authority funding the discounts to tenants. The expectation is that this will be achieved through the sale of 'high value' properties as they become vacant, at the discretion of the Council. An expanded piloted is due to be conducted before further decisions on this policy are made.

7.4 It has been proposed that from April 2019, a new framework for Funded Supported Housing will be introduced. Core rent and service charges will be funded by Universal Credit up to the level of the local housing allowance.

8. REVENUE FORECASTS

8.1 Revenue forecasts will be drawn up in line with this strategy, and the strategy itself will be reviewed every year when the budget is set. The current forecasts are set out in the February 2018 Budget Report, which reported savings required as follows in order to keep future Council Tax increases to £5.00. (before the use of any one-off reserves or balances)

	2017/18 £'000	2017/18 Latest £'000	2018/19 £'000	2019/20 £'000	2020/21 £'000	2021/22 £'000	2022/23 £'000
Deficit-Savings Required(+)/Surplus(-) future years	0	0	0	607	81	929	699
Change on previous year	0	0	0	607	-526	848	-230

These are indicative based on current assumptions, and assumes that savings are achieved and maintained.

9. ASSET RESOURCE BACKGROUND

9.1 Set out below is a summary of the Council's assets and its existing plans to use its resources to invest for the future.

9.2 The Council's assets as shown in the balance sheet as at 31st March 2017 are summarised below: -

	No	Value £'000
Operational Assets		
HRA		
Operational Land and Buildings	7,620	358,011
Surplus Assets/Work in Progress	2	4
Vehicles, Plant, Furniture and Equipment	-	237
General Fund		
Operational Land and Buildings	120	62,660
Surplus Assets/Work In Progress	8	3,415
Vehicles, Plant, Furniture and Equipment		1,880
Community Assets	-	6,721
Infrastructure	-	2,091
Heritage Assets	-	8,271
Total	**7,750**	**443,290**
Investment Properties	**88**	**11,425**

9.3 A summary of the proposed capital programme for the period to March 2021 is given below. This programme gives an indication of the level of the Council's available capital resources that are to be devoted to capital expenditure during this period.

	Latest Budget 2017/18 £'000's	Proposed Expend. 2018/19 £'000's	Proposed Expend. 2019/20 £'000's	Proposed Expend. 2020/21 £'000's	Proposed Expend. 2021/22 £'000's	TOTAL 2017/18 to 2021/22 £'000's
Strategic Leadership & CWLEP	275.3	153.0	149.0	149.0	252.0	978.3
Health & Community Protection	240.0	450.0	0.0	0.0	0.0	690.0
Culture Portfolio	12,500.0	1,188.2	0.0	0.0	0.0	13,688.2
Finance Portfolio	126.3	150.0	150.0	150.0	150.0	726.3
Neighbourhood Portfolio	849.7	1,680.8	142.0	80.0	80.0	2,832.5
Development Portfolio	3,958.0	49.8	0.0	0.0	0.0	4,007.8
Housing Investment	11,358.0	6,628.0	5,215.7	5,215.7	5,215.7	33,633.1
Total Capital Programme	**17,949.3**	**3,671.8**	**441.0**	**379.0**	**482.0**	**22,923.1**

10. CAPITAL PRIORITIES

10.1 The main focus of the programme is:

- Realising local aspirations as expressed within the Corporate Strategy (which incorporates the Community Plan and the Council's Resource Strategies) and it's Fit for the Future Programme;

- Maintaining, and where possible enhancing, the condition of the Council's existing assets so as to reduce future maintenance liabilities and to encourage their effective use. Where appropriate this will include working in partnership with others such as the County Council on the customer Access Project.

- Supporting capital schemes that provide revenue savings to the Council, in particular supporting investment in Information and Communication Technology so as to modernise activities and release resources for other purposes.

- Achieving regeneration and economic vitality in our main population centres.

10.2 Key particular projects that link to the corporate strategy are: -

- Enabling developments across the district that improve the environment such as Europa Way, and the improvement of Leamington Old Town.

- To continue to maintain the Government's "decent homes" standard.

- To increase the number of affordable houses in the district.

- Relocation of the Council's main office to a more efficient and cost effective building

- Enhanced Leisure Facilities

11. FINANCING THE CAPITAL STRATEGY

11.1 The Capital Strategy needs to have regard to the financial resources available to fund it. The main sources of funding are detailed below: -

- Capital Receipts – primarily resulting from the sale of the Council's assets. This income is lumpy and limited, although there are still schemes being considered that could realise further capital receipts.

  - The Council is required to sell homes to eligible tenants at a significant discount under the right-to buy (RTB). The proportion of such receipts are taken by the Treasury; with the balance retained by the Council, some having to be to provide for new dwellings and the remainder the Council having flexibility over its use.

  - Capital Contributions – including contributions from developers (often under Section 106 Planning Agreements and in the future, from the Community Infrastructure Levy as well) and grants towards specific schemes.

  - Use of Council's own resources – either by revenue contributions to capital, or use of earmarked reserves.

  - Borrowing – the Council has freedom to borrow under the Prudential System provided it can demonstrate that it has the resource to service the debt.

  - Leasing – the Council now requires that, where appropriate, an options appraisal is undertaken in order to identify the most efficient source of financing capital purchases. In certain cases this may take the form of either a finance or operating lease.

12. REVIEW

12.1 This strategy will be subject to annual review to ensure that changes are included and that development issues have been implemented. It has been reviewed in the light of the Fit for the Future programme.

13. RISKS

13.1 Previous years have demonstrated that the Council needs to consider the risk in setting and managing its budgets.

13.2 The key risks that could arise and ways in which they should be managed are set out in the main February Budget report and associated appendix.

13.3 The Council maintains a Significant Business Risk Register which is reviewed bi-annually by the Executive and quarterly by the Senior Management Team. Each Service Area has its own Service Risk Register. These are presented for the consideration of the Finance and Audit Scrutiny Committee on a quarterly rotating basis.

13.4 All major projects the Council undertakes have their own separate Risk Register.

ANNEX 1

Link Asset Services' View of the Economic Background

GLOBAL OUTLOOK. World growth looks to be on an encouraging trend of stronger performance, rising earnings and falling levels of unemployment. In October, the IMF upgraded its forecast for world growth from 3.2% to 3.6% for 2017 and 3.7% for 2018.

In addition, **inflation prospects are generally muted** and it is particularly notable that **wage inflation** has been subdued despite unemployment falling to historically very low levels in the UK and US. This has led to many comments by economists that there appears to have been a fundamental shift downwards in the Phillips curve (this plots the correlation between levels of unemployment and inflation e.g. if the former is low the latter tends to be high). In turn, this raises the question of what has caused this? The likely answers probably lay in a combination of a shift towards flexible working, self-employment, falling union membership and a consequent reduction in union power and influence in the economy, and increasing globalisation and specialisation of individual countries, which has meant that labour in one country is in competition with labour in other countries which may be offering lower wage rates, increased productivity or a combination of the two. In addition, technology is probably also exerting downward pressure on wage rates and this is likely to grow with an accelerating movement towards automation, robots and artificial intelligence, leading to many repetitive tasks being taken over by machines or computers. Indeed, this is now being labelled as being the start of the **fourth industrial revolution.**

KEY RISKS - central bank monetary policy measures
Looking back on nearly ten years since the financial crash of 2008 when liquidity suddenly dried up in financial markets, it can be assessed that central banks' monetary policy measures to counter the sharp world recession were successful. The key monetary policy measures they used were a combination of lowering central interest rates and flooding financial markets with liquidity, particularly through unconventional means such as Quantitative Easing (QE), where central banks bought large amounts of central government debt and smaller sums of other debt.

The key issue now is that that period of stimulating economic recovery and warding off the threat of deflation is coming towards its close and a new period has already started in the US, and more recently in the UK, on reversing those measures i.e. by raising central rates and (for the US) reducing central banks' holdings of government and other debt. These measures are now required in order to stop the trend of an on-going reduction in spare capacity in the economy, and of unemployment falling to such low levels that the re-emergence of inflation is viewed as a major risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this then also encouraged investors into a search for yield and into investing in riskier assets such as equities. This resulted in bond markets and equity market prices both rising to historically high valuation levels simultaneously. This, therefore, makes both asset categories vulnerable to a sharp correction. It is important, therefore, that central banks only gradually unwind their holdings of bonds in order to prevent destabilising the financial markets. It is also likely that the timeframe for central banks unwinding their holdings of QE debt purchases will be over several years. They need to balance their timing to neither squash economic recovery by taking too rapid and too strong action, or, alternatively, let inflation run away by taking action that was too slow and/or too weak. **The potential for central banks to get this timing and strength of action wrong are now key risks.**

There is also a potential key question over whether economic growth has become too dependent on strong central bank stimulus and whether it will maintain its momentum against a backdrop of rising interest rates and the reversal of QE. In the UK, a key vulnerability is the **low level of productivity growth**, which may be the main driver for increases in wages; and **decreasing consumer disposable income,** which is important in the context of consumer expenditure primarily underpinning UK GDP growth.

A further question that has come to the fore is whether **an inflation target for central banks of 2%**, is now realistic given the shift down in inflation pressures from internally generated inflation, (i.e. wage inflation feeding through into the national economy), given the above mentioned shift down in the Phillips curve.

- Some economists favour a shift to a **lower inflation target of 1%** to emphasise the need to keep the lid on inflation. Alternatively, it is possible that a central bank could simply 'look through' tepid wage inflation, (i.e. ignore the overall 2% inflation target), in order to take action in raising rates sooner than might otherwise be expected.
- However, other economists would argue for a **shift *UP* in the inflation target to 3%** in order to ensure that central banks place the emphasis on maintaining economic growth through adopting a slower pace of withdrawal of stimulus.
- In addition, there is a strong argument that central banks should **target financial market stability**. As mentioned previously, bond markets and equity markets could be vulnerable to a sharp correction. There has been much commentary, that since 2008, QE has caused massive distortions, imbalances and bubbles in asset prices, both financial and non-financial. Consequently, there are widespread concerns at the potential for such bubbles to be burst by exuberant central bank action. On the other hand, too slow or weak action would allow these imbalances and distortions to continue or to even inflate them further.
- Consumer debt levels are also at historically high levels due to the prolonged period of low cost of borrowing since the financial crash. In turn, this cheap borrowing has meant that **other non-financial asset prices**, particularly house prices, have been driven up to very high levels, especially compared to income levels. Any sharp downturn in the availability of credit, or increase in

the cost of credit, could potentially destabilise the housing market and generate a sharp downturn in house prices. This could then have a destabilising effect on consumer confidence, consumer expenditure and GDP growth. However, no central bank would accept that it ought to have responsibility for specifically targeting house prices.

UK. After the UK surprised on the upside with strong economic growth in 2016, **growth in 2017 has been disappointingly weak**; quarter 1 came in at only +0.3% (+1.8% y/y), quarter 2 was +0.3% (+1.5% y/y) and quarter 3 was +0.4% (+1.5% y/y). The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the EU referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 80% of GDP, has seen weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the **manufacturing sector** which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year while robust world growth has also been supportive. However, this sector only accounts for around 10% of GDP so expansion in this sector will have a much more muted effect on the overall GDP growth figure for the UK economy as a whole.

While the Bank of England is expected to give forward guidance to prepare financial markets for gradual changes in policy, the **Monetary Policy Committee, (MPC), meeting of 14 September 2017** managed to shock financial markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise soon. The Bank of England Inflation Reports during 2017 have clearly flagged up that it expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years' time. The Bank revised its forecast for the peak to just over 3% at the 14 September meeting. (Inflation actually came in at 3.0% in both September and October so that might prove now to be the peak.) This marginal revision in the Bank's forecast can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on an emerging view that with unemployment having already fallen to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that **the amount of spare capacity in the economy was significantly diminishing** towards a point at which they now needed to take action. In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of automation and globalisation. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a *decrease* in such globalisation pressures in the UK, and so this would cause additional inflationary pressure over the next few years.

At its 2 November 2017 meeting, the MPC duly delivered a 0.25% increase in Bank Rate. It also gave forward guidance that they expected to increase Bank Rate only twice more in the next three years to reach 1.0% by 2020. This is, therefore, not quite the 'one and done' scenario but is, nevertheless, a very relaxed rate of increase prediction in Bank Rate in line with previous statements that Bank Rate would only go up very gradually and to a limited extent.

However, some forecasters are flagging up that they expect growth to accelerate significantly towards the end of 2017 and then into 2018. This view is based primarily on the coming fall in inflation, (as the effect of the effective devaluation of sterling after the EU referendum drops out of the CPI statistics), which will bring to an end the negative impact on consumer spending power. In addition, a strong export performance will compensate for weak services sector growth. If this scenario was indeed to materialise, then the MPC would be likely to accelerate its pace of increases in Bank Rate during 2018 and onwards.

It is also worth noting the **contradiction within the Bank of England** between action in 2016 and in 2017 **by two of its committees**. After the shock result of the EU referendum, the **Monetary Policy Committee (MPC)** voted in August 2016 for emergency action to cut Bank Rate from 0.50% to 0.25%, restarting £70bn of QE purchases, and also providing UK banks with £100bn of cheap financing. The aim of this was to lower borrowing costs, stimulate demand for borrowing and thereby increase expenditure and demand in the economy. The MPC felt this was necessary in order to ward off their expectation that there would be a sharp slowdown in economic growth. Instead, the economy grew robustly, although the Governor of the Bank of England strongly maintained that this was *because* the MPC took that action. However, other commentators regard this emergency action by the MPC as being proven by events to be a mistake. Then in 2017, we had the **Financial Policy Committee (FPC)** of the Bank of England taking action in June and September over its concerns that cheap borrowing rates, and easy availability of consumer credit, had resulted in too rapid a rate of growth in consumer borrowing and in the size of total borrowing, especially of unsecured borrowing. It, therefore, took punitive action to clamp down on the ability of the main banks to extend such credit! Indeed, a PWC report in October 2017 warned that credit card, car and personal loans and student debt will hit the equivalent of an average of £12,500 per household by 2020. However, averages belie wide variations in levels of debt with much higher exposure being biased towards younger people, especially the 25 -34 year old band, reflecting their lower levels of real income and asset ownership.

One key area of risk is that consumers may have become used to cheap rates since 2008 for borrowing, especially for mortgages. It is a major concern that **some consumers may have over extended their borrowing** and have become complacent about interest rates going up after Bank Rate had been unchanged at 0.50% since March 2009 until falling further to 0.25% in August 2016. This is why forward guidance from the Bank of England continues to emphasise slow and gradual increases in Bank Rate in the coming years. However, consumer borrowing is a particularly vulnerable area in terms of the Monetary Policy Committee getting the pace and strength of Bank Rate increases right - without causing a sudden shock to consumer demand, confidence and thereby to the pace of economic growth.

Moreover, while there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two to three years will actually pan out.

EZ. Economic growth in the Eurozone (EZ), (the UK's biggest trading partner), had been lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of QE. However, growth picked up in 2016 and has now gathered substantial strength and momentum thanks to this stimulus. GDP growth was 0.6% in quarter 1 (2.0% y/y), 0.7% in quarter 2 (2.3% y/y) and +0.6% in quarter 3 (2.5% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in October inflation was 1.4%. It is therefore unlikely to start on an upswing in rates until possibly 2019. It has, however, announced that it will slow down its monthly QE purchases of debt from €60bn to €30bn from January 2018 and continue to at least September 2018.

USA. Growth in the American economy was notably erratic and volatile in 2015 and 2016. 2017 is following that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1% and quarter 3 coming in at 3.0%. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.1%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with four increases in all and three increases since December 2016; and there could be one more rate rise in 2017, which would then lift the central rate to 1.25 – 1.50%. There could then be another four increases in 2018. At its September meeting, the Fed said it would start in October to gradually unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

CHINA. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

JAPAN. has been struggling to stimulate consistent significant growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.