Appendix 11

Warwick District Council Financial Strategy 2021/22-2025/26

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 on a shorter period as risks and significant issues arising in the medium term could occur before the Council has developed the means of managing these. Forecast future levels of funding are projected alongside other known constraints and opportunities.

The Council has a Code of Financial Practice and Code of Procurement Practice which underpin the Strategy.

Monthly Budget Review Reports will be produced to be 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, and at other key points during the year if there have been material significant developments.

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. There is 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 since this scheme was introduced. The 4 year settlement announced in December 2015 and January 2016 saw Revenue Support Grant become zero in 2019/20, having reduced significantly over the 3 year period. The Council's other main income source is its local Council Tax payers.

2.3 In December 2017, the government announced the intention to increase the level of business rates retained by local government from the current 50% to the equivalent of 75% from April 2020. During 2019/20 selected authorities piloted this scheme. This Council will closely monitor further developments as the scheme evolves.

2.4 The Financial Strategy and projections have been updated in line with the 2021/22 Government Local Finance Settlement Figures announced in December 2020. The Council's Financial Strategy is based upon the absence of 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.

2.5 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 (the amount it retains) for 2020/21 is £3.447m. 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 £3.188 million, 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 had been inflated annually since the scheme commenced in 2013 until 2021, when there was due to be a "reset" of the system. However, this was postponed by a year to ensure stability during the COVID-19 pandemic. The proposed changes to the Business Rate Scheme are discussed in more detail in Section 3.5 of the Budget Report.

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 2021/22.

2.6 The Council also receives Government Support by way of New Homes Bonus (NHB) for 2021/22 this is £3.269 million. This allocation was significantly larger than originally forecast, following the extension of the scheme as part of the response to COVID-19. It was expected that the Council were to only receive 'legacy payments' from 2021/22.

Initially, NHB was funded on a 6 year rolling time limited basis. After consultation the Government phased a reduction for this from 6 (2016/17) to 4 years from 2018/19. It is paid on a rolling basis. To date the Council has not had to use New Homes Bonus 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 Reserve balances, and continue to allocate a proportion of this to the Waterloo Housing Association as part of the WDC Housing Joint Venture. A breakdown of these schemes is contained within the Budget report in section 3.11.4.

2.7 The Council have received many additional grants in 2020/21 to support continued service provision and offset income losses as a result of COVID-19. These have included an income compensation scheme, a furlough grant, business grants and rough sleeping grants.

2.8 The Council are permitted to increase their share of Council Tax by either 2% or £5 (per band D equivalent) without triggering a Referendum. It is therefore proposed to increase this by £5 per year (per band D equivalent) to £176.86 per year.

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. The latest iteration was presented to members in December 2020 (Executive Item 6).

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. However, as detailed in the Treasury Management Strategy, there are now limitations on Public Works Loans Board borrowing for investment purposes.

2.11 The Council reviews its budgets on a monthly basis, amending these as changes are identified, rather than just reporting upon variations and updating its current year's budgets once at part of the following year's budget setting process. The process is continuously reviewed to identify further efficiencies so that data can be produced in the most timely and accurate manner. It is expected that processes will improve as a result of a new Financial Management System being implemented, with an expected go live date in July 2021.

2.12 The production and publication of the latest Statement of Accounts for 2019/20 was completed successfully last year. The draft was published on

18th June, well in advance of the national deadline of 30th August. These were signed by external audit ahead of the 30th November deadline. This was achieved against the backdrop of COVID-19, and during a period of significant change and upheaval in working practices as part of the first National Lockdown necessitating a move to remote working. This further emphasises the great strides that the Council has made following the failure to publish its 2017/18 Accounts within the statutory deadline. Processes since have been thoroughly and continually reviewed and scrutinised, with Action plans being updated to include incremental improvements based on stakeholder feedback. As the 2020/21 Statement of Accounts will once again be produced and audited remotely, actions will be taken forward from the 2019/20 process, and any required changes will be implemented.

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-

The impact of Britain leaving the European Union, with the impact of changes in legislation and the impact on the economy still uncertain.

The continuing impact of COVID-19 on service provision and delivery, the income received from stakeholders in the District, and how the Council will be able to commence its recovery Strategy.

The ongoing project in conjunction with Stratford-on-Avon District Council assessing joint and collaborative working practices., including a potential full merger of the two local Authorities.

Announcements from both the Autumn Statement 2020, and the Local Government Finance Settlement, including changes to the National Living Wage, which will increase by 2.2% to £8.91 from 1 April 2021. It will also become available to people aged 23 and above, down from the current age of 25.

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 will identify this Council's progress in meeting its various savings initiatives and the profile of the savings still to be identified.

(ii) The impact of pressures to improve environmental sustainability, and meet the climate change agenda.

(iii) Energy costs which are extremely volatile.

(iv) Major developments that may occur, such as, Kenilworth School Relocation, Europa Way and other potential strategic opportunities.

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

(vi) 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 resource these costs. Additional funding for future liabilities has been included within the 2021/22 Budget Report.

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

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

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

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

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

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

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

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

(xv) 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.

(xvi) 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. Following the UK signing an agreement with the EU in December 2020, the impact on the Council's finances will be routinely assessed as more uncertainties are resolved or arise. The Council will amend its medium term financial forecasts as necessary to reflect any impact and related issues e.g. changes in legislation such as VAT.

(xvii) Renewal of the Council's major contracts in 2021/22 and 2022/23.

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 will continue to support the focus on remote working and the electronic storage of records. Agile working was already a focus pre COVID-19 and linked to the asset management plan strategy of reducing office space needs.

3.6 During 2017/18, the major refurbishment of 2 of the Council's Leisure Centres, Newbold Comyn and St Nicholas Park Leisure Centres was completed. The Council now moves to Phase 2 of its plan to develop all of its Leisure Centres and redevelop the 2 Kenilworth ones, as detailed within the report to February 2021 Executive. From June 2017, the Council outsourced the management of its 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, the Council agreed to receive an annual concession from the Operator. There is potential to receive more income from a "Profit Share" arrangement in the future. In the interests of prudence, none of this 'profit share' has been factored into the Financial Forecasts.

Due to COVID-19, the leisure centres in the District have been shut for prolonged periods since March 2020, and when they have been allowed to open, subject to reduced capacity and social distancing guidelines. This has resulted in a significant reduction in income. The Council is and will continue to work with the Operator to ensure the services remain available when restriction guidance permits, with agreements in place with regards to the concession and additional expenditure costs incurred by the provider.

3.7 Several Major Projects are currently being worked on, with reports regularly due to members.

- Working with partners to develop the land at Europa Way and deliver housing and a new stadium.
- Preparation for the Commonwealth Games Bowls in 2022 at Victoria Park which offers a significant opportunity to promote the Town and its attractions and support the local economy.
- Delivery of the St Marys Lands Masterplan to enhance and promote the landscape character creating a natural open green space and promote St. Mary's Lands as a visitor destination supporting the many organisations within it.
- Phase 2 of the Leisure Centres refurbishment project
- A number of significant housing projects, delivering both private and social housing.
- The creation of Tachbrook Country Park.
- The establishment of a local housing company.

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 income 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
- More efficient and greater use of 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 and rent 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. The Medium Term Financial Strategy is based on increases in discretionary fees and charges of up to 15% for 2022/23 and 2023/24 as agreed by Members in December 2020 as part of the Budget proposals.

(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
f) Enhancing quality of services

(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 and a General Fund Balance of £1.5m.

(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 and 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 in accordance with the Council's Capital Strategy.

Monitoring and managing budgets

5.3 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 in practice, and is reviewed by Accountancy in conjunction with the external auditors to ensure ongoing compliance.

5.4 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. It is expected that processes will be improved further as a result of a new Financial Management System being implemented, with an expected go live date in July 2021.

Consultation

5.5 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.

5.6 There is extensive consultation with partners on Fit For the Future.

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

5.8 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) Forecasts for Business Rates income are based upon the Council's local forecasts and out-turns. The Council uses a company called Analyse Local to forecast its provision for appeals and Local Government Futures to assist with the forecast level of retained business rates.

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

(iii) It is assumed general inflation will increase by 2% per annum. Where the Council is contractually bound to increase costs and the Business Rates multiplier are increased by the relevant percentages.

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. In December 2020 it was agreed that the policy for the Business Plan would be to reschedule the current debt rather than seeking to go debt free, so enabling additional investment in further housing.

7.2 There is a requirement to follow Central Government National Housing Rent Policy when determining rents on HRA dwellings. Over the period April 2016 – March 2020, the rent charged by local authorities has had to be reduced by 1% per year. From April 2020 the social rent policy changed, 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. When a new tenancy commences the Council can re-let at Target Social Rent, in time bringing all social housing rents in line with 2002 Convergence policy.

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 2021 Budget Report, which reported savings required as follows:

	2021/22 £'000	2022/23 £'000	2023/24 £'000	2024/25 £'000	2025/26 £'000
Deficit-Savings Req(+) / Surplus(-) future years	0	0	178	-30	-216
Change on prev year	0	0	178	-208	-186

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

8.2 The forecasts are reviewed throughout the year, with the Executive being informed of the latest projections as part of the Budget Process.

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 2020 are summarised below: -

	Value £'000
Operational Assets	
Council Dwellings	402,119
HRA land and buildings	8,016
Other land and buildings	73,262
Vehicles, Plant, Furniture and Equipment	3,510
Infrastructure Assets	1,961
Community Assets	7,703
Non-Operational Assets	74,391
Surplus Assets/Work In Progress	275
Assets under construction	5,534
Heritage Assets	9,005
Investment Properties	10,234
Intangible Assets	43
Total	**475,562**

9.3 A summary of the proposed capital programme for the period to March 2025 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.

Portfolio	Latest Budget 20/21 £'000's	Proposed Expend. 21/22 £'000's	Proposed Expend. 22/23 £'000's	Proposed Expend. 23/24 £'000's	Proposed Expend. 24/25 £'000's	Total 20/21 to 24/25 £'000's
Strategic Leadership & CWLEP	547.6	402.8	277.0	257.0	74.0	1,558.4
Health & Community Protection	562.5	129.0				691.5
Culture	4,449.6	2,395.2	107.2			6,952.0
Finance	160.4	335.0	100.0			595.4
Neighbourhood	3,072.1	6,671.2	3,612.0	1,082.0	80.0	14,517.3
Development	7,488.8	4,598.4	12,236.4			24,323.6
Housing Investment	37,277.0	45,276.1	15,679.5	9,109.3	9,115.4	116,457.3
Total Capital Programme	**53,558.0**	**59,807.7**	**32,012.1**	**10,448.3**	**9,269.4**	**165,095.5**

10. Capital Strategy

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 Friends of the Pump Room Gardens, Jockey Club and Golf Centre on St Marys Lands. 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 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.

- Promoting the Town and its attractions and support the local economy through hosting the Commonwealth Games in 2022.

- 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 as other receipts have fallen in recent years. 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). A 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 now 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 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.

13.5 There is a separate section on Risk in all Committee Reports to Members.

Annex 1

Link Asset Services Economic Background

UK

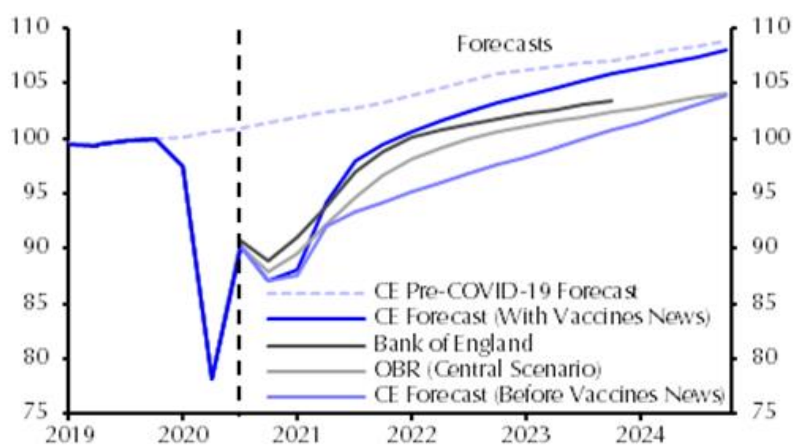
- The Bank of England's ("The Bank") Monetary Policy Committee (MPC) kept **Bank Rate** unchanged on 5 November 2020. However, it revised its economic forecasts to take account of a second national lockdown from 5 November to 2 December which will put back economic recovery and do further damage to the economy. The Bank, therefore, decided to do a further tranche of **quantitative easing** (QE) of £150bn, to start in January when the current programme of £300bn of QE announced in March to June, runs out. It did this so that "announcing further asset purchases now should support the economy and help to ensure the unavoidable near-term slowdown in activity was not amplified by a tightening in monetary conditions that could slow the return of inflation to the target".
- Its forecasts appeared, at the time, to be rather optimistic in terms of three areas:
  - The economy would recover to reach its pre-pandemic level in Q1 2022
  - The Bank also expects there to be excess demand in the economy by Q4 2022.
  - CPI inflation is therefore projected to be a bit above its 2% target by the start of 2023 and the "inflation risks were judged to be balanced".
- Significantly, there was no mention of **negative interest rates** in the minutes or Monetary Policy Report, suggesting that the MPC remains some way from being persuaded of the case for such a policy, at least for the next 6 -12 months. However, rather than saying that it "stands ready to adjust monetary policy", the MPC this time said that it will take "whatever additional action was necessary to achieve its remit". The latter seems stronger and wider and may indicate the Bank's willingness to embrace new tools.
- One key addition to **the Bank's forward guidance** in August was a new phrase in the policy statement, namely that "it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably". That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years' time, do not expect any action from the MPC to raise Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate. Link's Bank Rate forecast currently shows no increase (or decrease) through to quarter 1 2024 but there could well be no increase during the next five years as it will take some years to eliminate spare capacity in the economy, and therefore for inflationary pressures to rise to cause the MPC concern.
- **Inflation** is expected to briefly peak at around 2% towards the end of 2021 but this is a temporary short lived factor and so not a concern.

- However, the minutes did contain several references to **downside risks**. The MPC reiterated that the "recovery would take time, and the risks around the GDP projection were judged to be skewed to the downside". It also said "the risk of a more persistent period of elevated unemployment remained material". Downside risks could well include severe restrictions remaining in place in some form during the rest of December and most of January too. **Upside risks** included the early roll out of effective vaccines.
- **COVID-19 vaccines**. We had been waiting expectantly for news that various COVID-19 vaccines would be cleared as being safe and effective for administering to the general public. The Pfizer announcement on 9 November was very encouraging as its 90% effectiveness was much higher than the 50-60% rate of effectiveness of flu vaccines which might otherwise have been expected. However, this vaccine has demanding cold storage requirements of minus 70c that impairs the speed of application to the general population. It has therefore been particularly welcome that the Oxford University / AstraZeneca vaccine has now also been approved which is much cheaper and only requires fridge temperatures for storage. The Government has 60m doses on order and is aiming to vaccinate at a rate of 2m people per week starting in January, though this rate is currently restricted by a bottleneck on vaccine production; (a new UK production facility is due to be completed in June).
- These announcements, plus expected further announcements that other vaccines could be approved soon, have enormously boosted confidence that **life could largely return to normal during the second half of 2021**, with activity in the still-depressed sectors like restaurants, travel and hotels returning to their pre-pandemic levels, which would help to bring the unemployment rate down. With the household saving rate currently being exceptionally high, there is plenty of pent-up demand and purchasing power stored up for these services. A comprehensive roll-out of vaccines might take into late 2021 to fully complete; but if these vaccines prove to be highly effective, then there is a possibility that restrictions could begin to be eased, possibly in Q2 2021, once vulnerable people and front-line workers had been vaccinated. At that point, there would be less reason to fear that hospitals could become overwhelmed any more. Effective vaccines would radically improve the economic outlook once they have been widely administered; it may allow GDP to rise to its pre-virus level a year earlier than otherwise and mean that the unemployment rate peaks at 7% next year instead of 9%.
- **Public borrowing** is now forecast by the Office for Budget Responsibility (the OBR) to reach £394bn in the current financial year, the highest ever peace time deficit and equivalent to 19% of GDP. In normal times, such an increase in total gilt issuance would lead to a rise in gilt yields, and so PWLB rates. However, the QE done by the Bank of England has depressed gilt yields to historic low levels, (as has similarly occurred with QE and debt issued in the US, the EU and Japan). This means that new UK debt being issued, and this is being done across the whole yield curve in all maturities, is locking in those historic low levels through until maturity. In addition, the UK has one of the longest average maturities for its entire debt portfolio, of any country in the world. Overall, this means that the total interest bill paid by the Government is manageable despite the huge

increase in the total amount of debt. The OBR was also forecasting that the Government will still be running a budget deficit of £102bn (3.9% of GDP) by 2025/26. However, initial impressions are that they have taken a pessimistic view of the impact that vaccines could make in the speed of economic recovery.

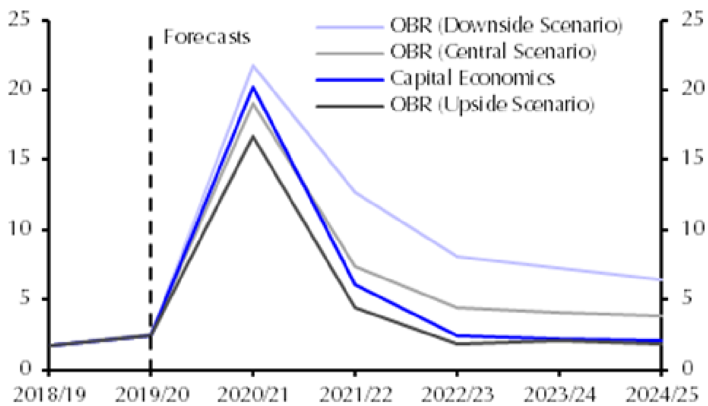
- Overall, the **pace of recovery** was not expected to be in the form of a rapid V shape, but a more elongated and prolonged one. The initial recovery was sharp after quarter 1 saw growth at -3.0% followed by -18.8% in quarter 2 and then an upswing of +16.0% in quarter 3; this still left the economy 8.6% smaller than in Q4 2019. It is likely that the one month national lockdown that started on 5th November, will have caused a further contraction of 8% month on month in November so the economy may have then been 14% below its pre-crisis level.
- **December 2020 / January 2021**. Since then, there has been rapid back-tracking on easing restrictions due to the spread of a new mutation of the virus, and severe restrictions were imposed across all four nations. These restrictions were changed on 5 January 2021 to national lockdowns of various initial lengths in each of the four nations, as the NHS was under extreme pressure. It is now likely that wide swathes of the UK will remain under these new restrictions for some months; this means that the near-term outlook for the economy is grim. However, the distribution of vaccines and the expected consequent removal of COVID-19 restrictions, should allow GDP to rebound rapidly in the second half of 2021 so that the economy could climb back to its pre-pandemic peak as soon as late in 2022. Provided that both monetary and fiscal policy are kept loose for a few years yet, then it is still possible that in the second half of this decade, the economy may be no smaller than it would have been if COVID-19 never happened. The significant caveat is if another mutation of COVID-19 appears that defeats the current batch of vaccines. However, now that science and technology have caught up with understanding this virus, new vaccines ought to be able to be developed more quickly to counter such a development and vaccine production facilities are being ramped up around the world.

Chart: Level of real GDP (Q4 2019 = 100)



- This recovery of growth which eliminates the effects of the pandemic by about the middle of the decade would have major repercussions for public finances as it would be consistent with the Government deficit falling to around 2.5% of GDP without any tax increases. This would be in line with the OBR's most optimistic forecast in the graph below, rather than their current central scenario which predicts a 4% deficit due to assuming much slower growth. However, Capital Economics forecasts assume that there is a reasonable Brexit deal and also that politicians do not raise taxes or embark on major austerity measures and so, (perversely!), depress economic growth and recovery.

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



- There will still be some **painful longer term adjustments** as e.g. office space and travel by planes, trains and buses may not recover to their previous level of use for several years, or possibly ever, even if vaccines are fully successful in overcoming the current virus. There is also likely to be a reversal of globalisation as this crisis has exposed how vulnerable long-distance supply chains are. On the other hand, digital services are one area that has already seen huge growth.
- **Brexit**. While the UK has been gripped by the long running saga of whether or not a deal would be made by 31 December 2020, the final agreement on 24 December, followed by ratification by Parliament and all 27 EU countries in the following week, has eliminated a significant downside risk for the UK economy. The initial agreement only covers trade so there is further work to be done on the services sector where temporary equivalence has been granted in both directions between the UK and EU; that now needs to be formalised on a permanent basis. As the forecasts in this report were based on an assumption of a Brexit agreement being reached, there is no need to amend these forecasts.
- **Monetary Policy Committee meeting of 17 December**. All nine Committee members voted to keep interest rates on hold at +0.10% and the Quantitative Easing (QE) target at £895bn. The MPC commented that the successful rollout of vaccines had reduced the downsides risks to the economy that it had highlighted in November. But this was caveated by it saying, "Although all members agreed that this would reduce downside risks, they placed different weights on the degree to which this was also expected to lead to stronger GDP growth in the central case." So, while the vaccine is a positive development, in the eyes of the MPC at least, the economy is far from out of the woods. As a result of these continued concerns, the MPC voted to extend the availability of the Term Funding

Scheme, (cheap borrowing), with additional incentives for small and medium size enterprises for six months from 30 April until 31 October 2021. (The MPC had assumed that a Brexit deal would be agreed.)

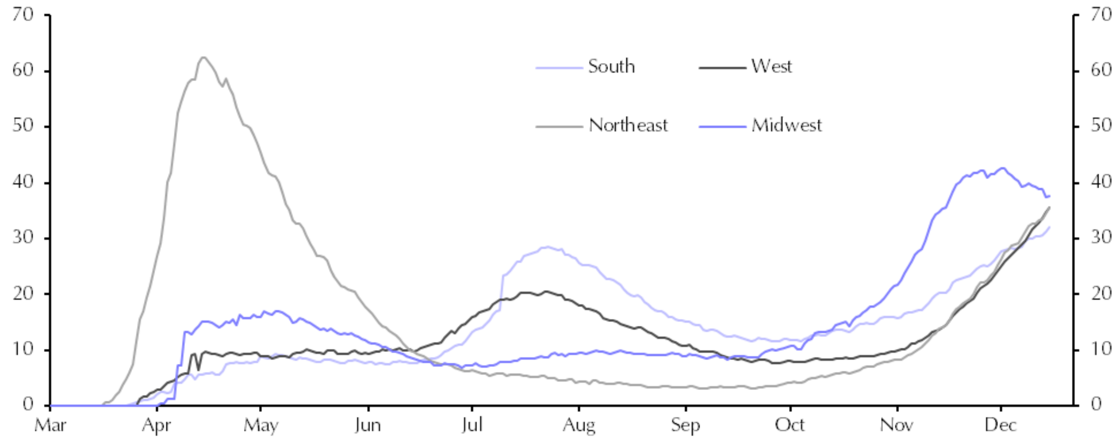
- **Fiscal policy**. In the same week as the MPC meeting, the Chancellor made a series of announcements to provide further support to the economy:
  - An extension of the COVID-19 loan schemes from the end of January 2021 to the end of March.
  - The furlough scheme was lengthened from the end of March to the end of April.
  - The Budget on 3 March 2021 will lay out the "next phase of the plan to tackle the virus and protect jobs". This does not sound like tax rises are imminent, (which could hold back the speed of economic recovery).
- The **Financial Policy Committee** (FPC) report on 6v August 2020 revised down their expected credit losses for the banking sector to "somewhat less than £80bn". It stated that in its assessment, "banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC's central projection". The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC's projection, with unemployment rising to above 15%.

USA

- The result of **the November elections** means that the Democrats have gained the presidency and a majority in the House of Representatives, and the winning of the two Senate seats in Georgia on 6 January mean they will hold a slim majority in the Senate. This means that the Democrats should be able to do a massive fiscal stimulus, as they had been hoping to do after the elections. That would result in another surge of debt issuance and could put particular upward pressure on debt yields – which could then also put upward pressure on gilt yields.
- Equity prices leapt up on 9 November on the first news of a successful vaccine and have risen further during November as more vaccines announced successful results. This could cause a big shift in investor sentiment i.e. a swing to sell out of Government debt to buy into equities which would normally be expected to cause debt prices to fall and yields to rise. However, the rise in yields has been quite muted so far and it is too early to say whether the Fed would feel it necessary to take action to suppress any further rise in debt yields. It is likely that the next two years, and possibly four years in the US, could be a political stalemate where neither party can do anything radical.
- The economy had been recovering quite strongly from its contraction in 2020 of 10.2% due to the **pandemic** with GDP only 3.5% below its pre-pandemic level and the unemployment rate dropping below 7%. However, the rise in new cases during quarter 4, to the highest level since mid-August, suggests that the US could be in the early stages of a third wave. While the first wave in March and April was concentrated in the Northeast, and the second wave in the South and West, the latest wave has been driven by a growing outbreak in the Midwest. The latest upturn poses a threat that the recovery in the economy could stall. This is

the single biggest downside risk to the shorter term outlook – a more widespread and severe wave of infections over the winter months, which is compounded by the impact of the regular flu season and, as a consequence, threatens to overwhelm health care facilities. Under those circumstances, states might feel it necessary to return to more draconian lockdowns.

COVID-19 hospitalisations per 100,000 population



- The restrictions imposed to control the spread of the virus are once again weighing on the economy with employment growth slowing sharply in November and retail sales dropping back. The economy is set for further weakness in December and into the spring. However, a $900bn fiscal stimulus deal passed by Congress in late December will limit the downside through measures which included a second round of direct payments to households worth $600 per person and a three-month extension of enhanced unemployment insurance (including a $300 weekly top-up payment for all claimants). GDP growth is expected to rebound markedly from the second quarter of 2021 onwards as vaccines are rolled out on a widespread basis and restrictions are loosened.

- After Chair Jerome Powell unveiled the **Fed's adoption of a flexible average inflation target** in his Jackson Hole speech in late August 2020, the mid-September meeting of the Fed agreed by a majority to a toned down version of the new inflation target in his speech - that *"it would likely be appropriate to maintain the current target range until labour market conditions were judged to be consistent with the Committee's assessments of maximum employment and inflation had risen to 2% and was on track to moderately exceed 2% for some time."* This change was aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary "trap" like Japan. It is to be noted that inflation has actually been under-shooting the 2% target significantly for most of the last decade, (and this year), so financial markets took note that higher levels of inflation are likely to be in the pipeline; long-term bond yields duly rose after the meeting. The FOMC's updated economic and rate projections in mid-September showed that officials expect to leave the fed funds rate at near-zero until at least end-2023 and probably for another year or two beyond that. There is now some expectation that where the Fed has led in changing its inflation target, other major central banks will follow. The increase in tension over the last year between the US and

China is likely to lead to a lack of momentum in progressing the initial positive moves to agree a phase one trade deal.

- The Fed's meeting on **5 November** was unremarkable - but at a politically sensitive time around the elections. At its **16 December** meeting the Fed tweaked the guidance for its monthly asset quantitative easing purchases with the new language implying those purchases could continue for longer than previously believed. Nevertheless, with officials still projecting that inflation will only get back to 2.0% in 2023, the vast majority expect the fed funds rate to be still at near-zero until 2024 or later. Furthermore, officials think the balance of risks surrounding that median inflation forecast are firmly skewed to the downside. The key message is still that policy will remain unusually accommodative – with near-zero rates and asset purchases – continuing for several more years. This is likely to result in keeping Treasury yields low – which will also have an influence on gilt yields in this country.

Eurozone

- In early December, the figures for Q3 GDP confirmed that the economy staged a rapid rebound from the first lockdowns. This provides grounds for optimism about growth prospects for next year. In Q2, GDP was 15% below its pre-pandemic level. But in Q3 the economy grew by 12.5% q/q leaving GDP down by "only" 4.4%. That was much better than had been expected earlier in the year. However, growth is likely to stagnate during Q4 and in Q1 of 2021, as a second wave of the virus has affected many countries: it is likely to hit hardest those countries more dependent on tourism. The €750bn fiscal support package eventually agreed by the EU after prolonged disagreement between various countries, is unlikely to provide significant support, and quickly enough, to make an appreciable difference in the countries most affected by the first wave.
- With inflation expected to be unlikely to get much above 1% over the next two years, the **ECB** has been struggling to get inflation up to its 2% target. It is currently unlikely that it will cut its central rate even further into negative territory from -0.5%, although the ECB has stated that it retains this as a possible tool to use. The ECB's December meeting added a further €500bn to the PEPP scheme, (purchase of government and other bonds), and extended the duration of the programme to March 2022 and re-investing maturities for an additional year until December 2023. Three additional tranches of TLTRO, (cheap loans to banks), were approved, indicating that support will last beyond the impact of the pandemic, implying indirect yield curve control for government bonds for some time ahead. The Bank's forecast for a return to pre-virus activity levels was pushed back to the end of 2021, but stronger growth is projected in 2022. The total PEPP scheme of €1,850bn of QE which started in March 2020 is providing protection to the sovereign bond yields of weaker countries like Italy. There is therefore unlikely to be a euro crisis while the ECB is able to maintain this level of support. However, as in the UK and the US, the advent of highly effective vaccines will be a game changer, although growth will struggle before later in quarter 2 of 2021.

China

- After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and then into Q3 and Q4; this has enabled China to recover all of the contraction in Q1. Policy makers have both quashed the virus and implemented a programme of monetary and fiscal support that has been particularly effective at stimulating short-term growth. At the same time, China's economy has benefited from the shift towards online spending by consumers in developed markets. These factors help to explain its comparative outperformance compared to western economies.
- However, this was achieved by major central government funding of yet more infrastructure spending. After years of growth having been focused on this same area, any further spending in this area is likely to lead to increasingly weaker economic returns in the longer term. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.

Japan

- A third round of fiscal stimulus in early December took total fresh fiscal spending this year in response to the virus close to 12% of pre-virus GDP. That's huge by past standards, and one of the largest national fiscal responses. The budget deficit is now likely to reach 16% of GDP this year. Coupled with Japan's relative success in containing the virus without draconian measures so far, and the likelihood of effective vaccines being available in the coming months, the Government's latest fiscal effort should help ensure a strong recovery and to get back to pre-virus levels by Q3 2021 – around the same time as the US and much sooner than the Eurozone.

World Growth

- World growth will have been in recession in 2020. Inflation is unlikely to be a problem for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.
- Until recent years, world growth has been boosted by increasing **globalisation** i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has depressed inflation. However, the rise of China as an economic superpower over the last thirty years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. The Chinese Government has targeted achieving major world positions in specific key sectors and products, especially high tech areas and production of rare earth minerals used in high tech products. It is achieving this by massive financial support, (i.e. subsidies), to state owned firms, government directions to other firms, technology theft, restrictions on market access by foreign firms and informal targets for the domestic market share of Chinese producers in the selected sectors. This is regarded as being unfair competition that is putting western firms at an unfair disadvantage or even putting some out of business. It is also regarded with suspicion on the political front as China is an authoritarian country that is not averse to using economic and military power for political

advantage. The current trade war between the US and China therefore needs to be seen against that backdrop. It is, therefore, likely that we are heading into a period where there will be a **reversal of world globalisation and a decoupling of western countries** from dependence on China to supply products. This is likely to produce a backdrop in the coming years of weak global growth and so weak inflation.

Summary

- Central banks are, therefore, likely to support growth by maintaining loose monetary policy through keeping rates very low for longer. Governments could also help a quicker recovery by providing more fiscal support for their economies at a time when total debt is affordable due to the very low rates of interest. They will also need to avoid significant increases in taxation or austerity measures that depress demand in their economies.
- If there is a huge surge in investor confidence as a result of successful vaccines which leads to a major switch out of government bonds into equities, which, in turn, causes government debt yields to rise, then there will be pressure on central banks to actively manage debt yields by further QE purchases of government debt; this would help to suppress the rise in debt yields and so keep the total interest bill on greatly expanded government debt portfolios within manageable parameters. It is also the main alternative to a programme of austerity.

Interest Rate Forecasts

Brexit. The interest rate forecasts provided by Link were predicated on an assumption of a reasonable agreement being reached on trade negotiations between the UK and the EU by 31 December 2020. There is therefore no need to revise these forecasts now that a trade deal has been agreed. Brexit may reduce the economy's potential growth rate in the long run. However, much of that drag is now likely to be offset by an acceleration of productivity growth triggered by the digital revolution brought about by the COVID-19 crisis.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably now skewed to the upside, but is still subject to some uncertainty due to the virus and the effect of any mutations, and how quick vaccines are in enabling a relaxation of restrictions.
- There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, could impact gilt yields, (and so PWLB rates), in the UK.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- **UK government** takes too much action too quickly to raise taxation or introduce austerity measures that depress demand in the economy.
- **UK - Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis.** The ECB has taken monetary policy action to support the bonds of EU states, with the positive impact most likely for "weaker" countries. In addition, the EU agreed a €750bn fiscal support package. These actions will help shield weaker economic regions for the next two or three years. However, in the case of Italy, the cost of the virus crisis has added to its already huge debt mountain and its slow economic growth will leave it vulnerable to markets returning to taking the view that its level of debt is unsupportable. There remains a sharp divide between northern EU countries favouring low debt to GDP and annual balanced budgets and southern countries who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come.
- Weak capitalisation of some **European banks**, which could be undermined further depending on extent of credit losses resultant of the pandemic.

- **German minority government & general election in 2021.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. The CDU has done badly in subsequent state elections but the SPD has done particularly badly. Angela Merkel has stepped down from being the CDU party leader but she will remain as Chancellor until the general election in 2021. This then leaves a major question mark over who will be the major guiding hand and driver of EU unity when she steps down.
- **Other minority EU governments.** Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU, and they had threatened to derail the 7 year EU budget until a compromise was thrashed out in late 2020. There has also been a rise in anti-immigration sentiment in Germany and France.
- **Geopolitical risks,** for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates

- **UK -** a significant rise in inflationary pressures e.g. caused by a stronger than currently expected recovery in the UK economy after effective vaccines are administered quickly to the UK population, leading to a rapid resumption of normal life and return to full economic activity across all sectors of the economy.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a rapid series of increases in Bank Rate to stifle inflation.