REPORT REFERENCE NO.	**DSFRA/22/6**
MEETING	**DEVON & SOMERSET FIRE & RESCUE AUTHORITY**
DATE OF MEETING	**18 FEBRUARY 2022 (Budget Meeting)**
SUBJECT OF REPORT	**TREASURY MANAGEMENT STRATEGY (INCLUDING PRUDENTIAL AND TREASURY INDICATORS) 2022-23 TO 2024-25**
LEAD OFFICER	**Director of Finance, People & Estates (Treasurer)**
RECOMMENDATIONS	***That, as recommended by the Resources Committee at its budget meeting on 8 February 2022, the Authority approves:*** ***(a). the expansion of its approved counter parties to include subsidiary entities but that the terms and conditions of any such arrangement be reserved to the Authority;*** ***(b). the Treasury Management Strategy and the Annual Investment Strategy;*** ***(c). the Minimum Revenue Provision statement for 2022-23, as contained as Appendix B;***
EXECUTIVE SUMMARY	As agreed at the Authority meeting of 18 December 2017, there is a requirement for Resources Committee to review the Treasury Management Strategy for recommendation to the Authority. This report sets out a treasury management strategy and investment strategy for 2022/23, including the Prudential Indicators associated with the capital programme for 2022/23 to 2024-25 considered elsewhere on the agenda of this meeting. A Minimum Revenue Provision Statement for 2022/23 is also included for approval. The 2021/22 revised Prudential Code also requires the Treasurer to certify that none of the Authority's spending plans include the acquisition of assets primarily for yield. The contents of this report were considered by the Resources Committee at its budget meeting on 8 February 2022. The Committee resolved to commend the Strategy and associated Prudential Indicators to the Authority for approval.
RESOURCE IMPLICATIONS	As indicated in this report
EQUALITY RISKS AND BENEFITS ANALYSIS	The contents of this report are considered compatible with existing human rights and equality legislation.

APPENDICES	A. Prudential and Treasury Management Indicators 2022/23 to 2023-25. B. Minimum Revenue Provision Statement 2022/23. C. Link Treasury Solutions economic report
BACKGROUND PAPERS	Local Government Act 2003. Chartered Institute of Public Finance Accountancy's (CIPFA) Prudential Code and CIPFA Treasury Management Code of Practice

1. INTRODUCTION

Background

1.1. The Authority is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low-risk counterparties or instruments commensurate with the Authority's low risk appetite, providing adequate liquidity initially before considering investment return.

1.2. The second main function of the treasury management service is the funding of the Authority's capital plans. These capital plans provide a guide to the borrowing need of the Authority, essentially the longer-term cash flow planning, to ensure that the Authority can meet its capital spending obligations. This management of longer-term cash may involve arranging long or short-term loans or using longer-term cash flow surpluses. On occasion, when it is prudent and economic, any debt previously drawn may be restructured to meet Authority risk or cost objectives.

1.3. The contribution the treasury management function makes to the authority is critical, as the balance of debt and investment operations ensure liquidity or the ability to meet spending commitments as they fall due, either on day-to-day revenue or for larger capital projects. The treasury operations will see a balance of the interest costs of debt and the investment income arising from cash deposits affecting the available budget. Since cash balances generally result from reserves and balances, it is paramount to ensure adequate security of the sums invested, as a loss of principal will in effect result in a loss to the General Fund Balance.

1.4. CIPFA defines treasury management as:

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

1.5. The Authority has not engaged in any commercial investments and has no non-treasury investments.

1.6. The contents of this report were considered by the Resources Committee at its budget meeting on 8 February 2022. The Committee resolved (Minute RC/21/21 refers:

that the Authority be recommended to approve:

(a). expansion of its approved counter-parties to include subsidiary entities, subject to the terms and conditions of any such arrangement being reserved to the Authority;

(b). the Treasury Management Strategy and Annual Investment Strategy 2022-23 as set out in report RC/22/4; and (c). the Minimum Revenue Provision Statement 2022-23 as appended to the report.

Statutory requirements

1.7. The Local Government Act 2003 (the Act) and supporting regulations requires the Authority to “have regard to” the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next three years to ensure that the Authority’s capital investment plans are affordable, prudent and sustainable.

1.8. The Act therefore requires the Authority to set outs its treasury strategy for borrowing and to prepare an Annual Investment Strategy (as required by Investment Guidance subsequent to the Act and included as Section 4 of this report); this sets out the Authority’s policies for managing its investments and for giving priority to the security and liquidity of those investments.

1.9. MHCLG (now Department for Levelling Up, Housing and Communities - DLUHC) issued revised investment guidance which came into force from 1 April 2018. This guidance was captured within the revised Chartered Institute of Public Finance and Accountancy’s (CIPFA) Treasury Management Code 2017.

CIPFA requirements

1.10. The CIPFA 2021/22 Prudential and Treasury Management Codes require all local authorities to prepare a capital strategy report which will provide the following:

- a high-level long-term overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services;
- an overview of how the associated risk is managed;
- the implications for future financial sustainability; and
- declare that the capital spends do not include the acquisition of assets primarily for yield.

1.11. The aim of this capital strategy is to ensure that all elected members on the full Authority fully understand the overall long-term policy objectives and resulting capital strategy requirements, governance procedures and risk appetite.

Treasury Management reporting

1.12. The Authority is currently required to receive and approve, as a minimum, three main treasury reports each year, which incorporate a variety of policies, estimates and actuals.

a. **Prudential and Treasury Indicators and Treasury Strategy** (this report): The first, and most important report is forward looking and covers:

   - the capital plans, (including prudential indicators);
   - a minimum revenue provision (MRP) policy, (how residual capital expenditure is charged to revenue over time);

- the treasury management strategy, (how the investments and borrowings are to be organised), including treasury indicators; and
- an investment strategy, (the parameters on how investments are to be managed).

b. A Mid-year Treasury Management Report: This is primarily a progress report and will update members on the capital position, amending prudential indicators as necessary, and whether any policies require revision. In addition, this Authority will receive quarterly update reports.

c. An Annual Treasury Report: This is a backward-looking review document and provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

1.13. The above reports are required to be adequately scrutinised before being recommended to the Authority. This role is undertaken by the Resources Committee.

1.14. The Authority has adopted the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management. The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Authority's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Authority will seek to achieve those policies and objectives.
- Receipt by the Authority of an annual Treasury Management Strategy Statement – including the Annual Investment Strategy and Minimum Revenue Provision Policy for the year ahead, a mid-year review report and an annual report (stewardship report) covering activities during the previous year.
- Delegation by the Authority of responsibilities for implementing and monitoring treasury management policies and practices - for the Authority the delegated body is Resources Committee - and for the execution and administration of treasury management decisions - for the Authority the responsible officer is the Treasurer.
- Delegation by the Authority of the role of scrutiny of treasury management strategy and polices to a named body - for the Authority the delegated body is Resources Committee.

Treasury Management Strategy for 2022/23

1.15. The suggested strategy for 2022/23 in respect of the following aspects of the treasury management function is based upon the treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Authority's treasury advisor, Link Group (Link).

1.16. The strategy for 2022/23 covers two main areas:

Capital Issues

- capital plans and prudential indicators
- the Minimum Revenue Provision statement

Treasury Management Issues

- treasury limits in force which will limit the treasury risk and activities of the Authority
- treasury Indicators
- the current treasury position
- the borrowing requirement
- prospects for interest rates
- the borrowing strategy
- policy on borrowing in advance of need
- debt rescheduling
- the investment strategy
- creditworthiness policy
- policy on use of external service providers

Training

1.17. The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny.

Treasury Management Advisors

1.18. The Authority uses Link Group, Treasury solutions as its external treasury management advisors.

1.19. The Authority recognises that responsibility for treasury management decisions remains with the Authority at all times and will ensure that undue reliance is not placed upon the services of its external service providers. All decisions will be undertaken with regards to all available information, including, but not solely, its treasury advisers.

1.20. The Authority also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Authority will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed, documented and subjected to regular review.

2. CAPITAL PRUDENTIAL INDICATORS FOR 2022/23 TO 2023-24

2.1. The Authority's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist Members' overview and confirm capital expenditure plans.

2.2. This prudential indicator is a summary of the Authority's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. Members are asked to approve the capital expenditure forecasts as proposed in the Capital Programme report considered elsewhere on the agenda. Other long-term liabilities such as PFI (Private Finance Initiative) and leasing arrangements which already include borrowing instruments are excluded.

Proposed Capital Expenditure	2021-22 (forecast spending)	2022-23	2023-24 (provisional)	2024-25 (provisional)
	£m	£m	£m	£m
Estates	3.655	3.123	6.600	2.200
Fleet & Equipment	6.172	3.931	9.400	5.800
Total	9.827	7.054	16.000	8.000

2.3. The following table summarises the financing of the capital programmes shown above. Additional capital finance sources may become available during the year, for example, additional grants or external contributions. The Authority will be requested to approve increases to the capital programme to be financed from other capital resources as and when the need arises.

Capital Financing	2021-22 (forecast spending)	2022-23	2023-24 (provisional)	2024-25 (provisional)
	£m	£m	£m	£m
Capital receipts/ contributions	0.000	0.300	0.000	0.000
Capital grants	0.000	0.000	0.000	0.000
Capital reserves	5.766	4.189	12.417	0.998
Revenue	2.037	1.200	2.300	2.300
Existing borrowing	2.024	1.365	1.283	1.370
New borrowing	0.000	0.000	0.000	3.332
Total	9.827	7.054	16.000	8.000

The Authority's Borrowing Need (Capital Financing Requirement)

2.4. The second prudential indicator is the Authority's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Authority's indebtedness and so its underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

2.5. The CFR does not increase indefinitely, as the Minimum Revenue Provision is a statutory annual revenue charge which broadly reduces the indebtedness in line with each asset's life, and so charges the economic consumption of capital assets as they are used.

2.6. The CFR includes any other long-term liabilities (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Authority's borrowing requirement, these types of scheme include a borrowing facility by the PFI via a public-private partnership lease provider and so the Authority is not required to separately borrow for these schemes. The Authority currently has £1.010m of such schemes within the CFR.

2.7. The Authority is asked to approve the CFR projections below as included in Appendix A:

Capital Financing Requirement (CFR)	2022-23 (forecast spending)	2023-24	2024-25 (provisional)	2025-26 (provisional)
	£m	£m	£m	£m
Non-HRA expenditure	24.264	23.771	26.645	28.820
Other Long Term Liabilities	1.686	1.308	1.007	0.661
Total CFR	25.950	25.078	27.652	29.481
Movement in CFR	2.534	(3.026)	0.445	(0.641)
Less MRP	2.249	(2.155)	(2.129)	(2.471)
Net movement in CFR	0.285	(0.872)	2.573	1.829

Core funds and expected investment balances

2.8. The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year-end balances for each resource and anticipated day-to-day cash flow balances.

Estimated Year end Resources	2022-23	2023-24	2024-25	2025-26
	£m	£m	£m	£m
Reserve Balances	16.996	27.090	13.901	9.529
Capital receipts/ contributions	0.300	0.000	1.250	0.250
Provisions	0.000	0.000	0.000	0.000
Other	8.899	10.903	12.432	14.455
Total core funds	26.195	37.993	27.583	24.234
Working capital*	1.000	1.000	1.000	1.000
Under/over borrowing	0.000	0.000	0.000	0.000
Expected investments	27.195	38.993	28.583	25.234

*Working capital balances shown are estimated year-end; these may be higher mid-year

Minimum Revenue Provision Strategy

2.9. The Authority is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the Minimum Revenue Provision), although it is also allowed to undertake additional voluntary payments if required (Voluntary Revenue Provision).

2.10. DLUCH (formally MHCLG) regulations have been issued which require the Authority to approve a **Minimum Revenue Provision Statement** in advance of each year. A variety of options are provided under which Minimum Revenue Provision could be made, with an overriding recommendation that the Authority should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits.

2.11. The Authority does not plan to make any Voluntary Revenue Provisions within the next three years.

2.12. Although four main options are provided under the guidance, the Authority has adopted:

The Asset Life Method

2.13. Where capital expenditure on an asset is financed wholly or partly by borrowing or credit arrangements, Minimum Revenue Provision is to be made in equal annual instalments over the life of the asset. In this circumstance the asset life is to be determined when Minimum Revenue Provision commences and not changed after that.

2.14. Minimum Revenue Provision should normally commence in the financial year following the one in which the expenditure is incurred. However, when borrowing to construct an asset, the Authority may treat the asset life as commencing in the year in which the asset first becomes operational. It may accordingly postpone beginning to make Minimum Revenue Provision until that year. Investment properties should be regarded as becoming operational when they begin to generate revenues.

2.15. As some types of capital expenditure incurred by the Authority are not capable of being related to an individual asset, asset lives will be assessed on a basis which most reasonably reflects the anticipated period of benefit that arises from the expenditure. Also, whatever type of expenditure is involved, it will be grouped together in a manner which reflects the nature of the main component of expenditure and will only be divided up in cases where there are two or more major components with substantially different useful economic lives.

2.16. A draft Minimum Revenue Provision statement for 2022/23 is attached as Appendix B for approval.

2.17. The financing of the approved 2022/23 capital programme, and the resultant prudential indicators have been set on the basis of the content of this statement.

Prudential Indicators for Affordability

2.18. The previous sections of the report cover the overall limits for capital expenditure and borrowing, but within the overall framework indicators are also included to demonstrate the affordability of capital investment plans.

2.19. A key indicator of the affordability of capital investment plans is the ratio of financing costs to the net revenue stream; this indicator identifies the trend in the cost of capital financing (borrowing costs net of investment income) against the Authority's net budget requirement. Annual capital financing costs are a product of total debt outstanding, the annual repayment regime and interest rates. The forecast ratios for 2022/23 to 2022-23 based on current commitments and the proposed Capital Programme are shown below.

Financing costs as a % of net revenue	2022-23 (forecast spending)	2023-24	2024-25 (provisional)	2025-26 (provisional)
Annual cost	4.19%	3.49%	3.54%	3.83%

3. BORROWING

3.1. The capital expenditure plans set out in Section 2 provide details of the service activity of the Authority. The treasury management function ensures that the Authority's cash is organised in accordance with the relevant professional codes, so that sufficient cash is available to meet this service activity and the Authority's capital strategy. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

Current borrowing position

3.2. The Authority's treasury portfolio position at 31 March 2021 and the current position are summarised below.

TREASURY PORTFOLIO				
	actual	actual	current	current
	31.3.21	**31.3.21**	**31.12.21**	**31.12.21**
Treasury investments	£000	%	£000	%
banks	13,001	34%	30,151	79%
building societies - unrated		0%		0%
building societies - rated		0%		0%
local authorities	21,500	57%	6,500	17%
DMADF (H.M.Treasury)		0%		0%
money market funds	3,515	9%	1,510	4%
certificates of deposit		0%		0%
Total managed in house	**38,016**	**100%**	**38,161**	**100%**
bond funds		0%		0%
property funds		0%		0%
Total managed externally	**0**	**0%**	**0**	**0%**
Total treasury investments	**38,016**	**100%**	**38,161**	**100%**
Treasury external borrowing				
local authorities		0%		0%
PWLB	24,851	100%	24,804	100%
LOBOs		0%		0%
Total external borrowing	**24,851**	**100%**	**24,804**	**100%**

3.3. The Authority's forward projections for borrowing are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement (CFR)), highlighting any over or under borrowing.

External Debt	2022-23 (forecast spending)	2023-24	2024-25	2025-26
	£m	£m	£m	£m
Debt at 1 April	24.264	23.771	26.645	28.820
Expected change in Debt	(0.493)	(0.493)	2.874	2.176
Other long-term liabilities (OLTL)	1.686	1.308	1.007	0.661
Expected change in OLTL	(0.378)	(0.301)	(0.346)	0.246
Actual gross debt at 31 March	25.079	24.285	30.179	31.903
CFR	25.950	25.078	27.652	29.481
Under/ Over borrowing	0.000	0.000	0.000	0.000

3.4. Within the prudential indicators there are a number of key indicators to ensure that the Authority operates its activities within well-defined limits. One of these is that the Authority needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2022/23 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue or speculative purposes.

3.5. The Authority complied with this prudential indicator in the current year and is not envisaging difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

Limits to Borrowing Activity

3.6. Two Treasury Management Indicators control the level of borrowing. They are:

- **The operational boundary.** This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt and the ability to fund under-borrowing by other cash resources.

Estimated Operational Boundary	2022-23	2023-24	2024-25	2025-26
	£m	£m	£m	£m
Non-HRA expenditure	24,857	24,364	27,203	29,014
Other Long Term Liabilities	1,689	2,186	1,808	1,507
Total	26,547	26,550	29,011	30,521

- **The authorised limit for external debt**. A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the Authority. It reflects the level o external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

  This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all Authority's plans, or those of a specific Authority, although this power has not yet been exercised.

3.7. The Authority is asked to approve the following authorised limit:

Estimated Authorised Limit	2022-23	2023-24	2024-25	2025-26
	£m	£m	£m	£m
Non-HRA expenditure	26,071	25,553	28,535	30,455
Other Long Term Liabilities	1,774	2,251	1,858	1,540
Total	27,844	27,804	30,393	31,995

Prospects for interest rates

3.8. The Authority has appointed Link Group as its treasury advisor and part of their service is to assist the Authority to formulate a view on interest rates. The table overleaf and narrative within Appendix C of this report gives their view.

Link Group Interest Rate View 20.12.21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
BANK RATE	0.25	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25
3 month ave earnings	0.20	0.30	0.50	0.50	0.60	0.70	0.80	0.90	0.90	1.00	1.00	1.00	1.00	1.00
6 month ave earnings	0.40	0.50	0.60	0.60	0.70	0.80	0.90	1.00	1.00	1.10	1.10	1.10	1.10	1.10
12 month ave earnings	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.10	1.10	1.20	1.20	1.20	1.20	1.20
5 yr PWLB	1.40	1.50	1.50	1.60	1.60	1.70	1.80	1.80	1.80	1.90	1.90	1.90	2.00	2.00
10 yr PWLB	1.60	1.70	1.80	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.10	2.20	2.30
25 yr PWLB	1.80	1.90	2.00	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.40	2.40	2.50	2.50
50 yr PWLB	1.50	1.70	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.20	2.20	2.30	2.30

Borrowing strategy

3.9. As reported in the separate report on this agenda "Capital Programme 2022-23 to 2023-24", it is the strategic intent of the Authority not to increase its exposure to external borrowing during the next three years. To achieve this a recommendation the Authority has supported the inclusion in the base revenue budget a revenue contribution to capital investment (£0.9m in 2022/23).

3.10. This being the case there is no intention to take out any new borrowing during 2022/23 as the Authority can rely on its prudent Capital Reserve. Should this position change then the Treasury Management Strategy will need to be reviewed to reflect any change to the borrowing strategy and would be subject to a further report to the Authority.

Policy on borrowing in advance of need

3.11. Per statutory requirements, the Authority will not borrow more than, or in advance of, its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be considered carefully to ensure value for money can be demonstrated and that the Authority can ensure the security of such funds.

Debt rescheduling

3.12. Officers regularly engage with Link to review the PWLB loan portfolio and consider opportunities for early repayment, this is not currently economically viable due to the penalties applied.

3.13. Rescheduling of current borrowing in our debt portfolio is unlikely to occur as the 100 bps increase in PWLB rates only applied to new borrowing rates and not to premature debt repayment rates.

3.14. If rescheduling was done, it will be reported to this Committee, at the earliest meeting following its action.

4. <u>ANNUAL INVESTMENT STRATEGY</u>

Investment Policy

4.1. The Authority's investment policy has regard to the MHCLG's Guidance on Local Government Investments ("the Guidance"), CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 ("the Code") and the CIPFA Treasury Management Guidance Notes 2018. The Authority's investment priorities will be security first, portfolio liquidity second, then yield.

4.2. In accordance with the above guidance from the MHCLG and CIPFA, and in order to minimise the risk to investments, the Authority applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the short-term and long-term ratings.

4.3. Ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To achieve this consideration the Authority will engage with its advisors to maintain a monitor on market pricing such as “credit default swaps” and overlay that information on top of the credit ratings.

4.4. Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

Creditworthiness Policy

4.5. The Authority applies the creditworthiness service provided by Link Group. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody’s and Standard & Poor’s.

4.6. The credit ratings of counterparties are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies;
- credit defaults swap spreads to give early warning of likely changes in credit ratings;
- Sovereign ratings to select counterparties from only the most creditworthy countries.

4.7. This modelling approach combines credit ratings, credit watches, credit outlooks and Credit Default Swap spreads in a weighted scoring system which is then combined with an overlay of Credit Default Swap spreads for which the end-product is a series of colour code bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Authority to determine the duration for investments and are therefore referred to as durational bands. The Authority is satisfied that this service now gives a much improved level of security for its investments. It is also a service which the Authority would not be able to replicate using in house resources.

4.8. The Link Group creditworthiness service uses a wider array of information than just primary ratings. Furthermore, by using a risk weighted scoring system, it does not give undue preponderance to just one agency’s ratings.

4.9. Typically the minimum credit ratings criteria the Authority use will be a Short-Term rating (Fitch or equivalents) of F1 and a Long-Term rating of A-. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

4.10. All credit ratings will be monitored weekly. The Authority is alerted to changes to ratings of all three agencies through its use of the Link creditworthiness service. If a downgrade results in the counterparty/investment scheme no longer meeting the Authority's minimum criteria, its further use as a new investment will be withdrawn immediately. In addition to the use of Credit Ratings, the Authority will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Authority's lending list.

4.11. Sole reliance will not be placed on the use of this external service. In addition the Authority will also use market data and market information, information on government support for banks and the credit ratings of that government support.

Approved Instruments for Investments

4.12. Investments will only be made with those bodies identified by the authority for its use through the Annual Investment Strategy.

4.13. **Country Limits.** The Authority will apply a sovereign rating at least equal to that of the United Kingdom for any UK based counterparty. At the time of writing this was AA long term and F1+ short term. It is possible that the credit rating agencies could downgrade the sovereign rating for the UK but as we have no minimum sovereign rating applying to the UK this approach will not limit the number of UK counterparties available to the Authority. Therefore, to ensure our credit risk is not increased outside the UK, the sovereign rating requirement for investments was amended to "Non UK countries with a minimum sovereign rating of AA-"

4.14. **IFRS9 Lease Accounting** As a result of the change in accounting standards for 2019/20 under IFRS 9, the Authority will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Fund. (In November 2018, MHCLG concluded a consultation for a temporary override to allow English local authorities time to adjust their portfolio of all pooled investments by announcing a statutory override to delay implementation of IFRS 9 for five years commencing from 1.4.18.). The Authority does not currently hold any finance leases to which this accounting standard would apply.

Non-specified Investments

4.15. Non specified investments are those which do not meet the Specified Investment Criteria and covers those counterparties where there is either no recognised credit rating and/or an anticipation that an investment will be for greater than one year in duration.

4.16. The Authority had not previously placed non-specified investments as a result of its prudent approach to place security and liquidity over yield. However, from April 2015 it was agreed that the strategy be amended to include investments with maturity of longer than 364 days. The maximum duration limit on any non-specified deposit will be determined by the colour assigned to the Counterparty on the Link Group credit list on the date the investment is placed, but typically will be for no longer than 24 months. Where such investments are placed via the Secondary Market i.e. buying the remaining term of an existing instrument, then the term will be for 24 months.

4.17. A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made it will fall into one of the categories outlined in Table 13 below.

4.18. The maturity limits recommended will not be exceeded. Under the delegated powers the Section 112 Officer (Treasurer) can set limits that are based on the latest economic conditions and credit ratings.

4.19. The following table shows those bodies with which the Authority will invest.

Specified Investments	**Non Specified Investments**
	Subsidiary entities
Deposits with the Debt Management Agency Deposit Facility	
Term Deposits with UK government, UK local authorities, highly credit rated banks and building societies (including callable deposits and forward deals)	Term Deposits with UK government, UK local authorities, highly credit rated banks and building societies (including callable deposits and forward deals) Non-credit rated building societies. ***The total amount of non-specified investments will not be greater than £5m in value.***
Banks nationalised/part nationalised or supported by the UK government	Banks nationalised/part nationalised or supported by the UK government
Money Market Funds	
Non UK highly credited rated banks	
UK Government Treasury Bills	
Certificates of Deposit	
Corporate Bonds	
Gilts	

4.20. The Authority's detailed risk management policy is outlined in the Treasury Management Policy which is reviewed and considered on an annual basis.

4.21. The above criteria has been amended since last year to reflect the potential for a loan to be made to the Authority's subsidiary company, although this would be subject to terms and conditions as approved by the Authority.

Investment Strategy

4.22. In-house funds: The Authority's in-house managed funds are mainly cash-flow derived and investments will accordingly be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates.

4.23. Investment returns: Bank Rate is unlikely to rise from 0.10% for a considerable period. It is very difficult to say when it may start rising so it may be best to assume that investment earnings from money market-related instruments will be sub 0.50% for the foreseeable future.

4.24. The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year are as follows:

2022/23	0.50%
2023/24	0.75%
2024/25	1.00%
2025/26	
Later years	2.00%

4.25. **Investment treasury indicator and limit** - total principal funds invested for greater than 365 days. These limits are set with regard to the Authority's liquidity requirements and to reduce the need for early sale of an investment and are based on the availability of funds after each year-end.

Maximum principal sums invested > 365 days			
£m	**2022-23**	**2023-24**	**2024-25**
Principal sums invested > 365 days	£5m	£5m	£5m

End of year investment report

4.26. At the end of the financial year, the Authority will report on its investment activity as part of its Annual Treasury Report.

Treasury Management Scheme of Delegation

The Authority;

- Receiving and reviewing reports on treasury management policies, practices and activities
- Approval of annual strategy

- Approval of/amendments to the Authority's adopted clauses, treasury management policy statement and treasury management practices
- Budget consideration and approval
- Approval of the division of responsibilities
- Approving the selection of external service providers and agreeing terms of appointment.
- Reviewing the treasury management policy and procedures and making recommendations to the Authority.

Resources Committee;

- Receiving and reviewing regular monitoring reports and acting on recommendations
- Review of annual strategy prior to recommendation to full authority

Role of the Section 112 officer (Director of Finance and Resourcing/ Treasurer)

- Recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance
- Submitting regular treasury management policy reports
- Submitting budgets and budget variations
- Receiving and reviewing management information reports
- Reviewing the performance of the treasury management function
- Ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function
- Ensuring the adequacy of internal audit and liaising with external audit
- Recommending the appointment of external service providers.

5. SUMMARY AND RECOMMENDATIONS

5.1. The Authority is required to consider and approve the treasury management strategy to be adopted prior to the start of the financial year. This strategy must also include proposed prudential indicators and a Minimum Revenue Provision statement. Approval of the strategy for 2022/23 as contained in this report will also incorporate the adoption of the revised CIPFA Treasury Management Code of Practice.

SHAYNE SCOTT
Director of Finance, People and Estates (Treasurer)

APPENDIX A TO REPORT DSFRA/22/6

PRUDENTIAL INDICATORS

	2022/23 £m Estimate	2023/24 £m Estimate	2024/25 £m Estimate	INDICATIVE INDICATORS 2025/26 £m Estimate	INDICATIVE INDICATORS 2026/27 £m Estimate
Capital Expenditure					
Non - HRA	7.054	16.000	8.000	6.600	6.400
HRA (applies only to housing authorities)					
Total	7.054	16.000	8.000	6.600	6.400
Ratio of financing costs to net revenue stream					
Non - HRA	4.19%	3.49%	3.54%	3.92%	3.66%
HRA (applies only to housing authorities)	0.00%	0.00%	0.00%	0.00%	0.00%
Capital Financing Requirement as at 31 March	£000	£000	£000	£000	£000
Non - HRA	24,264	23,771	27,545	29,645	31,747
HRA (applies only to housing authorities)	0	0	0	0	0
Other long term liabilities	1,686	1,308	1,007	661	381
Total	25,950	25,078	28,552	30,306	32,127
Annual change in Capital Financing Requirement	£000	£000	£000	£000	£000
Non - HRA	285	(872)	3,473	1,754	1,821
HRA (applies only to housing authorities)	0	0	0	0	0
Total	285	(872)	3,473	1,754	1,821
PRUDENTIAL INDICATORS - TREASURY MANAGEMENT					
Authorised Limit for external debt	£000	£000	£000	£000	£000
Borrowing	26,071	25,553	28,580	30,496	33,278
Other long term liabilities	1,774	2,251	1,858	1,540	1,180
Total	27,844	27,804	30,438	32,036	34,458
Operational Boundary for external debt	£000	£000	£000	£000	£000
Borrowing	24,857	24,364	27,203	29,014	31,690
Other long term liabilities	1,689	2,186	1,808	1,507	1,161
Total	26,547	26,550	29,011	30,521	32,851
Maximum Principal Sums Invested over 364 Days					
Principal Sums invested > 364 Days	5,000	5,000	5,000	5,000	5,000

TREASURY MANAGEMENT INDICATOR	Upper Limit %	Lower Limit %
Limits on borrowing at fixed interest rates	100%	70%
Limits on borrowing at variable interest rates	30%	0%
Maturity structure of fixed rate borrowing during 2022/23		
Under 12 months	30%	2%
12 months and within 24 months	30%	4%
24 months and within 5 years	50%	14%
5 years and within 10 years	75%	1%
10 years and above	100%	80%

APPENDIX B TO REPORT DSFRA/22/6

MINIMUM REVENUE STATEMENT 2022/23

Supported Borrowing

The Minimum Revenue Provision will be calculated using the regulatory method (option 1). Minimum Revenue Provision will therefore be calculated using the formulae in the old regulations, since future entitlement to RSG in support of this borrowing will continue to be calculated on this basis.

Un-Supported Borrowing (including un-supported borrowing prior to 1 April 2008)

The Minimum Revenue Provision in respect of unsupported borrowing under the prudential system will be calculated using the asset life method (option 3). The Minimum Revenue Provision will therefore be calculated to repay the borrowing in equal annual instalments over the life of the class of assets which it is funding. The repayment period of all such borrowing will be calculated when it takes place and will be based on the finite life of the class of asset at that time and will not be changed.

Finance Lease and PFI

In the case of Finance Leases and on balance sheet PFI schemes, the Minimum Revenue Provision requirement is regarded as met by a charge equal to the element of the annual charge that goes to write down the balance sheet liability. Where a lease of PFI scheme is brought, having previously been accounted for off-balance sheet, the Minimum Revenue Provision requirement is regarded as having been met by the inclusion of the charge, for the year in which the restatement occurs, of an amount equal to the write-down for the year plus retrospective writing down of the balance sheet liability that arises from the restatement. This approach produces a Minimum Revenue Provision charge that is comparable to that of the Option 3 approach in that it will run over the life of the lease or PFI scheme and will have a profile similar to that of the annuity method.

Minimum Revenue Provision will normally commence in the financial year following the one in which the expenditure was incurred. However, when borrowing to construct an asset, the authority may treat the asset life as commencing in the year in which the asset first becomes operational. It may accordingly postpone the beginning to make Minimum Revenue Provision until that year. Investment properties will be regarded as becoming operational when they begin to generate revenues.

Minimum Revenue Provision Overpayments

A change introduced by the revised MHCLG Minimum Revenue Provision Guidance was the allowance that any charges made over the statutory Minimum Revenue Provision, Voluntary Revenue Provision or overpayments, can, if needed, be reclaimed in later years if deemed necessary or prudent. In order for these sums to be reclaimed for use in the budget, this policy must disclose the cumulative overpayment made each year. Up until the 31 March 2020 the total Voluntary Revenue Provision overpayments were £nil.

APPENDIX C TO REPORT DSFRA/22/6

LINK TREASURY SOLUTIONS ECONOMIC REPORT

ECONOMIC BACKGROUND

COVID-19 vaccines.

These were the game changers during 2021 which raised high hopes that life in the UK would be able to largely return to normal in the second half of the year. However, the bursting onto the scene of the Omicron mutation at the end of November 2021 rendered the initial two doses of all vaccines largely ineffective in preventing infection. This has dashed such hopes and raises the spectre again that a fourth wave of the virus could overwhelm hospitals in early 2022. What is now known is that this mutation is very fast spreading with the potential for total case numbers to double every two to three days, although it possibly may not cause so much severe illness as previous mutations.

Rather than go for full lockdowns which heavily damages the economy, the government strategy this time is focusing on getting as many people as possible to have a third (booster) vaccination after three months from the previous last injection, as a booster has been shown to restore a high percentage of immunity to Omicron to those who have had two vaccinations. There is now a race on between how quickly boosters can be given to limit the spread of Omicron, and how quickly hospitals will fill up and potentially be unable to cope.

In the meantime, workers have been requested to work from home and restrictions have been placed on large indoor gatherings and hospitality venues. With the household saving rate having been exceptionally high since the first lockdown in March 2020, there is plenty of pent-up demand and purchasing power stored up for services in sectors like restaurants, travel, tourism and hotels which had been hit hard during 2021, but could now be hit hard again by either, or both, of government restrictions and/or consumer reluctance to leave home.

Growth will also be lower due to people being ill and not working, similar to the "pingdemic" in July 2021. The economy, therefore, faces significant headwinds although some sectors have learned how to cope well with Covid. However, the biggest impact on growth would come from another lockdown if that happened. The big question still remains as to whether any further mutations of this virus could develop which render all current vaccines ineffective, as opposed to how quickly vaccines can be modified to deal with them and enhanced testing programmes be implemented to contain their spread until tweaked vaccines become widely available.

A SUMMARY OVERVIEW OF THE FUTURE PATH OF BANK RATE

- In December 2021, the Bank of England became the first major western central bank to put interest rates up in this upswing in the current business cycle in western economies as recovery progresses from the Covid recession of 2020.
- The next increase in Bank Rate could be in February or May 2022, dependent on how severe an impact there is from Omicron.

- If there are lockdowns in January 2022, this could pose a barrier for the Monetary Policy Committee (MPC) to putting Bank Rate up again as early as 3 February 2022.
- With inflation expected to peak at around 6% in April 2022, the MPC may want to be seen to be active in taking action to counter inflation on 5 May 2022, the release date for its Quarterly Monetary Policy Report.
- The December 2021 MPC meeting was more concerned with combating inflation over the medium term than supporting economic growth in the short term.
- Bank Rate increases beyond May 2022 are difficult to forecast as inflation is likely to drop sharply in the second half of 2022.
- However, the MPC will want to normalise Bank Rate over the next three years so that it has its main monetary policy tool ready to use in time for the next down-turn; all rates under 2% are providing stimulus to economic growth.
- Year end 0.25% increases have been added into Quarter 1 of each financial year from 2023 to recognise this upward bias in Bank Rate - but the actual timing in each year is difficult to predict.
- Covid remains a major potential downside threat in all three years as we ARE likely to get further mutations.
- How quickly can science come up with a mutation proof vaccine, or other treatment, – and for them to be widely administered around the world?
- Purchases of gilts under Quantitative Easing (QE) ended in December 2021. Note that when Bank Rate reaches 0.50%, the MPC has said it will start running down its stock of QE.

MPC MEETING 16 DECEMBER 2021

- The MPC voted 8-1 to raise Bank Rate by 0.15% from 0.10% to 0.25% and unanimously decided to make no changes to its programme of QE purchases due to finish in December 2021 at a total of £895bn.

- The MPC disappointed financial markets by not raising Bank Rate at its November 2021 meeting. Until Omicron burst on the scene, most forecasters, therefore, viewed a Bank Rate increase as being near certain at this December 2021 meeting due to the way that inflationary pressures have been comprehensively building in both producer and consumer prices, and in wage rates. However, at the November meeting, the MPC decided it wanted to have assurance that the labour market would get over the end of the furlough scheme on 30th September without unemployment increasing sharply; their decision was, therefore, to wait until statistics were available to show how the economy had fared at this time.

- **On 10 December 2021, it was learnt of the disappointing 0.1% m/m rise in GDP** in October which suggested that economic growth had already slowed to a crawl even before the Omicron variant was discovered in late November. Early evidence suggests growth in November 2021 might have been marginally better. Nonetheless, at such low rates of growth, the government's "Plan B" COVID-19 restrictions could cause the economy to contract in December 2021.

- **On 14 December 2021, the labour market statistics** for the three months to October 2021 and the single month of October were released. The fallout after the furlough scheme was smaller and shorter than the Bank of England had feared. The single-month data were more informative and showed that LFS employment fell by 240,000, unemployment increased by 75,000 and the unemployment rate rose from 3.9% in September to 4.2%. However, the weekly data suggested this didn't last long as unemployment was falling again by the end of October. What's more, the 49,700 fall in the claimant count and the 257,000 rise in the PAYE measure of company payrolls suggests that the labour market strengthened again in November. The other side of the coin was a further rise in the number of vacancies from 1.182m to a record 1.219m in the three months to November which suggests that the supply of labour is struggling to keep up with demand, although the single-month figure for November fell for the first time since February, from 1.307m to 1.227m.

- These figures by themselves, would probably have been enough to give the MPC the assurance that it could press ahead to raise Bank Rate at this December meeting. However, the advent of Omicron potentially threw a spanner into the works as it poses a major headwind to the economy which, of itself, will help to cool the economy. The financial markets, therefore, swung round to expecting no change in Bank Rate.

- **On 15 December 2021, the CPI inflation** figure for November 2021 was received which spiked up further from 4.2% to 5.1%, confirming again how inflationary pressures have been building sharply. However, Omicron also caused a sharp fall in world oil and other commodity prices; (gas and electricity inflation has generally accounted on average for about 60% of the increase in inflation in advanced western economies).

- **Other elements of inflation are also transitory** e.g., prices of goods being forced up by supply shortages, and shortages of shipping containers due to ports being clogged have caused huge increases in shipping costs. But these issues are likely to clear during 2022, and then prices will subside back to more normal levels. Gas prices and electricity prices will also fall back once winter is passed and demand for these falls away.

- Although it is possible that the Government could step in with some **fiscal support for the economy**, the huge cost of such support to date is likely to pose a barrier to incurring further major economy wide expenditure unless it is very limited and targeted on narrow sectors like hospitality, (as announced just before Christmas). The Government may well, therefore, effectively leave it to the MPC, and to monetary policy, to support economic growth – but at a time when the threat posed by rising inflation is near to peaking!

- This is the adverse set of factors against which the MPC had to decide on Bank Rate. For the second month in a row, the MPC blind-sided financial markets, this time with a **surprise increase in Bank Rate from 0.10% to 0.25%.** What's more, the hawkish tone of comments indicated that the MPC is now concerned that inflationary pressures are indeed building and need concerted action by the MPC to counter. This indicates that there will be more increases to come with financial markets predicting 1% by the end of 2022. The 8-1 vote to raise the rate shows that there is firm agreement that inflation now poses a threat, especially after the CPI figure hit a 10-year high this week. The MPC commented that "there has been significant upside news" and that "there were some signs of greater persistence in domestic costs and price pressures".

- On the other hand, it did also comment that **"the Omicron variant is likely to weigh on near-term activity".** But it stressed that at the November meeting it had said it <u>would</u> raise rates if the economy evolved as it expected and that now "these conditions had been met". It also appeared more worried about the possible boost to inflation form Omicron itself. It said that "the current position of the global and UK economies was materially different compared with prior to the onset of the pandemic, including elevated levels of consumer price inflation". It also noted the possibility that renewed social distancing would boost demand for goods again, (as demand for services would fall), meaning "global price pressures might persist for longer". (Recent news is that the largest port in the world in China has come down with an Omicron outbreak which is not only affecting the port but also factories in the region.)

- On top of that, there were no references this month to inflation being expected to be below the **2% target in two years' time,** which at November's meeting the MPC referenced to suggest the markets had gone too far in expecting interest rates to rise to over 1.00% by the end of the year.

- These comments indicate that there has been a material reappraisal by the MPC of the inflationary pressures since their last meeting and the Bank also increased its forecast for inflation to peak at 6% next April, rather than at 5% as of a month ago. However, as the Bank retained its guidance that only **a "modest tightening"** in policy will be required, it cannot be thinking that it will need to increase interest rates that much more. A typical policy tightening cycle has usually involved rates rising by 0.25% four times in a year. "Modest" seems slower than that. As such, the Bank could be thinking about raising interest rates two or three times next year to 0.75% or 1.00%.

- In as much as a considerable part of the inflationary pressures at the current time are indeed **transitory,** and will naturally subside, and since economic growth is likely to be weak over the next few months, this would appear to indicate that this tightening cycle is likely to be comparatively short.

- As for the timing of the next increase in Bank Rate, the MPC dropped the comment from November's statement that Bank Rate would be raised "in the coming months". That may imply another rise is unlikely at the next meeting in February 2022 and that May 2022 is more likely. However, much could depend on how adversely, or not, the economy is affected by Omicron in the run up to the next meeting on 3 February 2022. Once 0.50% is reached, the Bank would act to start shrinking its stock of QE, (gilts purchased by the Bank would not be replaced when they mature).

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

- **US.** Shortages of goods and intermediate goods like semi-conductors, have been fuelling increases in prices and reducing economic growth potential. In November 2021, **CPI inflation hit a near 40-year record level of 6.8%** but with energy prices then falling sharply, this is probably the peak. The biggest problem for the Federal Bank (Fed) is the mounting evidence of a strong pick-up in cyclical price pressures e.g., in rent which has hit a decades high.
- **Shortages of labour** have also been driving up wage rates sharply; this also poses a considerable threat to feeding back into producer prices and then into consumer prices inflation. It now also appears that there has been a sustained drop in the labour force which suggests the pandemic has had a longer-term scarring effect in reducing potential GDP. Economic growth may therefore be reduced to between 2 and 3% in 2022 and 2023 while core inflation is likely to remain elevated at around 3% in both years instead of declining back to the Fed's 2% central target.
- Inflation hitting 6.8% and the feed through into second round effects, meant that it was near certain that the **Fed's meeting of 15 December 2021** would take aggressive action against inflation. Accordingly, the rate of tapering of monthly $120bn QE purchases announced at its 3 November 2021 meeting. was doubled so that all purchases would now finish in February 2022. In addition, Fed officials had started discussions on running down the stock of QE held by the Fed. Fed officials also expected three rate rises in 2022 of 0.25% from near zero currently, followed by three in 2023 and two in 2024, taking rates back above 2% to a neutral level for monetary policy.

  The first increase could come as soon as March 2022 as the chairman of the Fed stated his view that the economy had made rapid progress to achieving the other goal of the Fed – "maximum employment". The Fed forecast that inflation would fall from an average of 5.3% in 2021 to 2.6% in 2023, still above its target of 2% and both figures significantly up from previous forecasts.

What was also significant was that this month the Fed dropped its description of the current level of inflation as being “transitory” and instead referred to “elevated levels” of inflation: the statement also dropped most of the language around the flexible average inflation target, with inflation now described as having exceeded 2 percent “for some time”. It did not see Omicron as being a major impediment to the need to take action now to curtail the level of inflationary pressures that have built up, although Fed officials did note that it has the potential to exacerbate supply chain problems and add to price pressures.

See also comments in paragraph 3.3 under PWLB rates and gilt yields.

- **EU.** The slow role out of vaccines initially delayed **economic recovery** in early 2021 but the vaccination rate then picked up sharply. After a contraction of -0.3% in Quarter 1, Quarter 2 came in with strong growth of 2%. With Quarter 3 at 2.2%, the EU recovery was then within 0.5% of its pre Covid size. However, the arrival of Omicron is now a major headwind to growth in quarter 4 and the expected downturn into weak growth could well turn negative, with the outlook for the first two months of 2022 expected to continue to be very weak.
- **November 2021 inflation figures -** the breakdown shows that the increase in price pressures is not just due to high energy costs and global demand-supply imbalances for durable goods as services inflation also rose. Headline inflation reached 4.9% in November 2021, with over half of that due to energy. However, oil and gas prices are expected to fall after the winter and so energy inflation is expected to plummet in 2022. Core goods inflation rose to 2.4% in November 2021, its second highest ever level, and is likely to remain high for some time as it will take a long time for the inflationary impact of global imbalances in the demand and supply of durable goods to disappear. Price pressures also increased in the services sector, but wage growth remains subdued and there are no signs of a trend of faster wage growth which might lead to *persistently* higher services inflation - which would get the European Central Bank (ECB) concerned. The upshot is that the euro-zone is set for a prolonged period of inflation being above the ECB’s target of 2% and it is likely to average 3% in 2022, in line with the ECB’s latest projection.
- **ECB tapering.** The ECB has joined with the Fed by also announcing at its meeting on 16 December 2021 that it will be reducing its QE purchases - by half from October 2022, i.e., it will still be providing significant stimulus via QE purchases for over half of next year. However, as inflation will fall back sharply during 2022, it is likely that it will leave its central rate below zero, (currently -0.50%), over the next two years. The main struggle that the ECB has had in recent years is that inflation has been doggedly anaemic in sticking below the ECB’s target rate despite all its major programmes of monetary easing by cutting rates into negative territory and providing QE support.
- The ECB will now also need to consider the impact of **Omicron** on the economy, and it stated at its December 2021 meeting that it is prepared to provide further QE support if the pandemic causes bond yield spreads of peripheral countries, (compared to the yields of northern EU countries), to rise. However, that is the only reason it will support peripheral yields, so this support is limited in its scope.

- The EU has entered into a **period of political uncertainty** where a new German government formed of a coalition of three parties with Olaf Scholz replacing Angela Merkel as Chancellor in December 2021, will need to find its feet both within the EU and in the three parties successfully working together. In France there is a presidential election coming up in April 2022 followed by the legislative election in June 2022. In addition, Italy needs to elect a new president in January 2022 with Prime Minister Draghi being a favourite due to having suitable gravitas for this post. However, if he switched office, there is a significant risk that the current government coalition could collapse. That could then cause differentials between Italian and German bonds to widen when 2022 will also see a gradual running down of ECB support for the bonds of weaker countries within the EU. These political uncertainties could have repercussions on economies and on Brexit issues.
- **CHINA.** After a concerted effort to get on top of the virus outbreak in Quarter 1 of 2020, economic recovery was strong in the rest of **2020**; this enabled China to recover all the initial contraction. During 2020, policy makers both quashed the virus and implemented a programme of monetary and fiscal support that was particularly effective at stimulating short-term growth. At the same time, China's economy benefited from the shift towards online spending by consumers in developed markets. These factors helped to explain its comparative outperformance compared to western economies during 2020 and earlier in 2021.
- However, the pace of economic growth has now fallen back in **2021** after this initial surge of recovery from the pandemic and looks likely to be particularly weak in 2022. China has been struggling to contain the spread of the Delta variant through using sharp local lockdowns - which depress economic growth. Chinese consumers are also being very wary about leaving home and so spending money on services. However, with Omicron having now spread to China, and being much more easily transmissible, this strategy of sharp local lockdowns to stop the virus may not prove so successful in future. In addition, the current pace of providing boosters at 100 billion per month will leave much of the 1.4 billion population exposed to Omicron, and any further mutations, for a considerable time. The **People's Bank of China** made a start in December 2021 on cutting its key interest rate marginally so as to stimulate economic growth. However, after credit has already expanded by around 25% in just the last two years, it will probably leave the heavy lifting in supporting growth to fiscal stimulus by central and local government.
- Supply shortages, especially of coal for power generation, were causing widespread power cuts to industry during the second half of 2021 and so a sharp disruptive impact on some sectors of the economy. In addition, recent regulatory actions motivated by a political agenda to channel activities into officially approved directions, are also likely to reduce the dynamism and long-term growth of the Chinese economy.
- **JAPAN.** 2021 has been a patchy year in combating Covid. However, recent business surveys indicate that the economy has been rebounding rapidly in 2021 once the bulk of the population had been double vaccinated and new virus cases had plunged. However, Omicron could reverse this initial success in combating Covid.

The Bank of Japan is continuing its **very loose monetary policy** but with little prospect of getting inflation back above 1% towards its target of 2%, any time soon: indeed, inflation was actually negative in July 2021. New Prime Minister Kishida, having won the November 2021 general election, brought in a supplementary budget to boost growth, but it is unlikely to have a major effect.

- **WORLD GROWTH.** World growth was in recession in 2020 but recovered during 2021 until starting to lose momentum in the second half of the year, though overall growth for the year is expected to be about 6% and to be around 4-5% in 2022. Inflation has been rising due to increases in gas and electricity prices, shipping costs and supply shortages, although these should subside during 2022. While headline inflation will fall sharply, core inflation will probably not fall as quickly as central bankers would hope. It is likely that we are heading into a period where there will be a **reversal of world globalisation** and a decoupling of western countries from dependence on China to supply products, and vice versa. This is likely to reduce world growth rates from those in prior decades.

SUPPLY SHORTAGES. The pandemic and extreme weather events, followed by a major surge in demand after lockdowns ended, have been highly disruptive of extended worldwide supply chains. Major queues of ships unable to unload their goods at ports in New York, California and China built up rapidly during quarters 2 and 3 of 2021 but then halved during quarter 4. Such issues have led to a misdistribution of shipping containers around the world and have contributed to a huge increase in the cost of shipping. Combined with a shortage of semi-conductors, these issues have had a disruptive impact on production in many countries. The latest additional disruption has been a shortage of coal in China leading to power cuts focused primarily on producers (rather than consumers), i.e., this will further aggravate shortages in meeting demand for goods. Many western countries are also hitting up against a difficulty in filling job vacancies. It is expected that these issues will be gradually sorted out, but they are currently contributing to a spike upwards in inflation and shortages of materials and goods available to purchase