Appendix D

Economic Background

Since the last update, central banks in the developed economies have significantly quickened the pace of their monetary policy tightening. Although their policies are bespoke and reflect the economic backdrop in each of their countries, that is not to say there has not been a similar approach to dampening inflationary pressures that are still spiking upwards. In that respect, the US Federal Open Market Committee (FOMC) has led with increases of 2.25% in the year to date, whilst the Bank of England's MPC has increased its Bank Rate by 1.50% to 1.75%.

The latest Bank Rate increase was implemented on 4 August 2022. After an 8-1 vote in favour, Bank Rate increased by 0.50% from 1.25% to 1.75%, but the MPC was careful to keep its options open regarding future decision-making (also note that one vote was for only a 0.25% increase). It tweaked its forward guidance in a couple of ways. First, it added that "policy is not on a pre-set path" and that the MPC will decide the "appropriate level of Bank Rate at each meeting". Second, it now says that "further changes" rather than "further increases" in Bank Rate "will reflect the Committee's assessment of the economic outlook and inflationary pressures". The first change suggests that rates will not automatically rise by 0.50% at the next few meetings and that the higher rates go, the more important the level. The second change appears to open the door to rate cuts further ahead.

In addition, the MPC surprised the market with its candidness in respect of its UK economic growth forecast assumptions. It stated that the UK is in for five quarters of recession starting in Q4 2022 and running all the way through to the end of 2023. In the interim, it is projected that CPI inflation will exceed 13% in Q4 2022. Half of this increase can be attributed directly to gas/electricity price inflation and a further 2% - 2.5% to the indirect knock-on effects of higher energy on production/services.

Furthermore, the MPC said that it is "provisionally minded" to commence gilt sales of £10bn per quarter from the end of September. That means the balance sheet will soon start to shrink at a faster pace.

However, that said, the MPC appeared also to be sending dovish signals further ahead as the forecast recession involves a 2.2% decline in GDP and if interest rates rise to 3.00%, as the markets currently expect, inflation will be below the 2% target in three years' time. That appears to imply that rates don't need to rise as far as 3.00% and/or that at some point in the next three years rates will need to be cut again to boost inflation.

The Bank also acknowledged it has not taken account of the prospect of a change in Government policy regarding the potential tax cuts offered up by both Conservative leadership candidates vying to be the next Prime Minister. If this policy change occurs, regardless of whether it is to a lesser or greater extent, it is likely to add to inflationary pressures and will be an additional issue for the MPC to consider in full at its November meeting.

In the US, President Biden, and the Democratic party, have pushed through a huge programme of fiscal stimulus over the past couple of years, whilst the following factors were also in play:-

- A fast vaccination programme had enabled a rapid opening up of the economy during 2021
- The economy had been growing swiftly over the second half of 2021/22, whilst unemployment has continued to fall/spare capacity in the labour market has tightened.

It was not much of a surprise that a combination of these factors would eventually cause an excess of demand in the economy which generated strong inflationary pressures. This has eventually been recognised by the Fed and an aggressive response to damp inflation down during 2022 and 2023 is expected.

The flurry of comments from Fed officials following the mid-March meeting – including from Chair Jerome Powell himself – hammering home the hawkish message from the mid-March meeting makes it difficult to see how the Fed will not tighten aggressively through 2022 as a minimum with markets expecting the Fed Funds Rate to hit close to 2% by year end.

In addition, the Fed will soon announce an increasing series of caps on the value of assets they allow to run off the balance sheet each month.

In China, the pace of economic growth has now fallen back after the initial surge of recovery from the pandemic and China has been struggling to contain the spread of the Delta variant through using sharp local lockdowns - which depress economic growth. 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; this strategy poses a potential renewed threat to world supply chains. The People's Bank of China made a start in December 2021 on cutting its key interest rate to encourage flagging economic growth.

A summary overview of the future path of Bank Rate

The Central forecast for interest rates was previously updated on 21 June and reflected a view that the MPC will be keen to further demonstrate its anti-inflation credentials by delivering a succession of rate increases, including in August. Now we expect a further 0.5% increase in September: another 0.25% increase in November and a further 0.25% hike in February. But the timing and size of the hikes will be data dependent and, potentially, influenced by the actions of the US FOMC.

Further down the road, we anticipate the Bank of England will be keen to loosen monetary policy when the worst of the inflationary pressures are behind us – but that timing will be one of fine judgment: cut too soon, and inflationary pressures may well build up further; cut too late and the forecast recession may be prolonged.

The CPI measure of inflation will peak at upwards of 13% in Q4 2022 and the MPC will note the influence gas/electricity price hikes have on this number, and whether wages data is behaving itself. Currently wages are rising at above 4%, excluding bonuses, and above 6%, including bonuses. Despite the cost-of-living squeeze that is still taking shape, the Bank will want to see evidence that wages are not spiralling upwards in what is evidently a very tight labour market, where employers are out-bidding each other to ensure they have the pick of a limited labour pool.

Regarding the "provisional" plan to sell £10bn of gilts back into the market each quarter, starting in September, this will undoubtedly have an impact on the pricing of gilts to some degree, but we believe it will pale into insignificance against the other factors we have already outlined as influencing gilt yields.

Notwithstanding the MPC's clear desire to increase Bank Rate through the remainder of 2022, negative real earnings, the upcoming 60%+ hike in the Ofgem energy price cap from October (to be followed by a potential 10%+ further increase from January), at the same time as employees (and employers) have incurred a 1.25% Health & Social Care Levy, growing commodity and food price inflation plus council tax rises - all these factors will hit households' finances hard. However, lower income families will be hit disproportionately hard despite some limited assistance from the Government to postpone the full impact of rising energy costs.

In the upcoming months, forecasts will be guided not only by economic data releases and clarifications from the MPC over its monetary policies, but the on-going conflict between Russia and Ukraine, including the manner in which the West and NATO respond through sanctions and/or military intervention. Currently, oil, gas, wheat and other mainstream commodities have risen significantly in price and central banks will have to balance whether they prioritise economic growth or try to counter supply-side shock induced inflation. (More recently, the heightened tensions between China/Taiwan/US also have the potential to have a wider and negative economic impact.)

On the positive side, consumers are still estimated to be sitting on over £160bn of excess savings left over from the pandemic so that will cushion some of the impact of the above increases. However, most of those are held by more affluent people whereas lower income families already spend nearly all their income before these increases hit and have few financial reserves.

Borrowing

It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits". The Council's approved Treasury and Prudential Indicators (affordability limits) are included in the approved Treasury Management Strategy. A list of the approved limits is shown in Appendix B. The Prudential Indicators were not breached during the first quarter of 2022/23 and have not been previously breached. The schedule at Appendix C details the Prudential Borrowing approved and utilised to date.

In November 2020, the Chancellor announced the conclusion to the review of PWLB rates and subsequently all borrowing rates were reduced by 1%; but a prohibition was introduced to deny access to borrowing from the PWLB for any local authority which had purchase of assets for yield in its three-year capital programme. Link's target rate for new long-term borrowing (50 years) for the first quarter of 2022/23 increased to 2.99%. No new external borrowing was undertaken in the first quarter of 2022/23.

PWLB debt	Current borrowing rate as at 09.08.22 a.m.	Target borrowing rate now (end of Q3 2022)	Target borrowing rate previous (end of Q3 2022)
5 year	2.61%	2.80%	3.20%
10 year	2.81%	3.00%	3.40%
25 year	3.23%	3.40%	3.70%
50 year	2.99%	3.10%	3.40%

Long term PWLB rates are expected to rise to 3.1% in September 2022 before increasing to reach 3.2% by March 2023.