SOUTH HOLLAND DISTRICT COUNCIL

Report of:	**Executive Director Strategy and Resources (S151), Christine Marshall**
To:	**Governance and Audit Committee 29 July 2021** **Council 22 September 2021**
Author:	**Sean Howsam – Treasury & Investment Manager (PSPS)**
Subject:	**Annual Treasury Management Review 2020/21**
Purpose:	**To consider the Annual Treasury Management Review for 2020/21 prior to it being submitted to Council for approval.**

Recommendation(s):

1) That the Governance and Audit Committee scrutinise the Annual Treasury Management Review 2020/21 and make any comments for consideration by Council when they consider this document for approval at their meeting on 22 September 2021.

1.0 BACKGROUND

1.1 This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2020/21. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

For 2020/21 the following reports have been submitted:

- an annual treasury strategy in advance of the year (Council 26 February 2020);
- a mid year (minimum) treasury update report (Council 20 January 2021);
- An annual review following the end of the year describing the activity compared to the strategy (this report).

1.2 The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is therefore important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

1.3 This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Governance and Audit Committee. Member training on treasury management was last provided on 14 November 2019 in order to support the members' scrutiny role.

1.4 The Treasury Management function is administered by Public Sector Partnership Services Ltd on behalf of the Council.

1.5 The Council is currently in the process of producing its financial statements for the 2020/21 financial year and these will be subject to external audit. The figures in this report are therefore subject to change and any such changes will be reflected in the report submitted to Council.

2.0 **INTRODUCTION**

2.1 This report summarises the following :-

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- The actual prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to its indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Borrowing and investment outturn positions;
- Economy and interest rates.

3.0 **THE COUNCIL'S CAPITAL EXPENDITURE AND FINANCING 2020/21**

3.1 The Council undertakes capital expenditure on long-term assets. These activities may either be:

- financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- if insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

3.2 The actual capital expenditure forms one of the required prudential indicators. The following tables show the actual capital expenditure and how this was financed.

£'000 General Fund	**2019/20 Actual**	**2020/21 Estimate**	**2020/21 Actual**
Capital expenditure	4,046	8,741	7,661
Financed in year	(2,946)	(7,481)	(6,760)
Unfinanced capital expenditure	1,100	1,260	901

£'000 Housing Revenue Account (HRA)	**2019/20 Actual**	**2020/21 Estimate**	**2020/21 Actual**
Capital expenditure	8,888	6,371	4,912
Financed in year	(8,888)	(6,371)	(4,912)
Unfinanced capital expenditure	-	-	-

4.0 **THE COUNCIL'S OVERALL BORROWING NEED**

4.1 The Council’s underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council’s indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2020/21 unfinanced capital expenditure (see above table), and prior years’ net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

4.2 Part of the Council’s treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council’s cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced by utilising temporary cash resources within the Council or through borrowing from external bodies (such as the Government, through the Public Works Loan Board (PWLB) or the money markets).

4.3 Reducing the CFR – the Council’s (non HRA) underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision (MRP), to reduce the CFR. This is effectively a repayment of the non-HRA borrowing need (there is no statutory requirement to reduce the HRA CFR). This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

4.4 The Council’s 2020/21 MRP Policy as required by Ministry of Housing, Communities and Local Government (MHCLG) guidance was approved as part of the Treasury Management Strategy Report for 2020/21 on 26 February 2020.

4.5 The Council’s CFR for the year is shown below, and represents a key prudential indicator:

CFR (£’000): General Fund	**31 March 2020 Actual**	**31 March 2021 Budget**	**31 March 2021 Actual**
Opening Balance	5,451	6,565	6,565
Add unfinanced capital expenditure (as above)	1,100	1,260	901
Other adjustments	14	-	-
Closing Balance	**6,565**	**7,825**	**7,466**

CFR (£'000): HRA	31 March 2020 Actual	31 March 2021 Budget	31 March 2021 Actual
Opening Balance	68,441	68,427	68,427
Add unfinanced capital expenditure (as above)	-	-	-
Other adjustments	(14)	-	-
Closing Balance	**68,427**	**68,427**	**68,427**

Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

4.6 Gross borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the CFR in the preceding year (2019/20) plus the estimates of any additional CFR for the current (2020/21) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2020/21. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2020 Actual (£'000)	31 March 2021 Budget (£'000)	31 March 2021 Actual (£'000)
Gross Borrowing Position	67,456	67,456	67,456
CFR	74,992	76,252	75,893

4.7 The authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The following table demonstrates that during 2020/21 the Council has maintained gross borrowing within its authorised limit.

The operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2020/21
Authorised limit	£91m
Maximum gross borrowing position	£67.456m
Operational boundary	£87m
Average gross borrowing position	£67.456m
Financing costs as a proportion of net revenue stream – Non HRA HRA	-1.96% 39.85%

5.0 **TREASURY POSITION AS AT 31 MARCH 2021**

5.1 The Council's treasury management debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. At the beginning and the end of 2020/21 the Council's treasury position, including accrued interest, was as follows:

	31/3/20 Amount £'000	**Rate/ Return %**	**Average Life**	**31/3/21 Amount £'000**	**Rate/ Return %**	**Average Life**
Fixed rate funding						
PWLB	67,456	3.48	42 years	67,456	3.48	41 years
Leases	-	n/a		-	n/a	
Total debt	**67,456**	**3.48**	**42 years**	**67,456**	**3.48**	**41 years**
CFR	74,992			75,893		
Over/(under) borrowing	(7,536)			(8,437)		
Cash and investments:						
long term equity and service loans	(7,034)	n/a	n/a	(7,817)	n/a	n/a
short term	(26,118)	0.97	138 days	(34,524)	0.20	167 days
instant access deposits	(11,192)	0.57	1 day	(8,494)	0.02	1 day
Total cash and investments	**(44,344)**	**0.85**	**97 days**	**(50,835)**	**0.16**	**134 days**
Net debt	**23,112**			**16,621**		

5.2 Investments and Cash and Cash Equivalents held as at 31 March 2021, including accrued interest, were as follows:

INVESTMENT PORTFOLIO	**Actual 31/03/20 £000's**	**Actual 31/03/20 %**	**Actual 31/03/21 £000's**	**Actual 31/03/21 %**
Treasury Investments				
Banks	26,112	70	32,491	75
Building Societies	3,004	8	2,000	5
Local Authorities	2,001	5	5,027	12
Total managed in house	**31,117**	**83**	**39,518**	**92**
Money Market Funds	6,193	17	3,500	8
Total managed externally	**6,193**	**17**	**3,500**	**8**
Total Treasury Investments	**37,310**	**100**	**43,018**	**100**
Non-Treasury Investments (at fair value)				
Equity	3,664	52	3,963	51
Service Loans (long term debtors)	3,370	48	3,854	49
Total Non-Treasury Investments	**7,034**	**100**	**7,817**	**100**

SUMMARY	**Actual 31/03/20 £000's**	**Actual 31/03/20 %**	**Actual 31/03/21 £000's**	**Actual 31/03/21 %**
Total Treasury Investments	37,310	84	43,018	85
Total Non-Treasury Investments	7,034	16	7,817	15
Total of all Investments	**44,344**	**100**	**50,835**	**100**

The maturity structure of the investment portfolio was as follows:

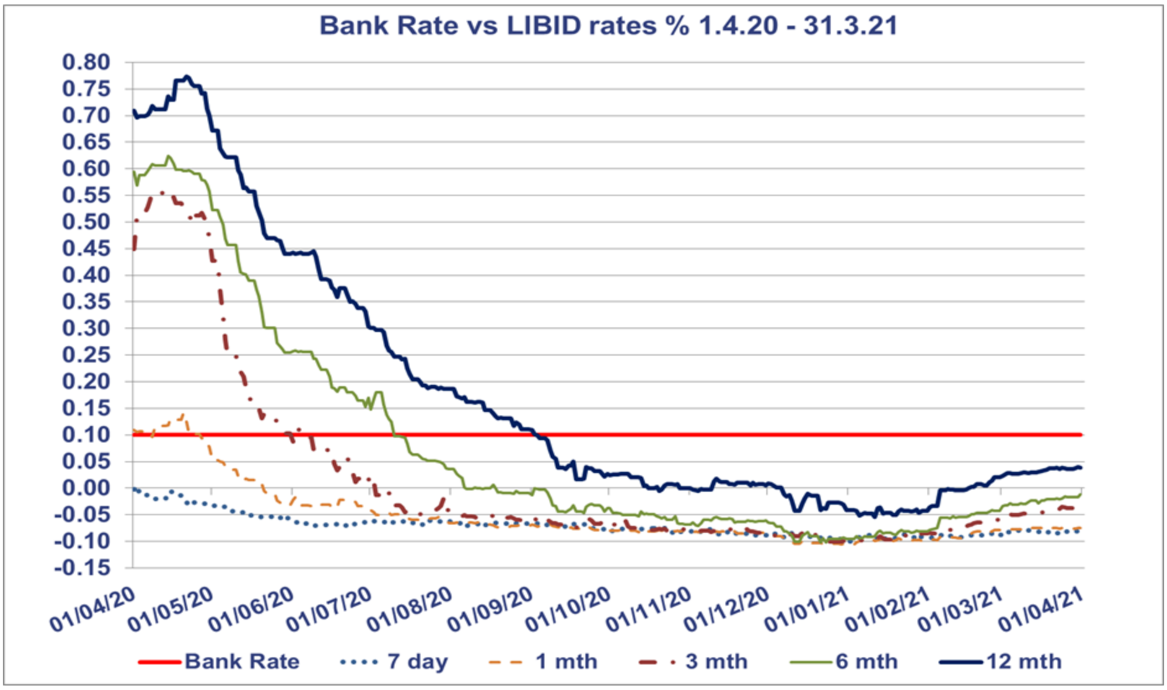
	2019/20 Actual £'000	**2020/21 Actual £'000**
Investments		
Longer than 1 year	7,034	7,817
Under 1 year	37,310	43,018
Total	44,344	50,835

The exposure to fixed and variable rates on investments was as follows:

	31/03/20 Actual £'000	31/03/21 Actual £'000
Fixed rate	29,488 (66%)	33,384 (66%)
Variable rate	14,856 (34%)	17,451 (34%)

6.0 THE STRATEGY FOR 2020/21

6.1 Investment strategy and control of interest rate risk



Investment returns which had been low during 2019/20, plunged during 2020/21 to near zero or even into negative territory. Most local authority lending managed to avoid negative rates and one feature of the year was the growth of inter local authority lending. The expectation for interest rates within the treasury management strategy for 2020/21 was that Bank Rate would continue at the start of the year at 0.75% before rising to end 2022/23 at 1.25%. This forecast was invalidated by the Covid-19 pandemic bursting onto the scene in March 2020 which caused the Monetary Policy Committee (MPC) to cut Bank Rate in March, first to 0.25% and then to 0.10%, in order to counter the hugely negative impact of the national lockdown on large swathes of the economy. The Bank of England and the Government also introduced new programmes of supplying the banking system and the economy with massive amounts of cheap credit so that banks could help cash-starved businesses to survive the lockdown. The Government also supplied huge amounts of finance to local authorities to pass on to businesses. This meant that for most of the year there was much more liquidity in financial markets than there was demand to borrow, with the consequent effect that investment earnings rates plummeted.

While the Council has taken a cautious approach to investing, it is also fully appreciative of changes to regulatory requirements for financial institutions in terms of additional capital and liquidity that came about in the aftermath of the financial crisis. These requirements have provided a far stronger basis for financial institutions, with annual stress tests by regulators evidencing how institutions are now far more able to cope with extreme stressed market and economic conditions.

Investment balances have been kept to a minimum through the agreed strategy of using reserves and balances to support internal borrowing, rather than borrowing externally from the financial markets. External borrowing would have incurred an additional cost, due to the differential between borrowing and investment rates as illustrated in the charts shown above and below. Such an approach has also provided benefits in terms of reducing the counterparty risk exposure, by having fewer investments placed in the financial markets.

6.2 **Borrowing strategy and control of interest rate risk**

During 2020/21, the Council maintained an under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. All current loan debt specifically relates to the HRA and the General Fund has no loan debt. This strategy was prudent as investment returns were very low and minimising counterparty risk on placing investments also needed to be considered.

A cost of carry remained during the year on any new long-term borrowing that was not immediately used to finance capital expenditure, as it would have caused a temporary increase in cash balances; this would have incurred a revenue cost – the difference between (higher) borrowing costs and (lower) investment returns.

The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this was kept under review to avoid incurring higher borrowing costs in the future when this authority may not be able to avoid new borrowing to finance capital expenditure.

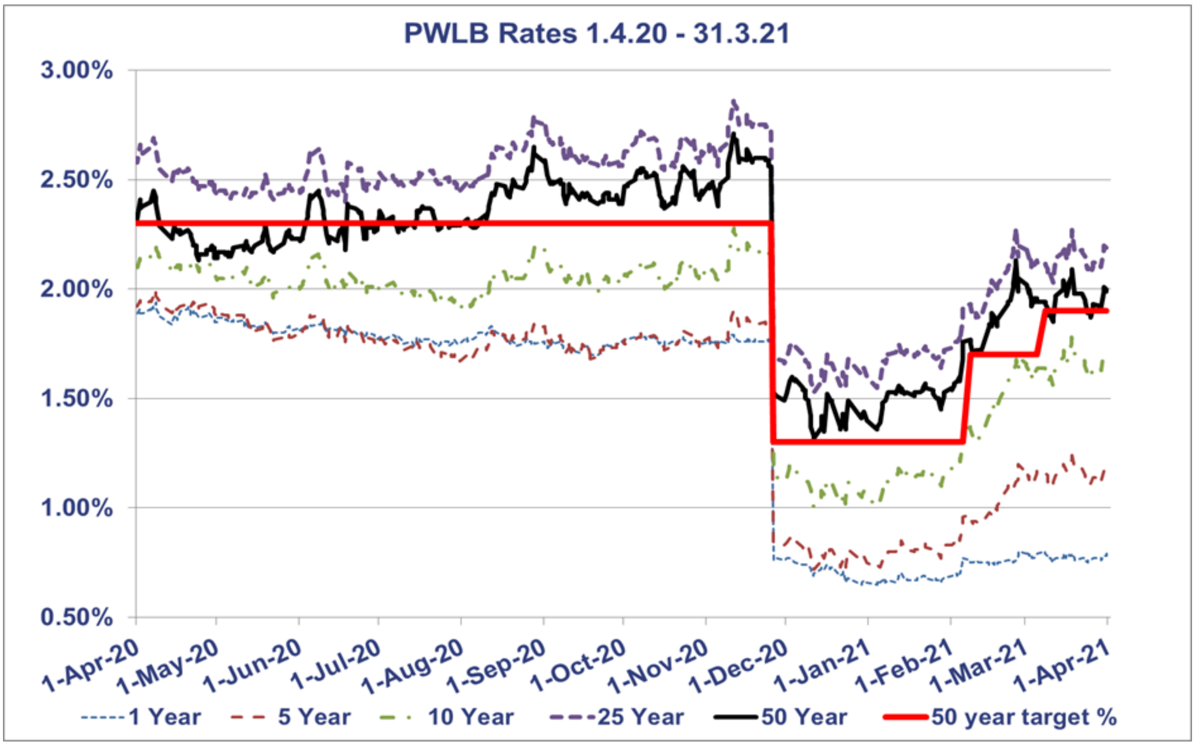
Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The Section 151 Officer therefore monitored interest rates in financial markets and adopted a pragmatic strategy based upon the following principles to manage interest rate risks:

- if it had been felt that there was a significant risk of a sharp FALL in long and short term rates, (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings would have been postponed.

- if it had been felt that there was a significant risk of a much sharper RISE in long and short term rates than initially expected, perhaps arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position would have been re-appraised. Most likely, fixed rate funding would have been drawn whilst interest rates were lower than they were projected to be in the next few years.

Interest rate forecasts expected only gradual rises in medium and longer term fixed borrowing rates during 2020/21 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period.

Link Asset Services Interest Rate View	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25	1.25	1.25	1.25
3 Month LIBID	0.70	0.70	0.80	0.80	0.90	1.00	1.00	1.10	1.20	1.30	1.30	1.30	1.30
6 Month LIBID	0.80	0.80	0.90	1.00	1.00	1.10	1.20	1.30	1.40	1.50	1.50	1.50	1.50
12 Month LIBID	0.90	0.90	1.00	1.10	1.20	1.30	1.40	1.50	1.60	1.70	1.70	1.70	1.70
5yr PWLB Rate	2.30	2.30	2.40	2.40	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10
10yr PWLB Rate	2.50	2.50	2.60	2.60	2.70	2.80	2.90	3.00	3.10	3.10	3.20	3.20	3.30
25yr PWLB Rate	3.00	3.00	3.10	3.20	3.30	3.40	3.50	3.60	3.70	3.80	3.80	3.90	3.90
50yr PWLB Rate	2.90	2.90	3.00	3.10	3.20	3.30	3.40	3.50	3.60	3.70	3.70	3.80	3.80



PWLB rates are based on, and are determined by, gilt (UK Government bonds) yields through H.M.Treasury determining a specified margin to add to gilt yields. The main influences on gilt yields are Bank Rate, inflation expectations and movements in US treasury yields. Inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation and the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers: this means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last 30 years. We have seen over the last two years, many bond yields up to 10 years in the Eurozone turn negative on expectations that the EU would struggle to get growth rates and inflation up from low levels. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession.

Gilt yields fell sharply from the start of 2020 and then spiked up during a financial markets melt down in March caused by the pandemic hitting western countries; this was rapidly countered by central banks flooding the markets with liquidity. While US treasury yields do exert influence on UK gilt yields so that the two often move in tandem, they have diverged during the first three quarters of 2020/21 but then converged in the final quarter. Expectations of economic recovery started earlier in the US than the UK but once the UK vaccination programme started making rapid progress in the new year of 2021, gilt yields and gilt yields and PWLB rates started rising sharply as confidence in economic recovery rebounded. Financial markets also expected Bank Rate to rise quicker than in the forecast tables in this report.

At the close of the day on 31 March 2021, all gilt yields from 1 to 5 years were between 0.19% – 0.58% while the 10-year and 25-year yields were at 1.11% and 1.59%.

HM Treasury imposed two changes of margins over gilt yields for PWLB rates in 2019/20 without any prior warning. The first took place on 9th October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then, at least partially, reversed for some forms of borrowing on 11th March 2020, but not for mainstream non-HRA capital schemes. A consultation was then held with local authorities and on 25th November 2020, the Chancellor announced the conclusion to the review of margins over gilt yields for PWLB rates; the standard and certainty margins 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. The new margins over gilt yields are as follows: -

- PWLB Standard Rate is gilt plus 100 basis points (G+100bps)
- PWLB Certainty Rate is gilt plus 80 basis points (G+80bps)
- PWLB HRA Standard Rate is gilt plus 100 basis points (G+100bps)
- PWLB HRA Certainty Rate is gilt plus 80bps (G+80bps)
- Local Infrastructure Rate is gilt plus 60bps (G+60bps)

There is likely to be only a gentle rise in gilt yields and PWLB rates over the next three years as Bank Rate is not forecast to rise from 0.10% by March 2024 as the Bank of England has clearly stated that it will not raise rates until inflation is sustainably above its target of 2%; this sets a high bar for Bank Rate to start rising.

7.0 BORROWING OUTTURN FOR 2020/21

7.1 Due to investment concerns with both counterparty risk and low investment returns, no new borrowing was undertaken during the year.

7.2 No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

7.3 The Council's external borrowing from the PWLB at 31 March 2021 remained at £67.456m at a fixed rate of 3.48% and matures on 28 March 2062.

8.0 INVESTMENT OUTTURN FOR 2020/21

8.1 **Investment Policy** – the Council's investment policy is governed by MHCLG guidance, which has been implemented in the annual investment strategy approved by the Council on 26 February 2020. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc).

8.2 The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

8.3 Resources – the Council's cash balances comprise revenue and capital resources and cash flow monies. The Council's core cash resources comprised as follows:

Balance Sheet Resources (£'000)	**31 March 2020**	**31 March 2021**
Balances	22,252	25,323
Earmarked Reserves	8,213	11,085
Major Repairs Reserve	3,586	4,356
Capital Grants and Contributions	2,991	5,279
Usable capital receipts	3,061	3,220
Total	**40,103**	**49,263**

8.4 The Council held average treasury investment balances of £50.7m which were mainly internally managed and achieved an average rate of return of 0.418% compared with the average 3 Month London Interbank Bid (LIBID) rate of 0.015%.

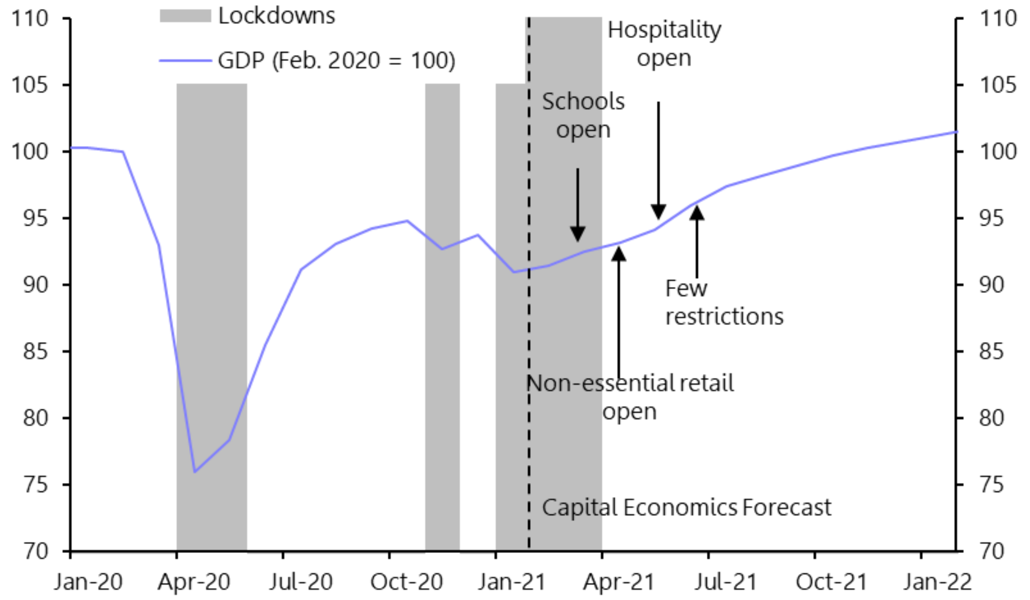
The Council also held average non-treasury investment balances (excluding equity) of £3.37m. The Council has issued five loans totalling £3.71m to Welland Homes Limited, which is the Council's wholly owned Housing Development Company. These are service loans (classified as long term debtors) and the Council receives interest of 3.5% on these loans which is payable on a quarterly basis. Total interest earned during the year was £113,134.

The combined rate of return on all investments averaged 0.603%.

8.5 Actual investment interest earned during 2020/21 was £325k which was £219k below the original budget of £544k. This can be attributed to the very low level of interest rates in the market during the financial year resulting from the COVID-19 pandemic.

9.0 THE ECONOMY AND INTEREST RATES DURING 2020-21 (commentary provided by Link Group - external treasury advisors)

9.1 **UK. Coronavirus.** The financial year 2020/21 will go down in history as being the year of the pandemic. The first national lockdown in late March 2020 did huge damage to an economy that was unprepared for such an eventuality. This caused an economic downturn that exceeded the one caused by the financial crisis of 2008/09. A short second lockdown in November did relatively little damage but by the time of the third lockdown in January 2021, businesses and individuals had become more resilient in adapting to working in new ways during a three month lockdown so much less damage than was caused than in the first one. The advent of vaccines starting in November 2020, were a game changer. The way in which the UK and US have led the world in implementing a fast programme of vaccination which promises to lead to a return to something approaching normal life during the second half of 2021, has been instrumental in speeding economic recovery and the reopening of the economy. In addition, the household saving rate has been exceptionally high since the first lockdown in March 2020 and so there is plenty of pent-up demand and purchasing power stored up for services in the still-depressed sectors like restaurants, travel and hotels as soon as they reopen. It is therefore expected that the UK economy could recover its pre-pandemic level of economic activity during quarter 1 of 2022.



Both the Government and the Bank of England took rapid action in March 2020 at the height of the crisis to provide support to financial markets to ensure their proper functioning, and to support the economy and to protect jobs.

The **Monetary Policy Committee** cut Bank Rate from 0.75% to 0.25% and then to 0.10% in March 2020 and embarked on a £200bn programme of quantitative easing (QE) (purchase of gilts so as to reduce borrowing costs throughout the economy by lowering gilt yields). The MPC increased then QE by £100bn in June and by £150bn in November to a total of £895bn. While Bank Rate remained unchanged for the rest of the year, financial markets were concerned that the MPC could cut Bank Rate to a negative rate; this was firmly discounted at the February 2021 MPC meeting when it was established that commercial banks would be unable to implement negative rates for at least six months – by which time the economy was expected to be making a strong recovery and negative rates would no longer be needed.

Average inflation targeting. This was the major change adopted by the Bank of England in terms of implementing its inflation target of 2%. The 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. This sets a high bar for raising Bank Rate and no increase is expected by March 2024, and possibly for as long as five years. Inflation has been well under 2% during 2020/21; it is expected to briefly peak at just over 2% towards the end of 2021, but this is a temporary short lived factor and so not a concern to the MPC.

Government support. The Chancellor has implemented repeated rounds of support to businesses by way of cheap loans and other measures, and has protected jobs by paying for workers to be placed on furlough. This support has come at a huge cost in terms of the Government's budget deficit ballooning in 20/21 and 21/22 so that the Debt to Gross Domestic Product (GDP) ratio reaches around 100%. The Budget on 3 March 2021 increased fiscal support to the economy and employment during 2021 and 2022 followed by substantial tax rises in the following three years to help to pay the cost for the pandemic. This will help further to strengthen the economic recovery from the pandemic and to return the government's finances to a balanced budget on a current expenditure and income basis in 2025/26. This will stop the Debt to GDP ratio rising further from 100%. An area of concern, though, is that the government's debt is now twice as sensitive to interest rate rises as before the pandemic due to QE operations substituting fixed long-term debt for floating rate debt; there is, therefore, much incentive for the Government to promote Bank Rate staying low e.g. by using fiscal policy in conjunction with the monetary policy action by the Bank of England to keep inflation from rising too high, and/or by amending the Bank's policy mandate to allow for a higher target for inflation.

BREXIT. The final agreement on 24 December 2020 eliminated a significant downside risk for the UK economy. The initial agreement only covered 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. There was much disruption to trade in January as form filling has proved to be a formidable barrier to trade. This appears to have eased somewhat since then but is an area that needs further work to ease difficulties, which are still acute in some areas.

9.2 **USA**. The US economy did not suffer as much damage as the UK economy due to the pandemic. The Democrats won the presidential election in November 2020 and have control of both Congress and the Senate, although power is more limited in the latter. This enabled the Democrats to pass a $1.9trn (8.8% of GDP) stimulus package in March on top of the $900bn fiscal stimulus deal passed by Congress in late December. These, together with the vaccine rollout proceeding swiftly to hit the target of giving a first jab to over half of the population within the President's first 100 days, will promote a rapid easing of restrictions and strong economic recovery during 2021. The Democrats are also planning to pass a $2trn fiscal stimulus package aimed at renewing infrastructure over the next decade. Although this package is longer-term, if passed, it would also help economic recovery in the near-term.

After Chair Jerome Powell spoke on 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 a new inflation target - 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. There is now some expectation that where the Fed has led in changing its policy towards implementing its inflation and full employment mandate, other major central banks will follow, as indeed the Bank of England has done so already. The Fed expects strong economic growth during 2021 to have only a transitory impact on inflation, which explains why the majority of Fed officials project US interest rates to remain near-zero through to the end of 2023. 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 at historically low levels. However, financial markets in 2021 have been concerned that the sheer amount of fiscal stimulus, on top of highly accommodative monetary policy, could be over-kill leading to a rapid elimination of spare capacity in the economy and generating higher inflation much quicker than the Fed expects. They have also been concerned as to how and when the Fed will eventually wind down its programme of monthly QE purchases of treasuries. These concerns have pushed treasury yields sharply up in the US in 2021 and is likely to have also exerted some upward pressure on gilt yields in the UK.

9.3 **EUROZONE**. Both the roll out and take up of vaccines has been disappointingly slow in the EU in 2021, at a time when many countries are experiencing a sharp rise in cases which are threatening to overwhelm hospitals in some major countries; this has led to renewed severe restrictions or lockdowns during March. This will inevitably put back economic recovery after the economy had staged a rapid rebound from the first lockdowns in Q3 of 2020 but contracted slightly in Q4 to end 2020 only 4.9% below its pre-pandemic level. Recovery will now be delayed until Q3 of 2021 and a return to pre-pandemic levels is expected in the second half of 2022.

Inflation was well under 2% during 2020/21. The European Central Bank (ECB) did not cut its main rate of -0.5% further into negative territory during 2020/21. It embarked on a major expansion of its QE operations (PEPP) in March 2020 and added further to that in its December 2020 meeting when it also greatly expanded its programme of providing cheap loans to banks. The total Pandemic Emergency Purchase Programme (PEPP) scheme of €1,850bn 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.

9.4 **CHINA.** After a concerted effort to get on top of the virus outbreak in Q1 of 2020, economic recovery was strong in the rest of the year; 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.

9.5 **JAPAN** - Three rounds of government fiscal support in 2020 together with Japan's relative success in containing the virus without draconian measures so far, and the roll out of vaccines gathering momentum in 2021, should help to ensure a strong recovery in 2021 and to get back to pre-virus levels by Q3.

9.6 **WORLD GROWTH**. World growth was in recession in 2020. Inflation is unlikely to be a problem in most countries for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

9.7 **DEGLOBALISATION.** 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 also depressed inflation. However, the rise of China as an economic superpower over the last 30 years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. In March 2021, western democracies implemented limited sanctions against a few officials in charge of government policy on the Uighurs in Xinjiang; this led to a much bigger retaliation by China and is likely to mean that the China / EU investment deal then being negotiated, will be torn up. After the pandemic exposed how frail extended supply lines were around the world, both factors are now likely to lead to a sharp retrenchment of economies into two blocs of western democracies v. autocracies. 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 and vice versa. This is likely to reduce world growth rates.

9.8 **CENTRAL BANKS' MONETARY POLICY.** During the pandemic, the governments of western countries have provided massive fiscal support to their economies which has resulted in a big increase in total government debt in each country. It is therefore very important that bond yields stay low while debt to GDP ratios slowly subside under the impact of economic growth. This provides governments with a good reason to amend the mandates given to central banks to allow higher average levels of inflation than we have generally seen over the last couple of decades. Both the Fed and Bank of England have already changed their policy towards implementing their existing mandates on inflation, (and full employment), to hitting an average level of inflation. Greater emphasis could also be placed on hitting subsidiary targets e.g. full employment before raising rates. Higher average rates of inflation would also help to erode the real value of government debt more quickly.

10.0 **OPTIONS**

10.1 There are no alternative options presented.

11.0 **REASONS FOR RECOMMENDATION**

11.1 To comply with the Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management 2017.

12.0 **EXPECTED BENEFITS**

12.1 The report provides Members with a summary of the economy, the effect it has had on financial markets and the treasury activity during 2020/21. The report requires scrutiny prior to submitting to Council for approval.

13.0 **IMPLICATIONS**

13.1 **Constitution & Legal**

13.1.1 This Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2020/21. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities.

13.1.2 The Council's financial strategy, capital financing and borrowing all form part of the Policy Framework and are therefore non-executive matters that fall within the remit of the full Council.

13.2 **Financial**

13.2.1 The report provides details of the treasury activity for the 2020/21 financial year to inform members on performance and to highlight any changes in the year.

13.2.2 Total interest received was £325k with £246k to the General Fund and £79k to the Housing Revenue Account. This was considerably below the original budget due to the exceptionally low interest rate environment throughout the financial year.

13.3 **Risk Management**

13.3.1 The Council's investment policy has regard to the MHCLG Guidance on Local Government Investments ("the Guidance") and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities are security first, liquidity second, then return.

14.0 **WARDS/COMMUNITIES AFFECTED**

14.1 Due to budgetary considerations all wards are affected.

15.0 **ACRONYMS**

15.1 PSPS – Public Sector Partnership Services Ltd
15.2 CIPFA – Chartered Institute of Public Finance and Accountancy
15.3 HRA – Housing Revenue Account
15.4 CFR – Capital Financing Requirement
15.5 PWLB – Public Works Loan Board
15.6 MRP – Minimum Revenue Provision
15.7 VRP – Voluntary Revenue Provision
15.8 MHCLG – Ministry of Housing, Communities and Local Government
15.9 EU – European Union
15.10 GDP – Gross Domestic Product
15.11 MPC – Monetary Policy Committee
15.12 LIBID – London Interbank Bid Rate
15.13 QE - Quantitative Easing
15.14 ECB – European Central Bank
15.15 PEPP – Pandemic Emergency Purchase Programme

Background papers: - SHDC Treasury Management Strategy Statement 2020/21

Lead Contact Officer
Name and Post: Sean Howsam – Treasury and Investment Manager (PSPS)
Telephone Number: 01507 613248
Email: Sean.Howsam@pspsl.co.uk

Key Decision: No

Exempt Decision: No

This report refers to a Mandatory Service

Appendices attached to this report: None