

Brighton & Hove City Council
Economic Overview and Interest Rate prospect 2014/15

ECONOMIC OVERVIEW (Source – Capita Asset Services, Treasury Solutions, February 2014)

THE UK ECONOMY

Economic growth. Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth strongly rebounded in 2013 to surpass all expectations as all three main sectors, services, manufacturing and construction contributed to this strong upturn. The Bank of England has, therefore, upgraded growth forecasts in the February quarterly Inflation Report for 2014 to 3.4%, 2015 to 2.7% and 2016 to 2.8%. The February Report stated that: -

The UK recovery has gained momentum and inflation has returned to the 2% target. Reduced uncertainty, easier credit conditions and the stimulative stance of monetary policy should support continued solid economic growth, with the expansion in demand becoming more entrenched and more broadly based.

Robust growth has not so far been accompanied by a material pickup in productivity. Instead, employment gains have been exceptionally strong and unemployment has fallen much more rapidly than expected. The LFS headline unemployment rate is likely to reach the MPC's 7% threshold by the spring of this year. Even so, the Committee judges that there remains spare capacity, concentrated in the labour market.

Inflation is likely to remain close to the target over the forecast period. Given this, and with spare capacity remaining, the MPC judges that there remains scope to absorb slack further before raising Bank Rate. Moreover, the continuation of significant headwinds — both at home and from abroad — mean that Bank Rate may need to remain at low levels for some time to come.

Forward guidance.

The Bank of England issued forward guidance in August which stated that the Bank will not start to consider raising interest rates until the jobless rate (Labour Force Survey / ILO i.e. not the claimant count measure), had fallen to 7% or below. However, unemployment has fallen much quicker than the Bank expected and currently (17.2.14), stands at 7.1%. Accordingly, in the February Report, the Bank has now broadened its approach as follows: -

1. The MPC reckons there is spare capacity in the economy of 1-1.5% of GDP, mainly in the labour market
2. They will refrain from raising Bank Rate until a significant inroad has been made into reducing this spare capacity

3. They will provide additional forecasts based on eighteen economic indicators which they will take into account in considering the path of Bank Rate and QE
4. First increase in Bank Rate likely to be around Q2 2015
5. Rate rises will be slow and gradual (translation - probably 25bp per quarter)
6. Governor Carney expected that Bank Rate would be around 2% in three years time i.e. Q1 2017
7. Bank Rate is unlikely to get back up to pre crisis levels of 5% even when the economy has returned to normal
8. The Bank will not sell any of their portfolio of asset purchases before the first rise in the Bank Rate (but that does not mean they WILL start then!) and will also reinvest maturing gilts until then
9. They were more pessimistic on growth of productivity which has failed to keep pace with rises in output
10. They will make it a priority to protect growth in the economy provided inflation remains subdued (inflation forecast to be well behaved over the next two years: 1.9% in two year's time)

Forward surveys are currently very positive in indicating that growth prospects are strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy is that wage inflation continues to remain significantly below CPI inflation so disposable income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. This, therefore, means that labour productivity must improve significantly for this situation to be corrected by the warranting of increases in pay rates.

Credit conditions

While Bank Rate has remained unchanged at 0.5% and quantitative easing has remained unchanged at £375bn in 2013, the Funding for Lending Scheme (FLS) was extended to encourage banks to expand lending to small and medium size enterprises. The second phase of Help to Buy, aimed at supporting the purchase of second hand properties, started in earnest in January 2014. These measures have been so successful in boosting the supply of credit for mortgages, and so of increasing house purchases, (though levels are still far below the pre-crisis level), that the Bank of England announced at the end of November that the FLS for mortgages would end in February 2014. While there have been concerns that these schemes are creating a bubble in the housing market, house price increases outside of London and the south-east have been much weaker. The Bank does not feel that Bank Rate increases would be effective in reducing house price inflation in London as a large part of property purchase is being done as cash transactions and / or by foreign purchasers, and is aggravated by a major short fall in new housing supply compared to the level of demand. As for bank lending to small and medium enterprises, this continues to remain weak and

inhibited by banks still repairing their balance sheets and anticipating tightening of regulatory requirements

Inflation. . Inflation has fallen from a peak of 3.1% in June 2013 to 2.0% in December. It is expected to remain near to the 2% target level over the MPC's two year time horizon.

AAA rating. The UK has lost its AAA rating from Fitch and Moody's but that caused little market reaction.

INTEREST RATE PROSPECTS

A forecast of interest rates over the medium term is set out in table A below.

The current economic outlook and structure of market interest rates and government debt yields have several treasury management implications:

- Eurozone concerns have subsided considerably in 2013. However, sovereign debt difficulties have not gone away, but have arguably been postponed. Counterparty risks therefore remain elevated and counterparty quality remains key.
- Investment returns are likely to remain low during 2014/15 and beyond
- Borrowing interest rates have risen significantly during 2013 and are on a rising trend. The policy of avoiding borrowing by running down spare cash balances (internal borrowing) has served us well over the last few years. However, this needs to be carefully reviewed to avoid incurring even higher borrowing costs
- However, a cost of carry remains to any new borrowing which causes and increased investments as this will incur a revenue loss between the cost of borrowing and the return on investments. The timing on new borrowing needs to be closely monitored.

Table A – Interest Rate forecasts April 2014 to March 2017 (annual averages)

	Bank Rate	Short-term rates		Long-term rates		
		3 mth	12 mths	5 year	25 year	50 year
2014/15	0.50%	0.50%	0.81%	2.70%	4.50%	4.53%
2015/16	0.58%	0.68%	1.21%	3.00%	4.80%	4.88%
2016/17	1.21%	1.22%	1.89%	3.30%	5.06%	5.13%