

## **Warwick District Council Financial Strategy 2017/18-2021/22**

### **1 INTRODUCTION**

“Money” is one of 3 keys strands of the Council’s Fit for the Future Programme. The others are People and Services. This document supports the delivery of the Council’s services and the projects within the Programme, as well as supporting all Council Strategies to deliver its aims and objectives.

It considers the major funding issues facing the Council in the Medium Term (the next 5 years). Extending the Strategy beyond this period would rely on broad estimates and many uncertainties. It would not be prudent to base the Strategy a shorter period as risks and significant issues arising in the medium term could arise before the Council has developed means of managing these. Forecast future levels of Funding are projected alongside other known constraints and opportunities. In drawing up a Medium Term Plan, the Strategy considers the constraints and opportunities facing the Council. The Council has a Code of Financial Practice and Code of Procurement Practice which underpin the Strategy.

Monthly Budget Review Reports are considered by the Senior Management Team, with Members of the Executive being updated on a quarterly basis. Alongside this, regular updated 5 year Financial Projections are included. Full Council receive the latest 5 Year Forecast alongside this Strategy within the Budget and Council Tax Reports presented in February of each year.

### **2. BACKGROUND**

- 2.1 The Economic Background, as provided by Treasury Advisors, Capita Asset Services – Their Report is reproduced as Annex 1.
- 2.2 Recent years have seen many changes to the nature of Funding Local Authorities receive from Central Government. The new Business Rate Retention Scheme was introduced from 1<sup>st</sup> April 2013. Whilst setting the NNDR Baseline, Government then allowed Council to retain a share of any growth above this Baseline. Similarly, should actual income received be below Baseline , there was a safety net whereby the Authority would receive a top up payment should actual Business Rates collected fall more than 7.5% below their Baseline. Alongside this, the proportion of Business Rates to revenue Support Grant has increased. The 4 year settlement announced in December 2015 and January 2016 show that by 2019/20 Revenue Support Grant will be zero, having reduced significantly over the next 3 years.(The Council’s other main income source is its local Council Tax Payers)

	2016/17 £'000'	2017/18 £'000's	2018/19 £'000's	2019/20 £'000's	2020/21 £'000's	2021/22 £'000's
Revenue Support Grant	1,597	804	311	0	0	0
Business Rate Retention	877	3,829	3,808	3,757	3,832	3,908
Total	2,473	4,633	4,119	3,757	3,832	3,908
Revenue Support Grant %	64.56%	17.35%	7.54%	0.00%	0.00%	0.00%
Business Rates %	35.44%	82.65%	92.46%	100.00%	100.00%	100.00%

- 2.3 The Government still propose to introduce a scheme to enable authorities to retain all the Business Rate Income they collect, as announced in the Autumn Statement of 2015. However, full details of the new proposals have yet to be published. The assumptions in the table above (2.2) are based upon existing arrangements until such information becomes available.
- 2.4 The Financial Strategy and projections have been updated in line with the 2017/18 Government Settlement Figures announced in December/January 2016/2017. The Council's Financial Strategy is based upon the 4 year Revenue Support Grant announced by the Government and its own Business Rates forecasts using the NNDR1 and NNDR3 returns and local intelligence, including support from "Analyse Local" independent Business Rates Consultants.
- 2.4 As referred to above, from 2013/14, the District Council retains 20% of any growth in business rates above the pre-determined Baseline. The Council's Baseline for 2017/18 is £3.219m. This is the amount the Council retains. If the actual amount collected varies to the Baseline, the Council will retain more or less income, working out at the Council retaining 20% of any increased revenues. Conversely, if there is any reduction in the new business rate receipts, the Council will bear 20% of this cost. There is a Safety Net whereby the Council will not be able to receive less than £2.978m, this being within 7.5% of the Baseline retained income figure. However, this Authority has entered into Pooling arrangements. This means the Safety Net payment would be paid to the Pool rather than the actual authority falling into the Safety Net.

The Baseline is due to continue to be inflated annually originally until 2020 when there was due to be a "reset" of the system. However, in light of proposals for Authorities to retain all Business Rates collected, this may no longer be the case

The Council entered into a "pooling" arrangement with the other Warwickshire Councils and Coventry City Council. Under this arrangement the amounts due to be paid to Central Government under the Levy should

greatly reduce, meaning more income will be retained locally. Whilst there are risks attached to pooling, especially if income should substantially decline, however, based on the latest projections, the Council should benefit from remaining in the pool in 2017/18.

- 2.5 The Council also receives Government Support by way of New Homes Bonus (NHB) for 2017/18 this is £1.938million. A proportion of this is allocated to the Waterloo Housing Association as part of the WC Housing Joint Venture. NHB was previously funded on a 6 year rolling time limited basis. After Consultation the government has reduced this to 5 years for 2017/18. Subsequent years will reduce again to a 4 year rolling basis. To date the Council has not to relied upon it for revenue support and has not had to use it to support recurring expenditure on core service provision. This prudence has proved wise so far, whilst allowing the Council to support new schemes and replenish its Reserves.
- 2.6 In total, the District had a 2016/17 Council Tax at Band D of £1,618.03. However, the District element (including parish precepts) is only £177.03. This Council's own Band D charge had been frozen since 2010/11, before 2016/17 saw the first year of an increase to £151.86. This increase was in line with the £5.00 referendum limit announced by the Government in February 2016. A further £5.00 increase is proposed for 2017/18. The District element is just outside the lowest quarter nationally, with the District and Parish charge being well within the lowest national Quartile. The District and Parish charge is still the lowest of the 5 Warwickshire Authorities.
- 2.7 In March 2012 the Housing Revenue Account (HRA) borrowed £136.2m to make a one off 'buy out' payment when the Housing Subsidy system was replaced by 'Self Financing'. This debt is serviced from HRA rental income, in place of the payments previously made to the National Housing Rent Pool under the Housing Subsidy system. A 50 year Business Plan is maintained to demonstrate the viability of the HRA and the capacity to invest in the service and provide new homes.
- 2.8 A 'Prudential Framework' for borrowing was introduced from 2004/05. Local authorities no longer have to obtain Government approval before borrowing. Control is by prudential limits based on the authority's revenue resources. The Council can borrow if it can afford the revenue consequences.
- 2.9 The Council reviews its budgets on a monthly basis, amending these as changes are identified, rather than reporting upon variations and updating its current year's budgets once at part of the following year's budget setting process. The process will be constantly reviewed to identify further efficiencies so that data can be produced in the most timely and accurate manner.

### **3. CORPORATE STRATEGY AND FIT FOR THE FUTURE PROGRAMME**

3.1 The Council's Organisational Purpose being:

**"Warwick District: a great place to live, work and visit".**

3.2 During 2010, the Council adopted its Fit For the Future programme as its Corporate Strategy to provide an organisation framework to progress these objectives. As well as focusing on delivering quality services that its customers' need, the programme and subsequent updates have set challenging savings targets to be delivered. Achieving these will assist the Council in delivering its services in the future in light of uncertainty surrounding the economic climate, and future reductions in Central Government Support.

This programme needs to stay up to date and relevant in providing the strategic framework for the Council to meet the challenges it faces. Projects within the programme will be adjusted to reflect opportunities and challenges arising from Government initiatives and legislation as well as the Council's own Local Priorities.

These include-

In June 2018 Universal Credit will be rolled out to this Council. This Authority will retain responsibility for pensioners. New working age customers will be dealt with by the DWP. Existing working age customers will transfer as and when there are changes to their circumstances

The Chancellor indicated in his Autumn Statement that local Authorities would at a point in the future be able to retain 100% Business Rates locally. However, more details on how the scheme would be implemented have yet to be issued.

The impact of Brexit on the economy and changes in legislation as Britain leaves the European Union.

In his Autumn Statement 2016, the Chancellor announced that the National Living Wage would rise to £8.45 in April 2017.

3.3 As well as these initiatives, other major issues that will affect the Council's finances over this period are:

- (i) Monitoring the medium term financial forecast and this Council's progress in meeting its various savings initiatives.
- (ii) The impact of pressures to improve environmental sustainability. Alongside this, CO<sup>2</sup> emissions need to be reduced to meet the climate change agenda.

- (iii) Energy costs are extremely volatile.
- (iv) Major developments that may occur, such as, Chandos Street, Office (H.Q) Relocation and other potential strategic opportunities.
- (vi) Major investment in multi storey car parks that will require structural renewal.
- (vii) The Council completed condition surveys on its Corporate Assets. The Council continues to strive to ensure its Corporate Asset properties are maintained at a reasonable standard. So far it has been able to resources these costs. Funding for the full liabilities for the next five years of the plan have yet to be found.
- (viii) The potential to work with partners and realising savings by pooling resources.
- (ix) Capital receipts have reduced considerably and any for the future are extremely uncertain.
- (x) The volatility of many of the Council's income budgets.
- (xi) The rate of economic recovery and investment interest returns.
- (xii) Trees throughout the district need replacing for which funding will need to be sought.
- (xiii) Ongoing reviews on how the Council manages and delivers its services.
- (xiv) Development of the Fit for the Future Programme and the Council's ability to adapt to change.
- (xv) Efficient procurement to deliver quality services at minimum cost.
- (xvi) Superannuation Fund and pensions changes further to the changes to the Local Government Pension Scheme introduced in April 2014. The pensions fund, in common with most others, continues to carry a projected deficit, although plans are in place to seek to ensure the fund is in surplus.
- (xvii) In June 2016, the country voted to leave the European Union. The initial impact saw a reduction in interest rates and a drop in the pound against other currencies. The market has still not recovered from this initial reaction. The Council continues to monitor this situation and will amend its medium term financial forecasts to incorporate future changes including changes in legislation, such as VAT.
- (xviii) 2016 also saw the election of the American Republican President, Donald Trump. The new President did not take office until January 2017. This may see changes in the relationship between the United States and the rest of the world.

3.4 The Council will plan replacements and renewals of equipment (including ICT Resources), and repair and maintenance in a careful manner concentrating on the sustainability of services as a first priority. In addition the Council needs to continually review its reserves in the light of a very ambitious programme of change, and constant uncertain external pressures on the planning regime.

3.5 The Council continues to promote agile working, and this links to the asset management plan strategy of reducing office space needs.

- 3.6 On 18 November 2015 Members approved funding for work to progress to develop a £12 million investment plan for Newbold Comyn and St Nicholas Park Leisure Centres. From June 2017, the Council will outsource the management of its Leisure Centres. A private contractor will be able to operate in a more cost efficient way, benefitting from Mandatory Rate Relief and achieving economies of scale from operating many Leisure Centres across the country.

#### **4. FINANCIAL PRINCIPLES**

- 4.1 The following are the principles (for both the General Fund and the Housing Revenue Account) that underpin the Financial Strategy:

- (i) Savings and developments will be based upon corporate priorities as set out in the Council's Fit for the Future programme.
- (ii) In order to achieve further savings the Council continues to explore all avenues including
  - Shared services and joint working
  - Outsourcing where other providers can deliver a minimum of the same standard of service more efficiently
  - Efficient Procurement
  - Benchmarking costs and understanding differences
  - Increasing fees and paying customers where there is spare capacity and Looking for opportunities to maximize income
  - Accessing grants to assist with corporate priorities
  - Controlling costs
  - Workforce planning
  - Improved more efficient technology
- (iii) The Council has ambitions to effectively manage its resources. In setting both its Council Tax and Housing Rents, the Council takes account of its budget requirement, the support it receives from Central Government, inflation and the affordability of its local tax-payers.
- (iv) The Council's base policy for Council house rent increases is currently to follow Central Government guidance. Any diversion from this policy will be requested in the annual Rent Setting report to Council, and reflected in the HRA Business Plan.
- (v) Whilst the Council will aim for Fees and Charges to be increased so that income is at least maintained in real terms, it will be mindful of the reality of the current economic conditions and its competitors. The Council is committed to making good use of the ability to raise funds through charges and put them to good use for the community.

- (vi) The Council still needs to develop its ability to benchmark all services across the Council.
- (vii) This Council takes a positive approach to partnership working, realising the following benefits: -
  - a) Levering in additional external funding.
  - b) Ensuring improved use of sites, whether or not in the ownership of the Council.
  - c) Ensuring the future sustainability of projects.
  - d) Sharing/Reducing costs
  - e) Strengthening the Resilience of the Service
- (viii) The Financial Strategy takes account of all revenue effects of the capital programme to ensure that the decisions taken are sustainable into the future.
- (ix) The Council will hold reserves for specific purposes, as to be agreed by Executive.
- (x) The Capital Investment Reserve shall be maintained with a minimum uncommitted balance of £1m.
- (xi) Any unplanned windfalls of income, whether service specific or more general, will be reported to the Executive who will prioritise how such income is used as part of setting future balanced budgets and meeting the Council's priorities.

## **5. PROCESS & MONITORING**

### ***Preparing budgets***

- 5.1 The budget setting process is consistent with the service area planning process and the Fit for the Future Programme with recent years focusing on reductions in budgets and efficiencies.
- 5.2 When the Capital Programme is approved by Council the capital schemes will still be subject to individual approval on the basis of an evaluation and Business Case that needs to be agreed by Executive. .

### ***Monitoring and managing budgets***

- 5.4 Under the monthly "Budget Review" Process, Budgets are amended as soon as changes are identified. The Financial Code of Practice is regularly updated to incorporate any changes. The Financial Code of Practice was reviewed and updated in 2015 to reflect changes in this process and procurement practices.

- 5.5 Accountants work with Service Areas to identify budget variances and changes, these are reported to the Senior Management Team on a monthly basis. A minimum of quarterly reports are submitted for consideration by the Executive and Scrutiny Committees. The Council continues to review and refine its current processes, putting tighter controls in place to improve the quality and accuracy of the review process.

### **Consultation**

- 5.6 The Council has a track record of consulting both partner organisations and the public this is an important contribution to assist identifying options and in learning lessons.
- 5.7 There is extensive consultation with partners on Fit For the Future, and the Sustainable Community Strategy.
- 5.8 The Council takes a strategic 5 year approach to determine how budgets are set and service prioritised.
- 5.9 The Council has a record of consulting where appropriate on the development of individual schemes.

## **6 ASSUMPTIONS**

- 6.1 The following assumptions will be used in bringing forward proposals on the budget
- (i) Whilst The Council has built the indicative RSG settlements, announced as part of the four year settlement announced in January 2016, into its financial forecasts, its Business Rates forecasts are based upon its own local forecasts and out-turns.
  - (ii) Interest projections will continue to be based on the rates projected by Capita Asset Services Treasury Solutions, the treasury management advisers.
  - (iii) No allowance for inflation has been applied to most budgets from 2017/18 until 2019/20 which then incorporate a 2% increase. Where the Council is contractually bound to increase costs and uplifted fees and charges budgets will be increased.

## **7. HOUSING REVENUE ACCOUNT (HRA)**

- 7.1 Housing Self Financing was implemented on 1<sup>st</sup> April 2012. A 50 year HRA Business Plan has been developed to ensure sufficient funds will be available to service the £136.2m debt taken out with the PWLB in order to 'buy' the Council out of the existing Housing Subsidy system, provide the necessary



funding to maintain the stock and enable the building of new homes over the life of the Business Plan.

- 7.2 The Council has freedom over setting its rents as long it acts 'reasonably'. There is no requirement to follow Central Government rent guidelines. Consequently the Council has the freedom to set dwelling rents, garage rents, Warwick Response charges or rents for HRA owned shops and commercial properties.
- 7.3 The Housing and Planning Act received Royal Assent in May 2016. It includes a number of policy changes that will impact on the HRA Business Plan and potentially adversely affect its financial viability. The Act will extend the Right-to-Buy policy to Housing Association properties, with the Local Housing Authority funding the discount. The expectation is that this will be achieved through the sale of 'high value' properties as they become vacant, at the discretion of the Council. It is no longer proposed to be introduced during 2017/18, and potentially introduced after being piloted in certain areas.
- 7.4 From April 2018, the amount of Local Housing Allowance paid to those of working age below 35 will be restricted to the cost of single room in a shared household. This Council will consider its policy, and the financial impact on the HRA Business Plan

## **8. REVENUE FORECASTS**

- 8.1 Revenue forecasts will be drawn up in line with this strategy, and the strategy itself will be reviewed every year when the budget is set. The current forecasts are set out in the February 2017 Budget Report, which reported savings required as follows in order to keep future Council Tax increases to £5.00. (before the use of any one-off reserves or balances)

	<b>2018/19 £'000</b>	<b>2019/20 £'000</b>	<b>2020/21 £'000</b>	<b>2021/22 £'000</b>
Deficit-Savings Required(+)/Surplus(-) future years	412	201	-202	830
Change on previous year	412	-211	-403	1,032

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

## **9. ASSET RESOURCE BACKGROUND**

- 9.1 Set out below is a summary of the Council's assets and its existing plans to use its resources to invest for the future.

9.2 The Council's assets as shown in the balance sheet as at 31<sup>st</sup> March 2016 are summarised below: -

	<b>No</b>	<b>Value £'000</b>
<b>Operational Assets</b>		
<b>HRA</b>		
Operational Land and Buildings	7,473	289,549
Surplus Assets/Work in Progress	3	6,967
Vehicles, Plant, Furniture and Equipment	-	55
<b>General Fund</b>		
Operational Land and Buildings	111	62,181
Surplus Assets/Work In Progress	5	614
Vehicles, Plant, Furniture and Equipment		1,735
Community Assets	-	6,653
Infrastructure	-	2,150
Heritage Assets	-	8,255
<b>Total</b>	<b>7,592</b>	<b>378,159</b>
<b>Investment Properties</b>	<b>138</b>	<b>11,477</b>

9.3 A summary of the proposed capital programme for the period to March 2021 is given below. This programme gives an indication of the level of the Council's available capital resources that are to be devoted to capital expenditure during this period.

	<b>2016/17 £'000</b>	<b>2017/18 £'000</b>	<b>2018/19 £'000</b>	<b>2019/20 £'000</b>	<b>2020/21 £'000</b>
Strategic Leadership	444	139	117	75	150
Culture Portfolio	4,072	11,272	181	0	0
Finance Portfolio	90	150	150	150	150
Neighbourhood Portfolio	2,153	517	125	125	125
Health & Community Protection Portfolio	2	100	0	0	0
Development Portfolio	1,524	50	318	0	0
Housing Investment Programme	13,230	6,628	5,216	5,216	5,216
<b>TOTAL</b>	<b>21,515</b>	<b>18,856</b>	<b>6,107</b>	<b>5,566</b>	<b>5,641</b>
<b>ESTIMATED RESOURCES</b>	<b>62,030</b>	<b>67,548</b>	<b>64,092</b>	<b>73,428</b>	<b>83,341</b>

## **10. CAPITAL PRIORITIES**

10.1 The main focus of the programme is:

- Realising local aspirations as expressed within the Corporate Strategy (which incorporates the Community Plan and the Council's Resource Strategies) and its Fit for the Future Programme;
- Maintaining, and where possible enhancing, the condition of the Council's existing assets so as to reduce future maintenance liabilities and to encourage their effective use. Where appropriate this will include working in partnership with others such as the County Council on the customer Access Project.
- Supporting capital schemes that provide revenue savings to the Council, in particular supporting investment in Information and Communication Technology so as to modernise activities and release resources for other purposes.
- Achieving regeneration and economic vitality in our main population centres.

10.2 Key particular projects that link to the corporate strategy are: -

- Enabling developments across the district that improve the environment such as Europa Way, and the improvement of Leamington Old Town.
- To continue to maintain the Government's "decent homes" standard.
- To increase the number of affordable houses in the district.
- Relocation of the Council's main office to a more efficient and cost effective building

## **11. FINANCING THE CAPITAL STRATEGY**

11.1 The Capital Strategy needs to have regard to the financial resources available to fund it. The main sources of funding are detailed below: -

- Capital Receipts – primarily resulting from the sale of the Council's assets. This income is lumpy and limited, although there are still schemes being considered that could realise further capital receipts.
- The Council is required to sell homes to eligible tenants at a significant discount under the right-to buy (RTB). The proportion of such receipts are

taken by the Treasury; with the balance retained by the Council, some having to be to provide for new dwellings and the remainder the Council having flexibility over its use.

- Capital Contributions – including contributions from developers (often under Section 106 Planning Agreements and in the future, from the Community Infrastructure Levy as well) and grants towards specific schemes.
- Use of Council’s own resources – either by revenue contributions to capital, or use of earmarked reserves.
- Borrowing – the Council has freedom to borrow under the Prudential System provided it can demonstrate that it has the resource to service the debt.
- Leasing – the Council now requires that, where appropriate, an options appraisal is undertaken in order to identify the most efficient source of financing capital purchases. In certain cases this may take the form of either a finance or operating lease.

## **12. REVIEW**

12.1 This strategy will be subject to annual review to ensure that changes are included and that development issues have been implemented. It has been reviewed in the light of the Fit for the Future programme.

## **13. RISKS**

13.1 Previous years have demonstrated that the Council needs to consider the risk in setting and managing its budgets.

13.2 The key risks that could arise and ways in which they should be managed are set out in the main February Budget report and associated appendix.

13.3 The Council maintains a Significant Business Risk Register which is reviewed bi-annually by the Executive and quarterly by the Senior Management Team. Each Service Area has its own Service Risk Register. These are presented for the consideration of the Finance and Audit Scrutiny Committee on a quarterly rotating basis.

13.4 All major projects the Council undertakes have their own separate Risk Register.

**Capita Asset Services' View of the Economic Background**

**1. United Kingdom.**

- 1.1 GDP growth rates in 2013, 2014 and 2015 of 2.2%, 2.9% and 1.8% were some of the strongest rates among the G7 countries. Growth is expected to have strengthened in 2016 with the first three quarters coming in respectively at +0.4%, +0.7% and +0.5%. The latest Bank of England forecast for growth in 2016 as a whole is +2.2%. The figure for quarter 3 was a pleasant surprise which confounded the downbeat forecast by the Bank of England in August of only +0.1%, (subsequently revised up in September, but only to +0.2%). During most of 2015 and the first half of 2016, the economy had faced headwinds for exporters from the appreciation of sterling against the Euro, and weak growth in the EU, China and emerging markets, and from the dampening effect of the Government's continuing austerity programme.
- 1.2 The referendum vote for Brexit in June 2016 delivered an immediate shock fall in confidence indicators and business surveys at the beginning of August, which were interpreted by the Bank of England in its August Inflation Report as pointing to an impending sharp slowdown in the economy. However, the following monthly surveys in September showed an equally sharp recovery in confidence and business surveys so that it is generally expected that the economy will post reasonably strong growth numbers through the second half of 2016 and also in 2017, albeit at a slower pace than in the first half of 2016.
- 1.3 The Monetary Policy Committee, (MPC), meeting of 4th August was therefore dominated by countering this expected sharp slowdown and resulted in a package of measures that included a cut in Bank Rate from 0.50% to 0.25%, a renewal of quantitative easing, with £70bn made available for purchases of gilts and corporate bonds, and a £100bn tranche of cheap borrowing being made available for banks to use to lend to businesses and individuals.
- 1.4 The MPC meeting of 3 November left Bank Rate unchanged at 0.25% and other monetary policy measures also remained unchanged. This was in line with market expectations, but a major change from the previous quarterly Inflation Report MPC meeting of 4 August, which had given a strong steer, in its forward guidance, that it was likely to cut Bank Rate again, probably by the end of the year if economic data turned out as forecast by the Bank. The MPC meeting of 15 December also left Bank Rate and other measures unchanged.
- 1.5 The latest MPC decision included a forward view that Bank Rate could go either up or down depending on how economic data evolves in the coming months. Our central view remains that Bank Rate will remain unchanged

at 0.25% until the first increase to 0.50% in quarter 2 2019 (unchanged from our previous forecast). However, we would not, as yet, discount the risk of a cut in Bank Rate if economic growth were to take a significant dip downwards, though we think this is unlikely. We would also point out that forecasting as far ahead as mid 2019 is highly fraught as there are many potential economic headwinds which could blow the UK economy one way or the other as well as political developments in the UK, (especially over the terms of Brexit), EU, US and beyond, which could have a major impact on our forecasts.

- 1.6 The pace of Bank Rate increases in our forecasts has been slightly increased beyond the three year time horizon to reflect higher inflation expectations.
- 1.7 The August quarterly Inflation Report was based on a pessimistic forecast of near to zero GDP growth in quarter 3 i.e. a sharp slowdown in growth from +0.7% in quarter 2, in reaction to the shock of the result of the referendum in June. However, consumers have very much stayed in a 'business as usual' mode and there has been no sharp downturn in spending; it is consumer expenditure that underpins the services sector which comprises about 75% of UK GDP. After a fairly flat three months leading up to October, retail sales in October surged at the strongest rate since September 2015 and were again strong in November. In addition, the GfK consumer confidence index recovered quite strongly to -3 in October after an initial sharp plunge in July to -12 in reaction to the referendum result. However, in November it fell to -8 indicating a return to pessimism about future prospects among consumers, probably based mainly around concerns about rising inflation eroding purchasing power.
- 1.8 Bank of England GDP forecasts in the November quarterly Inflation Report were as follows, (August forecasts in brackets) - 2016 +2.2%, (+2.0%); 2017 1.4%, (+0.8%); 2018 +1.5%, (+1.8%). There has, therefore, been a sharp increase in the forecast for 2017, a marginal increase in 2016 and a small decline in growth, now being delayed until 2018, as a result of the impact of Brexit.  
Capital Economics' GDP forecasts are as follows: 2016 +2.0%; 2017 +1.5%; 2018 +2.5%. They feel that pessimism is still being overdone by the Bank and Brexit will not have as big an effect as initially feared by some commentators.
- 1.9 The Chancellor has said he will do 'whatever is needed' i.e. to promote growth; there are two main options he can follow – fiscal policy e.g. cut taxes, increase investment allowances for businesses, and/or increase government expenditure on infrastructure, housing etc. This will mean that the PSBR deficit elimination timetable will need to slip further into the future as promoting growth, (and ultimately boosting tax revenues in the longer term), will be a more urgent priority. The Governor of the Bank of England, Mark Carney, had warned that a vote for Brexit would be likely to

cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. He also warned that the Bank could not do all the heavy lifting to boost economic growth and suggested that the Government would need to help growth e.g. by increasing investment expenditure and by using fiscal policy tools. The newly appointed Chancellor, Phillip Hammond, announced, in the aftermath of the referendum result and the formation of a new Conservative cabinet, that the target of achieving a budget surplus in 2020 would be eased in the Autumn Statement on 23 November. This was duly confirmed in the Statement which also included some increases in infrastructure spending.

1.10 The other key factor in forecasts for Bank Rate is inflation where the MPC aims for a target for CPI of 2.0%. The November Inflation Report included an increase in the peak forecast for inflation from 2.3% to 2.7% during 2017; (Capital Economics are forecasting a peak of just under 3% in 2018). This increase was largely due to the effect of the sharp fall in the value of sterling since the referendum, although during November, sterling has recovered some of this fall to end up 15% down against the dollar, and 8% down against the euro (as at the MPC meeting date – 15.12.16). This depreciation will feed through into a sharp increase in the cost of imports and materials used in production in the UK. However, the MPC is expected to look through the acceleration in inflation caused by external, (outside of the UK), influences, although it has given a clear warning that if wage inflation were to rise significantly as a result of these cost pressures on consumers, then they would take action to raise Bank Rate.

1.11 What is clear is that consumer disposable income will come under pressure, as the latest employers' survey is forecasting median pay rises for the year ahead of only 1.1% at a time when inflation will be rising significantly higher than this. The CPI figure has been on an upward trend in 2016 and reached 1.2% in November. However, prices paid by factories for inputs rose to 13.2% though producer output prices were still lagging behind at 2.3% and core inflation was 1.4%, confirming the likely future upwards path.

1.12 Gilt yields, and consequently PWLB rates, have risen sharply since hitting a low point in mid-August. There has also been huge volatility during 2016 as a whole. The year started with 10 year gilt yields at 1.88%, fell to a low point of 0.53% on 12 August, and hit a new peak on the way up again of 1.55% on 15 November. The rebound since August reflects the initial combination of the yield-depressing effect of the MPC's new round of quantitative easing on 4 August, together with expectations of a sharp downturn in expectations for growth and inflation as per the pessimistic Bank of England Inflation Report forecast, followed by a sharp rise in growth expectations since August when subsequent business surveys, and

GDP growth in quarter 3 at +0.5% q/q, confounded the pessimism. Inflation expectations also rose sharply as a result of the continuing fall in the value of sterling.

1.13 Employment had been growing steadily during 2016 but encountered a first fall in over a year, of 6,000, over the three months to October. The latest employment data in December, (for November), was distinctly weak with an increase in unemployment benefits claimants of 2,400 in November and of 13,300 in October. House prices have been rising during 2016 at a modest pace but the pace of increase has slowed since the referendum; a downturn in prices could dampen consumer confidence and expenditure.

## **2. United States of America.**

2.1 The American economy had a patchy 2015 with sharp swings in the quarterly growth rate leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 at +0.8%, (on an annualised basis), and quarter 2 at 1.4% left average growth for the first half at a weak 1.1%. However, quarter 3 at 3.2% signalled a rebound to strong growth. The Fed. embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene, and then the Brexit vote, have caused a delay in the timing of the second increase of 0.25% which came, as expected, in December 2016 to a range of 0.50% to 0.75%. Overall, despite some data setbacks, the US is still, probably, the best positioned of the major world economies to make solid progress towards a combination of strong growth, full employment and rising inflation: this is going to require the central bank to take action to raise rates so as to make progress towards normalisation of monetary policy, albeit at lower central rates than prevailed before the 2008 crisis. The Fed. therefore also indicated that it expected three further increases of 0.25% in 2017 to deal with rising inflationary pressures.

2.2 The result of the presidential election in November is expected to lead to a strengthening of US growth if Trump's election promise of a major increase in expenditure on infrastructure is implemented. This policy is also likely to strengthen inflation pressures as the economy is already working at near full capacity. In addition, the unemployment rate is at a low point verging on what is normally classified as being full employment. However, the US does have a substantial amount of hidden unemployment in terms of an unusually large, (for a developed economy), percentage of the working population not actively seeking employment.

2.3 Trump's election has had a profound effect on the bond market and bond yields rose sharply in the week after his election. Time will tell if this is a reasonable assessment of his election promises to cut taxes at the same time as boosting expenditure. This could lead to a sharp rise in total debt



issuance from the current level of around 72% of GDP towards 100% during his term in office. However, although the Republicans now have a monopoly of power for the first time since the 1920s, in having a President and a majority in both Congress and the Senate, there is by no means any certainty that the politicians and advisers he has been appointing to his team, and both houses, will implement the more extreme policies that Trump outlined during his election campaign. Indeed, Trump may even rein back on some of those policies himself.

- 2.4 In the first week since the US election, there was a a major shift in investor sentiment away from bonds to equities, especially in the US. However, gilt yields in the UK and bond yields in the EU have also been dragged higher. Some commentators are saying that this rise has been an overreaction to the US election result which could be reversed. Other commentators take the view that this could well be the start of the long expected eventual unwinding of bond prices propelled upwards to unrealistically high levels, (and conversely bond yields pushed down), by the artificial and temporary power of quantitative easing.

### **3. Eurozone.**

- 3.1 In the Eurozone, the ECB commenced, in March 2015, its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month. This was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At its December and March 2016 meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise significantly from low levels towards the target of 2%. Consequently, at its December meeting it extended its asset purchases programme by continuing purchases at the current monthly pace of €80 billion until the end of March 2017, but then continuing at a pace of €60 billion until the end of December 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim. It also stated that if, in the meantime, the outlook were to become less favourable or if financial conditions became inconsistent with further progress towards a sustained adjustment of the path of inflation, the Governing Council intended to increase the programme in terms of size and/or duration.
- 3.2 EZ GDP growth in the first three quarters of 2016 has been 0.5%, +0.3% and +0.3%, (+1.7% y/y). Forward indications are that economic growth in the EU is likely to continue at moderate levels. This has added to comments from many forecasters that those central banks in countries

around the world which are currently struggling to combat low growth, are running out of ammunition to stimulate growth and to boost inflation. Central banks have also been stressing that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand and economic growth in their economies.

### 3.3 There are also significant specific political and other risks within the EZ:

- Greece continues to cause major stress in the EU due to its tardiness and reluctance in implementing key reforms required by the EU to make the country more efficient and to make significant progress towards the country being able to pay its way – and before the EU is prepared to agree to release further bail out funds.
- Spain has had two inconclusive general elections in 2015 and 2016, both of which failed to produce a workable government with a majority of the 350 seats. At the eleventh hour on 31 October, before it would have become compulsory to call a third general election, the party with the biggest bloc of seats (137), was given a majority confidence vote to form a government. This is potentially a highly unstable situation, particularly given the need to deal with an EU demand for implementation of a package of austerity cuts which will be highly unpopular.
- The under capitalisation of Italian banks poses a major risk. Some German banks are also undercapitalised, especially Deutsche Bank, which is under threat of major financial penalties from regulatory authorities that will further weaken its capitalisation. What is clear is that national governments are forbidden by EU rules from providing state aid to bail out those banks that are at risk, while, at the same time, those banks are unable realistically to borrow additional capital in financial markets due to their vulnerable financial state. However, they are also 'too big, and too important to their national economies, to be allowed to fail'.
- 4 December Italian constitutional referendum on reforming the Senate and reducing its powers; this was also a confidence vote on Prime Minister Renzi who has resigned on losing the referendum. However, there has been remarkably little fall out from this result which probably indicates that the financial markets had already fully priced it in. A rejection of these proposals is likely to inhibit significant progress in the near future to fundamental political and economic reform which is urgently needed to deal with Italy's core problems, especially low growth and a very high debt to GDP ratio of 135%. These reforms were also intended to give Italy more stable government as no western European country has had such a multiplicity of governments since the Second World War as Italy, due to the equal split of power between the two chambers of the Parliament which are both voted in by the Italian electorate but by using different voting systems. It is currently unclear what the political, and other, repercussions are from this result.

- Dutch general election 15.3.17; a far right party is currently polling neck and neck with the incumbent ruling party. In addition, anti-big business and anti-EU activists have already collected two thirds of the 300,000 signatures required to force a referendum to be taken on approving the EU – Canada free trade pact. This could delay the pact until a referendum in 2018 which would require unanimous approval by all EU governments before it can be finalised. In April 2016, Dutch voters rejected by 61.1% an EU – Ukraine cooperation pact under the same referendum law. Dutch activists are concerned by the lack of democracy in the institutions of the EU.
  - French presidential election; first round 13 April; second round 7 May 2017.
  - French National Assembly election June 2017.
  - German Federal election August – 22 October 2017. This could be affected by significant shifts in voter intentions as a result of terrorist attacks, dealing with a huge influx of immigrants and a rise in anti EU sentiment.
  - The core EU, (note, not just the Eurozone currency area), principle of free movement of people within the EU is a growing issue leading to major stress and tension between EU states, especially with the Visegrad bloc of former communist states.
- 3.4 Given the number and type of challenges the EU faces in the next eighteen months, there is an identifiable risk for the EU project to be called into fundamental question. The risk of an electoral revolt against the EU establishment has gained traction after the shock results of the UK referendum and the US Presidential election. But it remains to be seen whether any shift in sentiment will gain sufficient traction to produce any further shocks within the EU.

#### **4. Asia.**

- 4.1 Economic growth in China has been slowing down and this, in turn, has been denting economic growth in emerging market countries dependent on exporting raw materials to China. Medium term risks have been increasing in China e.g. a dangerous build up in the level of credit compared to the size of GDP, plus there is a need to address a major over supply of housing and surplus industrial capacity, which both need to be eliminated. This needs to be combined with a rebalancing of the economy from investment expenditure to consumer spending. However, the central bank has a track record of supporting growth through various monetary policy measures, though these further stimulate the growth of credit risks and so increase the existing major imbalances within the economy.
- 4.2 Economic growth in Japan is still patchy, at best, and skirting with deflation, despite successive rounds of huge monetary stimulus and massive fiscal action

to promote consumer spending. The government is also making little progress on fundamental reforms of the economy.

## **5. Emerging countries.**

- 5.1 There have been major concerns around the vulnerability of some emerging countries exposed to the downturn in demand for commodities from China or to competition from the increase in supply of American shale oil and gas reaching world markets. The ending of sanctions on Iran has also brought a further significant increase in oil supplies into the world markets. While these concerns have subsided during 2016, if interest rates in the USA do rise substantially over the next few years, (and this could also be accompanied by a rise in the value of the dollar in exchange markets), this could cause significant problems for those emerging countries with large amounts of debt denominated in dollars. The Bank of International Settlements has recently released a report that \$340bn of emerging market corporate debt will fall due for repayment in the final two months of 2016 and in 2017 – a 40% increase on the figure for the last three years.
- 5.2 Financial markets could also be vulnerable to risks from those emerging countries with major sovereign wealth funds, that are highly exposed to the falls in commodity prices from the levels prevailing before 2015, especially oil, and which, therefore, may have to liquidate substantial amounts of investments in order to cover national budget deficits over the next few years if the price of oil does not return to pre-2015 levels.