Appendix 3

Economic and Interest Outlook

At the time of determining the Treasury Strategy Statement for 2009/10 the outlook for the economy and interest rates is summarised below:

(a) Background

Central bankers acted decisively in October 2008 as the effective breakdown of financial systems threatened to destabilise the global economy. It included government sponsored recapitalisations, interventions through the provision of liquidity and guarantees for lending; in some instances nationalisation of private sector financial institutions; the removal of compromised assets from banks' balance sheets through special finance mechanisms; and co-ordinated emergency interest rates cuts. The UK, Eurozone and US economies contracted in the third and fourth quarters of 2008.

(b) Outlook

- Availability of credit is likely expected to remain restricted and credit conditions challenging, particularly as banks change their lending behaviour and lower their lending risk. The poorly functioning transmission mechanism for lower rates to be passed to consumers could cause governments to intervene directly between banks and corporates/individuals.
- Inflation : The elevated levels of commodity, food and energy inflation which exerted a powerful squeeze on real incomes in 2008 are expected to fade in 2009. CPI, which had risen to 5.2% in 2008, is now expected to fall below the MPC's lower boundary of 1%. Whilst this will provide consumers some relief, lower inflation erodes debt burdens more slowly.
- Labour market : Unemployment, already at 6%, is expected to rise further. The fear of unemployment will keep wage bargaining and wage inflation to a minimum.
- Housing / Consumer Confidence : The prospect of negative housing equity, and/or rising unemployment and depressed asset values could culminate in a further negative loop-back for confidence. Consumers and businesses will scale back spending to conserve or repair their balance sheets.
- Growth : The effort to reduce erstwhile ballooning debt will hit economic activity and growth in the UK, US and in Europe. The prospects for growth remains uniformly poor in for much of 2009. Asset values are forecast to drop further, particularly those which are commodities- and housing-related.
- Interest rates / Central Bank policies : To avoid deflation and to mitigate the severity of the economic slowdown, there will be a growing willingness by Central Bankers to countenance abnormally low interest rates and/or some form of quantitative easing (i.e. using more unconventional methods such as expanding the central bank's balance sheet and injecting cash into the economy), sooner rather than later.
- UK : During the autumn on 2008 and in January 2009, the Bank of England's Monetary Policy Committee cut rates by a cumulative 3.5%, bringing the Bank Rate down to 1.5%, a level the Bank deemed appropriate for the prevalent economic conditions(this rate is the lowest in the Bank of england's 315 year

history.) It is expected that the Bank Rate will be cut to 1% or lower during 2009

- US : The Federal Funds rate was cut to 1%, before the decision in December 2008 to lower the rate to a range between 0% and 0.25% alongside the announcement of quantitative easing policies (among them, the purchase of large and unlimited quantities of agency and mortgage backed debt and the potential purchase of longer term Treasuries).
- Euroland : The European Central Bank is expected to cut rates more cautiously from the current level of 2.0% due to the different imbalances in each of the member states.

Market conditions and volatility : Market volatility remains high, risk appetite at a low ebb; markets are expected to continue in 'capital preservation mode' into early 2009. Although Libor is falling, the gap between official and market interest rates is likely to remain relatively wide for some months to come..

The deterioration in public finances – both via the cost of shoring up the financial system and also as recession hits the government's revenue streams – and the burgeoning budget deficit will require significant new gilt issuance in 2009. This excess supply is expected to push longer dated yields higher although not aggressively so. Short-dated gilt yields are however expected to fall with the gathering momentum of a fall in official policy rates.

The price destruction in equities will keep stock markets subdued and, even though there may be tentative signs of stability, it would be too early to say if a bottom has been reached.

Our Financial Advisors forecast for the UK Bank Rate (December 2008) is:

	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
Official Bank Rate Upside risk							+0.25	+0.25	+0.25
Central case	**1.00**	**1.00**	**1.00**	**1.00**	**1.00**	**1.50**	**2.00**	**2.50**	**2.50**
Downside risk	-0.50	-0.75	-0.75	-0.75	-0.75	-0.50	-0.50	-0.50	-0.50

The probability or zero or near zero interest rates – unthinkable just a few months ago – is now very high. The reduction in official interest rates to historically very low levels will have direct and indirect consequences for the financial operations and budgets of this Council.