APPENDIX 1

SUMMARY OF THE 2010 ECONOMIC BACKGROUND & OUTLOOK FOR 2011

Economic Background

At the time of determining the strategy for 2010/11, interest rates were expected to remain low in response to the fragile state of the UK economy. Spending cuts and tax increases seemed inevitable post the General Election if the government had a clear majority. The markets had, at the time, viewed a hung parliament as potentially disruptive particularly if combined with a failure to articulate a credible plan to bring down government borrowing. The outlook for growth was uncertain due to consumers and businesses trimming their spending and financial institutions exercising restraint in new lending.

The economy's two headline indicators moved in opposite directions – growth was lacklustre whilst inflation spiked sharply higher. The economy grew by just 1.3% in calendar year 2010; the forecast for 2011 was revised down to 1.7% by the Office of Budget Responsibility in March. Higher commodity, energy and food prices and the increase in VAT to 20% pushed the February 2011 annual inflation figure to 4.4%. The Bank Rate was held at 0.5% as the economy grappled with uneven growth and the austerity measures set out in the coalition government's Comprehensive Spending Review. Significant cuts were made to public expenditure, in particular local government funding.

The US Federal Reserve (the Fed) kept rates on hold at 0.25% following a slowdown in American growth. The European Central Bank (ECB) maintained rates at 1%, with the markets expecting a rate rise in early Spring.

The credit crisis migrated from banks to European sovereigns. The ratings of Ireland and Portugal were downgraded to the 'triple-B' category whilst the rating of Greece was downgraded to sub-investment (or 'junk') grade. The sovereign rating of Spain was also downgraded but remained in the 'double-A' category. The results from the EU Bank Stress Tests, co-ordinated by the Committee of European Banking Supervisors, highlighted that only seven out of the 91 institutions failed the 'adverse scenario' tests. The tests were a helpful step forward, but there were doubts if they were far-reaching or demanding enough. The main UK banks' (Barclays, HSBC, Lloyds and RBS) Tier 1 ratios all remained above 9% under both the 'benchmark scenario' and the 'adverse scenario' stress tests. The tests were repeated in the Spring of 2011.

Gilts benefitted from the Comprehensive Spending Review (CSR) plans, which were judged by the markets to be decisive, as well as from their relative 'safe haven' status in the face of European sovereign weakness. 5-year and 10-year gilt yields fells to lows of 1.44% and 2.83% respectively. However yields rose in the final quarter across all gilt maturities on concern that higher inflation would become embedded and greatly diminish the real rate of return for fixed income investors.

During the year money market rates increased marginally at the shorter end (overnight to three months). 6 - 12 month rates increased between 0.25% to 0.30% over the 12 month period reflecting the expectation that the Bank Rate would be raised later in 2011.

Outlook for 2011

The economic interest rate outlook provided by the Council’s treasury advisor, Arlingclose Ltd, as at June 2011 is detailed below. The Council will reappraise its strategy from time to time and, if needs be, realign it with evolving market conditions and expectations for future interest rates.

	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14
Official Bank Rate													
Upside risk	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	0.50	0.75	1.00	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.00	3.00
Downside risk		-0.25	-0.25	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-1.50	-0.50

- CPI remained persistently high at 4.5% in May. Despite the reduction in petrol prices double digit gas and electricity price hikes could push inflation close to 5% in 2011 .CPI is forecast to remain above the Bank's 2% inflation target for the whole of 2012.
- The UK economy is growing but only modestly. The outlook for exports remains positive but household purchasing power is constrained by a much-needed adjustment of personal balance sheets (seen through a higher savings ratio and debt reduction) and the effect of higher consumer prices.
- Retail sales are contracting. Consumer spending has not shown any growth over the year due to a fall in disposable income, weak house price growth and a lack of consumer confidence. Unemployment is just under 2.5M and will increase as the public sector shrinks but private sector employment grows at only a modest pace.
- The MPC members are likely to remain 7 to 2 in favour of an unchanged policy, although markets will be interested to see whether new member Ben Broadbent will be hawkish like his predecessor.
- Eurozone finance ministers delayed a further Greek handout, in order to see whether the Greek government would pass austerity measures. The threat of Greek default has increased which has caused further anxieties about the threat of contagion to Eurozone peripheries such as Ireland and Portugal.
- Despite southern Europe’s debt problems, the ECB is still likely to raise rates in a bid to control inflation as indicated by President Jean-Claude Trichet in his June press conference.
- S&P has revised its outlook on the long-term rating for the US to negative amidst fears that the government will not agree a medium-and long-term strategy to tackle their fiscal challenges. Fitch has indicated that it may follow S&P if the debt ceiling is not increase by August.
- The Federal Open Market Committee in the US may choose to initiate a new bout of Quantitative Easing (QE) in order to boost their faltering economy, although the Chairman of the Fed Ben Bernanke is more likely to pressure Congress into increasing the debt limit rather than use monetary policy.