2011 ECONOMIC BACKGROUND AND THE OUTLOOK FOR 2012

2011 Economic Background

At the time of determining the strategy for the 2011/12 in February 2011, there were tentative signs that the UK was emerging from recession with the worst of the financial crisis behind it. Recovery in growth was expected to be slow and uneven as the austerity measures announced in the 2010 Comprehensive Spending Review CSR) were implemented in order to bring down the budget deficit and government borrowing and rebalance the economy and public sector finances. Inflation measured by the Consumer Price Index (CPI) had remained stubbornly above 3%, unemployment was at a 16-year high at 2.5 million, and was expected to rise further as the public and private sector contracted. There was also a high degree of uncertainty surrounding Eurozone sovereign debt sustainability.

a) **Inflation:** During 2011/12 inflation remained high with CPI (the official measure) and RPI rising in September to 5.2% and 5.6% respectively, primarily due to escalating utility prices and the January 2011 increase in VAT to 20%. Inflation eased slowly as reductions in transport costs, food prices, intensifying competition amongst retailers and supermarkets and the VAT effect falling out in 2012, pushed February 2012's CPI down to 3.4% and RPI to 3.7%. This, however, was not enough to offset low wage growth and, as a result, Britons suffered the biggest drop in disposable income in more than three decades.

b) **Growth, Employment, House Prices:** Growth, on the other hand, remained elusive. The Bank's Quarterly Inflation Reports painted a bleak picture as the outlook was downgraded to around 1% in 2011 and 2012. The unresolved problems in the Eurozone weighed negatively on global economic prospects. UK Gross Domestic Product (GDP) was positive in only the first and third calendar quarters of 2011; annual GDP to December 2011 registered just 0.5%. Unemployment rose to 2.68 million and, worryingly, youth unemployment broke through the one million barrier. House prices struggled to show sustained growth and consumer confidence remained fragile.

c) **Monetary Policy:** It was not surprising that the Bank of England's Monetary Policy Committee (MPC) maintained the status quo on the Bank Rate which has now been held at 0.5% since March 2009, but increased asset purchases by £75 billion in October 2011 and another £50 billion in February 2012 taking the Quantitative Easing (QE) total to £325 billion. The policy measures announced in the March 2012 Budget statement were judged to be neutral. The government stuck broadly to its austerity plans as the economy was rebalancing slowly. The opinion of the independent Office for Budget Responsibility (OBR) was that the government was on track to meet its fiscal targets. The OBR identified oil price shocks and a further deterioration in Europe as the main risks to the outlook for growth and meeting the fiscal target.

d) **US:** The US economy continued to show tentative, positive signs of growth alongside a gradual decline in the unemployment rate. The US Federal Reserve (the Fed) committed to keeping policy rates low until 2014, although a modest shift in the Fed's language in March, alongside an improvement in economic activity, cast doubts about the permanence of the Fed's policy commitment.

e) **Europe**: In Europe, sovereign debt problems for some peripheral countries became critical. Several policy initiatives were largely ineffectual; two bailout packages were required for Greece and one for Portugal, and the contagion spread to Spain and Italy, whose sovereign bonds came under increased stress in November. Standard & Poor's downgraded nine European sovereigns and the European Financial Stability Facility (EFSF) bailout fund. The successful Greek sovereign bond swap in March 2012 shortly after its second bailout package allowed it to avoid bankruptcy later that month, but it was not a long-term solution. The European Central Bank's (ECB) €1.3 trillion Long-Term refinancing Operations (LTROs) flooded the financial markets with ultra-cheap 3-year liquidity and relieved much of the immediate funding pressure facing European banks in 2012, but markets ultimately took the view the LTROs simply served to delay a resolution of, rather than addressed, the fundamental issues underpinning Euroland's problems.

f) **Credit**: Europe's banking sector was inextricably linked with the sovereign sector. Sharp moves in sovereign Credit Deposit Swops (CDS) and bond yields were fairly correlated with the countries' banking sector performance. The deterioration in the prospects for real growth had implications for earnings and profit growth and banks' creditworthiness. The European Banking Authority's banking stress tests of 70 EU banks undertaken in October 2011 identified a collective €106 billion shortfall to banks' Core Tier 1 ratio of 9%. The slowdown in debt and equity capital market activity also had implications for banks' funding and liquidity. These principal factors, as well as a reassessment by the rating agencies of future sovereign support for banks, resulted in downgrades to the long-term ratings of several UK and non-UK financial institutions in autumn 2011.

Markets sentiment oscillated between 'risk on'/'risk off' modes, this swing becoming the norm for much of 2011/12 as investors shifted between riskier assets and the relative safety of higher quality government bonds. Gilts, however, were a principal beneficiary of the 'risk-off' theme which helped push yields lower. There was little market reaction to or impact on gilts by the decision by Fitch and Moody's to change the outlook on the UK's triple-A rating from stable to negative. Over the 12 month period from April 2011 to March 2012, 5-year gilt yields more than halved from 2.40% to 1.06%; 10-year gilt yields fell from 3.67% to 2.25%; 20-year yields fell from 4.30% to 3.20% and 50-year yields from 4.20% to 3.35%. PWLB borrowing rates fell commensurately (see Table 2 in Appendix 2), but the cost of carry associated with borrowing longer-term loans whilst investing temporarily until the money is required for capital financing remained high, in excess of 4.1 % for 20-year PWLB Maturity borrowing.

The Outlook for 2012

The economic interest rate outlook provided by the Council's treasury advisor, Arlingclose Ltd, as at April 2012 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.

	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
Official Bank Rate													
Upside risk				0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Central case	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk													

- CPI remains above target at 3.5% and we expect near-term price pressures to rise again in the months ahead as pipeline price pressures from higher oil prices work their way through the production chain. By year end CPI may have remained above the 2% target as the surge in energy prices in autumn 2011 falls out.
- GDP contracted 0.2 % in Quarter 1 2012; and combined with the Quarter 4 2011 contraction of 0.3%, the UK is in technical recession (defined as two straight quarters of contraction). Rising energy prices, government spending cuts and anaemic wage growth are squeezing consumers, creating a drag on the recovery. However, in spite of the UK entering technical recession, we do not expect the MPC to vote for more QE at the May meeting.
- However the gilt market will find it difficult to dismiss the potential for more QE and will therefore be more sensitive to incoming domestic and international economic data.
- Faltering global growth will not be helped by the considerable uncertainty and contagion risks presented by the crisis in the Eurozone and gridlock in the US going into an election year. The knock-on effects could in turn weigh on growth in China and emerging market countries.
- Despite the ECB flooding the financial system with €1.3 trillion liquidity in the form of LTROs, markets are becoming nervous with signs that some of the periphery are struggling to keep to their budget deficit reduction plans and political risk remaining high with upcoming elections in France, Greece, Germany and Italy.
- US economic recovery is gathering momentum, tempering expectations of further QE by the Fed.
- The US Federal Reserve has signalled it will keep interest rates "at exceptionally low levels" until 2014. We believe that it could be 2016 before official UK interest rates rise.
- The UK's safe haven status and minimal prospect of an increase in policy rates are expected to keep gilt yields at their lows in the near term. However with QE potentially coming to an end, gilt values could be more sensitive to sentiment.
- Political shocks and a disorderly outcome to the Eurozone sovereign crisis remain key economic and credit risks.