Economic Update
Corporate Resources O&SC

29 November 2016

Background

- The draft four year Medium Term Financial Plan and Budget for 2017/18 is due to be presented to the Overview & Scrutiny Committees in January 2017.
- In advance of that the Corporate Resources OSC asked for an economic update given the uncertainty resulting from the referendum decision to leave the European Union (BREXIT). The recent US election result could also have economic repercussions.
- This briefing is based on the latest published views from the Bank of England Monetary Policy Committee and other sources such as the National Institute for Economic and Social Research and the Office for National Statistics (ONS).
- The Council's treasury management advisors, Arlingclose, are presenting to Members later today on their views on the economic situation.

Monetary Policy

- The Bank of England's Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target and in such a way that helps to sustain growth and employment.
- At its meeting on the 3rd November 2016, the MPC voted unanimously to maintain Bank Rate at 0.25%.
- The Committee voted unanimously to continue with the programme of sterling non-financial investment-grade corporate bond purchases ("asset purchases") totalling up to £10 billion, financed by the issuance of central bank reserves.
- The Committee also voted unanimously to continue with the programme of £60 billion of UK government bond purchases to take the total stock of these purchases to £435 billion, financed by the issuance of central bank reserves.
- The above measures (known as Quantative Easing) are expected to boost sterling asset prices (stabilise balance sheets and hence credit worthiness), improve the supply of money in the economy and lower the cost of finance for UK companies in order to support the UK economy.

Economic Growth

- In August, the MPC projected that demand growth would slow materially in the second half of 2016, although there was considerable uncertainty around that judgement and the precise extent and timing of any slowing was hard to judge from the range of indicators available.
- Since then, the slowing in growth has been much less severe than those indicators initially suggested. According to the latest ONS estimates, GDP growth slowed only slightly to 0.5% in 2016 Q3 from 0.7% in Q2. It is expected to remain at or around 0.5% during Q4 (Oct to Dec), compared to the August projection of 0.1%.
- Exchange rates - At the time of the August Report, sterling had depreciated by 15% relative to its November 2015 peak. By the 26 October it had depreciated by a further 6½%. The bulk of the decline in sterling is largely attributed to changes in perceptions of the United Kingdom's future trading arrangements.
- One impact of that is the overall FTSE All-Share index has risen recently. It has been boosted by the effect of the fall in sterling on the value of companies' foreign income; domestically focused companies' equity prices fell.

Inflation

- The November 2016 Quarterly Inflation Report issued by the Bank of England advised that inflation is projected to rise above the 2% target within the next twelve months, and the fall in sterling since the referendum suggests inflation forecast could reach 2.7% in 2018. The most recent official figures showed that inflation is running at 1%.

- The Bank does not expect inflation to return to its 2% target until 2020.

- Others see a more dramatic move higher in inflation. The National Institute for Economic and Social Research said it expected inflation to quadruple to about 4% in the second half of 2017. The think tank also warned that prices would "accelerate rapidly" during 2017 as the fall in sterling is passed on to consumers.

Consumer Price Index

- CPI inflation picked up to 1.0% in September (ONS), from 0.5% in June but remains below the 2% target.

- CPI inflation is projected to continue to rise over the next three months and over 2017. The contribution to inflation from petrol prices is expected to turn increasingly positive, in part reflecting rises in oil prices since January. In addition, sterling has depreciated by 21% since its peak in November 2015, which will continue to push up the prices of energy and other imported goods and services.

- The precise path for inflation will depend on the speed and degree to which companies pass through rising external costs to consumer prices, given domestic conditions. Subdued domestic demand growth is likely to weigh somewhat on companies' margins and wage growth, and offset slightly the upward pressure from external costs on inflation.

Employment

- There is at present very little evidence to assess how the labour market is evolving following the referendum. Official data for the post-referendum period will not be available for some time, and there are currently limited survey data.
- Further, many businesses are likely to take time to reassess their employment plans. Those indicators that are available suggest that labour demand growth is likely to slow in the near term.
- Surveys of changes in companies’ employment and their employment intentions conducted since the referendum have fallen and are now below their past averages.
- Additionally, those surveys that have asked specifically about the impact of the referendum vote indicate, on average, that over half of firms expect the outcome to reduce recruitment, in some cases significantly.
- That said, Nissan, a company that previously suggested that the UK leaving the EU could result in its withdrawal from the UK, recently announced major new investment in the North East With two new models to be built.

Unemployment

- The ONS reports that unemployment is expected to remain stable during 2016 and is currently at 4.9% nationally (June to August 2016 figures). The unemployment rate is projected to rise to around 5½% by the middle of 2018 and to stay at around that level throughout 2019.

Outlook

- Since the August report, the exchange rate has fallen even further and the outlook for growth in the short term has improved whilst the outlook for medium term growth has weakened.

- UK GDP growth in Q3 was 0.5%. This was slightly lower than Q2 growth but still far above what was expected in the August report. However, the path of output growth will be down to how successful the UK government is in arranging new trade deals with the EU. Household spending has been strong even after the UK's vote to leave the EU.

- Having deteriorated post-Brexit, conditions in the property market have since improved on both a retail and a commercial level. Employment growth is still expected to weaken, albeit at a slower pace than previously expected. The level of unemployment is forecast to remain stable in the near term.

- The significant fall in the pound since August is likely to push up inflation for years to come. This, along with past depreciation of the pound, means that inflation is projected to rise above the 2% target over the next twelve months and will only begin to fall back around the middle of 2018.

Impact for CBC

- The Council is exposed to risk in terms of interest rate movements on its borrowings and investments. Movements in interest rates have a complex impact on the Council. For example, a rise in interest rates would increase the revenue cost of borrowings at variable rates. The Council has a number of strategies for managing interest rate risk and aims to keep a maximum of 50% of its borrowings in variable rate loans.
- With short term interest rates being much lower than long term rates, it continues to be more cost effective in the short term to use a combination of internal resources and short term borrowing, rather than undertake further long term borrowing. By doing so, the Council is able to minimise net borrowing costs and reduce overall treasury risk.
- In addition to interest rate risks, there are also financial uncertainties surrounding new responsibilities (as yet undefined) that are expected to be passed to Local Authorities as part of 100% retention of NNDR.
- The Draft MTFP currently assumes a number of pressures from 2019/20 – 2020/21 including the impact of higher rates of inflation and exchange rates differences.

Any questions?