

# Appendix 1 - Treasury Management Update Report Q3 2021/22

## 1. Introduction

- 1.1. The Authority has adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports. This quarterly report provides an additional update.
- 1.2. The Authority's treasury management strategy for 2021/22 was approved at a full Council meeting on 1 March 2021. The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk remains central to the Authority's treasury management strategy.
- 1.3. The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 1 March 2021.

## 2. External Context (provided by the Council's treasury management advisor, Arlingclose)

### **Economic background**

- 2.1. The economic recovery from coronavirus pandemic, together with higher inflation and higher interest rates were major issues over the period.
- 2.2. The Bank of England (BoE) increased Bank Rate to 0.25% in December 2021 but maintained its Quantitative Easing programme at £895 billion. The Monetary Policy Committee (MPC) voted 8-1 in favour of raising rates, and unanimously to maintain the asset purchase programme.
- 2.3. Within the announcement, the MPC noted that the pace of the global recovery was broadly in line with its November Monetary Policy Report. Prior to the emergence of the Omicron coronavirus variant, the Bank also considered the UK economy to be evolving in line with expectations. However due to the increased uncertainty and risk to activity the new variant presented at the time, the Bank revised down its estimates for Q4 GDP growth to 0.6% from 1.0%.
- 2.4. Inflation was projected to be higher than previously forecast, with CPI likely to remain above 5% throughout the winter and peak at 6% in April 2022. The labour market was generally performing better than previously forecast and the BoE now expects the unemployment rate to fall to 4% compared to 4.5% forecast previously.
- 2.5. UK CPI for November 2021 registered 5.1% year on year, up from 4.2% in the previous month. Core inflation, which excludes the more volatile components, rose to 4.0% year on year from 3.4%. The most recent labour market data for the three months to October 2021 showed the unemployment rate fell to 4.2% while the employment rate rose to 75.5%.
- 2.6. Government support in the form of the furlough scheme ended on 30th September 2021 but the subsequent impact on jobs appears to have been more muted than previously

been feared. In October 2021, the headline 3-month average annual growth rate for wages was 4.9% for total pay and 4.3% for regular pay. In real terms, after adjusting for inflation, total pay growth was up 1.7% while regular pay was up 1.0%. The change in pay growth has been affected by a change in composition of employee jobs, where there has been a fall in the number and proportion of lower paid jobs.

- 2.7. The UK's gross domestic product (GDP) grew by 1.1% in the quarter ending 30 September 2021 according to the final estimate, compared to a gain of 5.4% quarter over quarter reported in the previous quarter. The annual rate slowed to 6.8% from 23.6%. The data however predates the escalation in virus infections caused by the Omicron variant in December which will very likely result in a slowdown in activity in the quarter ending 31 December 2021.
- 2.8. GDP growth in the euro zone increased by 2.2% in the quarter ending 30 September 2021. Headline inflation has been strong in the region, with CPI registering 5.0% year on year in December, the sixth successive month of inflation. At these levels, inflation is above the European Central Bank's target of 'below, but close to 2%', putting some pressure on its long-term stance of holding its main interest rate of 0%.
- 2.9. The US economy expanded at an upwardly revised annualised rate of 2.3% in the quarter ending 30 September 2021, slowing sharply from gains of 6.7% and 6.3% respectively in the previous two quarters.
- 2.10. In its December 2021 interest rate announcement, the Federal Reserve continue to maintain the Fed Funds rate at between 0% and 0.25% but outlined its plan to reduce its asset purchase programme earlier than previously stated and signalled they are in favour of tightening interest rates at a faster pace in 2022, with three 0.25% movements now expected.

### **Financial Markets**

- 2.11. Ongoing monetary and fiscal stimulus together with rising economic growth supported equity markets over the period, but higher inflation and the prospect of higher interest rates mixed with the emergence of the new coronavirus variant ensured it was a bumpy period. The Dow Jones hit another record high during the quarter while the UK-focused FTSE 250 index continued making gains over pre-pandemic levels. The more internationally focused FTSE 100 saw more modest gains over the period and remains below its pre-crisis peak.
- 2.12. Inflation worries dominated bond yield movements over the period as initial expectations for transitory price increases turned into worries that higher inflation was likely to persist for longer meaning central bank action was likely to start sooner and rates increases are expected at a faster pace than previously thought.
- 2.13. The 5-year UK benchmark gilt yield began the quarter at 0.62% before rising to 0.82%. Over the same period the 10-year gilt yield fell from 1.00% to 0.97% and the 20-year yield declined from 1.35% to 1.20%. The Sterling Overnight Rate (SONIA) averaged 0.07% over the quarter.

### **Credit Review**

- 2.14. Relatively benign credit conditions caused credit default swap (CDS) prices for the larger UK banks to remain low and had steadily edged down throughout the year up until mid-

November when the emergence of Omicron caused them to rise modestly but have since continued their downward trajectory.

- 2.15. The ongoing vaccine rollout programme is credit positive for the financial services sector in general but there remains uncertainty around the full extent of the losses banks and building societies will suffer due to the pandemic-related economic slowdown, but the sector is in a generally better position now compared to earlier in the financial year and 2020.
- 2.16. At the end of the period Arlingclose had completed its full review of its credit advice on unsecured deposits for UK and non-UK institutions whereby the maximum duration for all recommended counterparties was extended to 100 days. The institutions and durations on the Authority's counterparty list recommended by treasury management advisors Arlingclose remain under constant review

### 3. Local Context

- 3.1. On 31<sup>st</sup> March 2021, the Authority had net borrowing of £555.9m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

**Table 1: Balance Sheet Summary**

Type of Liability	31.03.21 Actual £m
General Fund CFR	505.5
HRA CFR	332.3
<b>Total CFR</b>	<b>837.8</b>
Less: *Other debt liabilities	(28.2)
<b>Borrowing CFR – comprised of:</b>	<b>809.6</b>
- External borrowing	555.9
- Internal borrowing	253.7

\* finance leases, PFI liabilities and transferred debt that form part of the Authority's total debt

- 3.2. Lower official interest rates have lowered the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The Authority continued to pursue its long-standing strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk.
- 3.3. The treasury management position on 31 December 2021 and the change over the year is shown in Table 2 on the following page.

**Table 2: Treasury Management Summary**

Type of Borrowing / Investment	31.03.21 Balance (£m)	Movement (£m)	31.12.21 Balance (£m)	31.12.21 Rate (%)
Long-term borrowing	496.9	41.0	537.9	3.22

Short-term borrowing	59.0	40.0	99.0	0.12
<b>Total borrowing</b>	<b>555.9</b>	<b>81.0</b>	<b>636.9</b>	<b>2.65</b>
Long-term investments	0.0	0.0	0.0	0.00
Short-term investments	5.0	0.0	5.0	0.12
Cash and cash equivalents	12.0	(6.2)	5.8	0.00
<b>Total investments</b>	<b>17.0</b>	<b>(6.2)</b>	<b>10.8</b>	<b>0.06</b>
<b>Net borrowing</b>	<b>538.9</b>	<b>87.2</b>	<b>626.1</b>	

#### **4. Borrowing Update**

- 4.1. CIPFA published a revised Prudential Code for Capital Finance in Local Authorities on 20<sup>th</sup> December 2021. The Code took immediate effect although local authorities may defer introducing the revised reporting requirements until the 2023/24 financial year.
- 4.2. In order to comply with the Code, authorities must not borrow to invest primarily for financial return. The Code also states that it is not prudent for local authorities to make investment or spending decisions that will increase the CFR unless directly and primarily related to the functions of the authority.
- 4.3. Borrowing is permitted for the purposes of cashflow management, managing interest rate risk, refinancing existing borrowing and to adjust levels of internal borrowing. Authorities can borrow to refinance capital expenditure primarily related to the delivery of a local authority's function, provided that financial return is not the primary reason for the expenditure.
- 4.4. The changes align the CIPFA Code with the PWLB which prohibits access to authorities planning to purchase 'investment assets primarily for yield' except to refinance existing loans or externalise internal borrowing. Acceptable use of PWLB borrowing includes service delivery, housing, regeneration, preventative action, refinancing and treasury management.
- 4.5. The Authority does not plan to borrow to invest primarily for commercial return and so is unaffected by these changes and so is able to continue to fully access the PWLB.

#### **Municipal Bonds Agency (MBA)**

- 4.6. The MBA continues to work to deliver a new short-term loan solution, available in the first instance to principal local authorities in England, allowing them access to short-dated, low rate, flexible debt. The minimum loan size is expected to be £25 million. Importantly, local authorities will borrow in their own name and will not cross guarantee any other authorities.
- 4.7. If the Authority were to consider future borrowing through the MBA, it would first ensure that it had thoroughly scrutinised the legal terms and conditions of the arrangement and taken proper advice on these.

#### **UK Infrastructure Bank**

- 4.8. £4bn has been earmarked for lending to local authorities by the UK Infrastructure Bank which is wholly owned and backed by HM Treasury. There is an application and bidding process for these loans which is likely to favour environmental or regeneration projects. Loans will be available for qualifying projects at gilt yields plus 0.60%, which is 0.20% lower

than the PWLB certainty rate. The bank made it first loan in October 2021 to Tees Valley Combined Authority.

### Borrowing strategy during the period

- 4.9. On 31<sup>st</sup> December 2021, the Authority held £636.9m of loans (an increase of £81.0m compared to 31<sup>st</sup> March 2021) as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 31<sup>st</sup> December 2021 are summarised in Table 3 below.

**Table 3: Borrowing Position**

	<b>31.03.21 Balance £m</b>	<b>Net Movement £m</b>	<b>31.12.21 Balance £m</b>	<b>31.12.21 Weighted Average Rate %</b>	<b>31.12.21 Weighted Average Maturity (years)</b>
Public Works Loan Board	371.9	41.0	412.9	2.63	28.4
Banks (LOBO)	125.0	0.0	125.0	4.72	38.4
Local authorities (short-term)	59.0	40.0	99.0	0.12	0.4
<b>Total borrowing</b>	<b>555.9</b>	<b>81.0</b>	<b>636.9</b>	<b>2.65</b>	<b>26.0</b>

- 4.10. The Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.
- 4.11. With short-term interest rates remaining much lower than long-term rates and with surplus of liquidity continuing to feature in the local authority to local authority market, the Authority considered it to be more cost effective in the near term to use short-term loans to satisfy liquidity requirements during the first half of the year. The net movement in temporary short-term loans is shown in Table 3 above.
- 4.12. Having considered the appropriate duration and structure of the Authority's borrowing in consultation with the Authority's treasury advisor Arlingclose, the Authority decided to take some advantage of the fall in external borrowing rates and borrowed a combined £55m of medium-term Equal Instalments of Principal (EIP) loans and longer-term maturity loans from the PWLB, at an average of 1.54%. This will provide longer-term certainty and stability to the debt portfolio.
- 4.13. The Authority has a significant capital programme which extends into the foreseeable future. A large proportion of this will be financed by borrowing, which the Authority will have to undertake in the current and coming years. In line with the approved Treasury Management Strategy, additional long-term borrowing is anticipated to be raised over the remaining course of the 2021/22 financial year.
- 4.14. Any borrowing which is taken prior to capital expenditure taking place, and reducing the extent of the Authority's internal borrowing, would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing, creating an immediate cost for revenue budgets. The Authority's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short and long-term borrowing is maintained.

- 4.15. Arlingclose undertakes a weekly ‘cost of carry’ analysis which informs the Authority on whether it is financially beneficial to undertake long-term borrowing now or delay this for set time periods based on PWLB interest rate forecasts.

### **LOBO Loans**

- 4.16. The Authority continues to hold £125m of LOBO (Lender’s Option Borrower’s Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the year.

## **5. Treasury Investment Activity**

- 5.1. CIPFA published a revised Treasury Management in the Public Services Code of Practice Cross-Sectoral Guidance Notes on 20<sup>th</sup> December 2021. These define treasury management investments as investments that arise from the organisation’s cash flows or treasury risk management activity that ultimately represents balances that need to be invested until the cash is required for use in the ordinary course of business.
- 5.2. The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority’s investment balances ranged between £10.8 and £50.1 million due to timing differences between income and expenditure. The investment position is shown in table 4 on the following page.

**Table 4: Treasury Investment Position**

Investments	31.03.21 Balance £m	Net Movement £m	31.12.21 Balance £m	31.12.21 Rate of Return %	31.12.21 Weighted Average Maturity (Days)
Money Market Funds	0.0	4.7	4.7	0.03	1
UK Government:					
- Local Authorities	5.0	0.0	5.0	0.12	234
- Debt Management Office	12.0	(10.9)	1.1	-0.14	1
<b>Total investments</b>	<b>17.0</b>	<b>(6.2)</b>	<b>10.8</b>	<b>0.06</b>	<b>1</b>

- 5.3. Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Authority’s objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.
- 5.4. Ultra-low short-dated cash rates which have been a feature since March 2020 when Bank Rate was cut to 0.10% have resulted in the return on sterling low volatility net asset value money market funds (LVNAV MMFs) being close to zero even after some managers have temporarily waived or lowered their fees.
- 5.5. Deposit rates with the Debt Management Account Deposit Facility (DMADF) are also largely around zero, depending on the length of deposit.
- 5.6. The progression of risk and return metrics are shown in the extracts from Arlingclose’s quarterly investment benchmarking in Table 5 below.

**Table 5: Investment Benchmarking – Treasury investments managed in-house**

	<b>Credit Score</b>	<b>Credit Rating</b>	<b>Bail-in Exposure</b>	<b>Weighted Average Maturity (Days)</b>	<b>Rate of Return</b>
31.03.2021	<b>3.91</b>	<b>AA-</b>	<b>0%</b>	<b>8</b>	<b>0.28%</b>
31.12.2021	<b>4.46</b>	<b>AA-</b>	<b>44%</b>	<b>110</b>	<b>0.06%</b>
Similar Local Authorities	<b>4.77</b>	<b>A+</b>	<b>72%</b>	<b>56</b>	<b>0.14%</b>
All Local Authorities	<b>4.64</b>	<b>A+</b>	<b>66%</b>	<b>16</b>	<b>0.10%</b>

Scoring: AAA = highest credit quality = 1; D = lowest credit quality = 26

Aim = A- or higher credit rating, with a score of 7 or lower, to reflect current investment approach with main focus on security

### **Non-Treasury Investments**

- 5.7. The definition of investments in CIPFA's revised 2021 Treasury Management Code covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. Investments that do not meet the definition of treasury management investments (i.e., management of surplus cash) are categorised as either for service purposes (made explicitly to further service objectives) and/or for commercial purposes (primarily for financial return).
- 5.8. Investment Guidance issued by the Department for Levelling Up, Housing and Communities (DLUHC) also broadens the definition of investments to include all assets held partially for financial return.

### **Treasury Performance**

- 5.9. Treasury investments generated an average rate of return of 0.02% in the first three quarters of the financial year. The Authority's treasury investment income for the year is likely to be less than the budget forecast due to a lower than anticipated average rate of return.
- 5.10. Borrowing costs for 2021/22 are forecast at £16.5m (£10.5m HRA, £6.0m General Fund) against a budget of £24.8m (£16.2m HRA, £8.6m General Fund). In prior years, these budgets have underspent due to a number of factors, including: the current lower interest rate environment reducing interest costs for the Council, and delays in the capital programme's delivery. Should slippage in the Council's capital programme occur, it will reduce the borrowing requirement, and reduce this forecast.

## **6. Compliance**

- 6.1. The Director of Finance reports that all treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy.
- 6.2. Compliance with the authorised limit and operational boundary for external debt is demonstrated in Table 6 below.

**Table 6: Debt Limits**

	<b>31.12.21 Actual £m</b>	<b>2021/22 Operational Boundary £m</b>	<b>2021/22 Authorised Limit £m</b>	<b>Complied?</b>
Borrowing	597.2	1,157.4	1,207.4	Yes
PFI and Finance Leases	28.2	28.2	31.0	Yes
<b>Total debt</b>	<b>625.4</b>	<b>1,185.6</b>	<b>1,238.4</b>	<b>Yes</b>

- 6.3. Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure, however, Haringey's debt remained well below this limit at all points during first half of the year.

### **Treasury Management Indicators**

- 6.4. The Authority measures and manages its exposures to treasury management risks using the following indicators.

### **Security**

- 6.5. The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	<b>31.12.21 Actual</b>	<b>2021/22 Target</b>	<b>Complied?</b>
Portfolio average credit score	4.46 (AA-)	7.0 (A-)	Yes

### **Liquidity**

- 6.6. The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing.

	<b>31.12.21 Actual</b>	<b>2021/22 Target</b>	<b>Complied?</b>
Total cash available within 3 months	20.0	10.0	Yes

### **Interest Rate Exposures**

- 6.7. This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests was:

<b>Interest rate risk indicator</b>	<b>31.12.21 Actual</b>	<b>2021/22 Target</b>	<b>Complied?</b>
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	£0.20m	£2m	Yes
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	£0.20m	£2m	Yes



6.8. The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current rates.

**Maturity Structure of Borrowing**

6.9. This indicator is set to control the Authority’s exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	<b>31.12.21 Actual</b>	<b>Upper Limit</b>	<b>Lower Limit</b>	<b>Complied?</b>
Under 12 months	16.48%	50%	0%	Yes
12 months and within 24 months	1.88%	40%	0%	Yes
24 months and within 5 years	5.79%	40%	0%	Yes
5 years and within 10 years	4.59%	40%	0%	Yes
10 years and within 20 years	14.50%	40%	0%	Yes
20 years and within 30 years	7.07%	40%	0%	Yes
30 years and with 40 years	23.00%	50%	0%	Yes
40 years and within 50 years	26.69%	50%	0%	Yes
50 years and above	0.00%	40%	0%	Yes

6.10. Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

6.11. The Authority has used short term borrowing (under 1 year in duration) from other local authorities extensively in recent years, as an alternative to longer term borrowing from PWLB, due to lower interest rates, and corresponding revenue savings. Short term borrowing exposes the Authority to refinancing risk: the risk that rates rise quickly over a short period of time and are at significantly higher rates when loans mature, and new borrowing has to be raised. With this in mind, the Authority has set a limit on the total amount of short-term local authority borrowing, as a proportion of all borrowing.

<b>Short term borrowing</b>	<b>Limit</b>	<b>31.12.21</b>	<b>Complied?</b>
Upper limit on short-term borrowing from other local authorities as a percentage of total borrowing	30%	16%	Yes

**Principal Sums Invested for Periods Longer than a year**

6.12. The purpose of this indicator is to control the Authority’s exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	<b>2021/22</b>	<b>2022/23</b>	<b>2023/24</b>
Actual principal invested beyond year end	Nil	Nil	Nil
Limit on principal invested beyond year end	£10m	£10m	£10m
Complied?	Yes	Yes	Yes

**7. Revisions to CIPFA Codes**

7.1. CIPFA published revised Prudential and Treasury Management Codes in December 2021. The Prudential Code takes immediate effect although detailed reporting requirements may be deferred until the 2023/24 financial year and have thus not been included in this report. There is no mention of the date of initial application of the TM Code.

7.2. The accompanying guidance notes to the Codes including the treasury management prudential indicators have not yet been published. The main changes or expected changes from previous codes that have not already been discussed above include:

- Additional reporting requirements for Capital Strategy.
- For service and commercial investments, in addition to assessments of affordability and prudence, an assessment of proportionality in respect of the Authority’s overall financial capacity (i.e. whether plausible losses could be absorbed in budgets or reserves without unmanageable detriment to local services).
- Forward looking prudential code indicators must be monitored and reported to members at least quarterly.
- A new indicator for net income from commercial and service investments to net revenue stream.
- Inclusion of the liability benchmark as a treasury management prudential indicator. CIPFA recommends this is presented as a chart of four balances – existing loan debt outstanding; loans CFR, net loans requirement, liability benchmark – over at least 10 years and ideally cover the authority’s full debt maturity profile.
- Excluding investment income from the definition of financing costs.
- Credit and counterparty policies should set out the Authority’s policy and practices relating to Environmental, Social and Governance (ESG) investment considerations.
- Additional focus on the knowledge and skills of officers and elected members involved in decision making.

**8. Outlook for the remainder of 2021/22 and beyond (provided by the Council’s treasury management advisor, Arlingclose)**

8.1. The table below shows the latest interest rate forecast produced by Arlingclose.

	Current	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.50	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Downside risk	0.00	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50

8.2. Arlingclose anticipate the MPC will want to build on the strong message it delivered in December and January by tightening policy further to dampen aggregate demand and reduce the risk of sustained higher inflation.

- 8.3. Despite this expectation, risks to the forecast remain weighted to the upside for 2022, becoming more balanced over time. The Arlingclose central forecast remains below the market forward curve.
- 8.4. Gilt yields are expected to remain broadly flat from current levels, which have risen sharply since mid-December 2021. Significant volatility is, however, likely which should offer tactical opportunities for borrowing and investment.
- 8.5. The post COVID global economy has entered a higher inflationary phase, driven by a combination of resurgent demand and supply bottlenecks in goods and energy markets. Geopolitics are also playing a role, driving energy prices upwards which are being passed on to consumers. Tighter labour markets due to reduced participation rates have prompted concerns about wage-driven inflation, leading central banks to tighten policy to ensure inflation expectations remain anchored.
- 8.6. Supply constraints are also evident in the labour market. Underlying wage growth is running above pre-COVID levels despite employment being lower now than in early 2020. Evidence suggests that labour pools have diminished. Higher wage growth will be a contributory factor to sustained above-target inflation this year.
- 8.7. However, higher inflation will dampen demand. In the UK, households face a difficult outlook. Fiscal and monetary headwinds alongside a sharp reduction in real income growth will weigh on disposable income, ultimately leading to slower growth.
- 8.8. The Bank of England will tighten policy further over the next few months to ensure that aggregate demand slows to reduce business pricing power and labour wage bargaining power. Markets have priced in a significant rise in Bank Rate, but Arlingclose believe the MPC will be more cautious given the medium-term outlook, assessing the impact of the first round of rises rather than following the market higher.