

INTEREST RATE FORECASTS AND ECONOMIC BACKGROUND

Forecasts on interest rates that are key considerations for the Council's Treasury Management Strategy. In coming to a decision about its benchmark for 2010/11, the Council reviewed a number of interest rate forecasts. Appendix B draws together a number of current city banks and academic institution forecasts for short term bank rate and longer term fixed interest rates. The table below gives the central view of these forecasts:

	Q/E1 2010 %	Q/E2 2010 %	Q/E3 2010 %	Q/E4 2010 %	Q/E1 2011 %	Q/E2 2011 %	Q/E3 2011 %	Q/E4 2011 %	Q/E1 2012 %	Q/E2 2012 %	Q/E3 2012 %	Q/E4 2012 %	Q/E1 2013 %
Bank Rate	0.50	0.50	0.75	1.00	1.50	2.25	2.75	3.25	3.50	3.75	4.25	4.25	4.50
5 yr PWLB	3.05	3.20	3.30	3.40	3.60	3.85	4.15	4.55	4.60	4.80	4.80	4.85	4.85
10yr PWLB	4.00	4.05	4.15	4.30	4.45	4.60	4.80	4.90	5.00	5.10	5.10	5.15	5.15
25 yr PWLB	4.55	4.65	4.70	4.80	4.90	5.00	5.05	5.10	5.20	5.30	5.30	5.35	5.35
50 yr PWLB	4.60	4.70	4.75	4.90	5.00	5.10	5.15	5.20	5.30	5.40	5.40	5.45	5.45

Economic background

The long awaited start of economic growth following the recession eventually came in quarter 3 2009 in the US and the EU. However, there was disappointment that the UK failed to emerge from recession in quarter 3.

UK

- GDP growth will almost get back to the long term average of about 2.5% in 2011;
- Sterling has depreciated by 25% since the peak in 2007 and is likely to stay weak;
- CPI inflation expected to peak @ 2.5% in early 2010 after the rise in VAT in January but then to fall to a trough near 1.5% in early 2011 and to stay below 2% for the rest of 2011;
- The first Bank Rate increase is expected in Q3 2009_[ad1];
- Gilt yields are currently artificially low due to the Bank of England's Quantitative Easing operations. Long gilt yields are therefore forecast to reach 6% during 2011; and
- The major risk to this scenario would be a lack of supply of bank credit. However, it is felt that the Bank of England is on alert to ensure that this does not happen and would continue various measures to assist the expansion of credit.

Summary

- The current economic cycle is not a normal business cycle but a balance sheet driven cycle. Repayment of debt will therefore act as a major head wind to the required increase in demand in the economy. GDP growth is forecast to reach only +1.5% in 2011;

- Long PWLB rates will **fall** from current levels to near 4% in 2010 due to weak economic recovery and minimal inflation so that the real rate of return (net of inflation) on long gilts is healthy at these low levels; and
- There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas: -
 - degree of speed and severity of fiscal contraction after the general election
 - timing and amounts of the reversal of Quantitative Easing,
 - speed of recovery of banks' profitability and balance sheet imbalances
 - changes in the consumer savings ratio
 - rebalancing of the UK economy towards exporting and substituting imports