

Global economic outlook and the UK economy

The UK

- 10.1 Domestic demand has grown robustly, supported by sustained real income growth and a gradual decline in private sector savings. Low oil and commodity prices were a notable feature of 2015, and contributed to annual CPI inflation falling to 0.2% in December 2015. Wages are growing at 3% a year, and the unemployment rate has dropped to 5.4%. Mortgage approvals have risen to over 70,000 a month and annual house price growth is around 3.5%. These factors have boosted consumer confidence, helping to underpin retail spending and hence GDP growth, which was an encouraging 2.3% a year in the third quarter of 2015.
- 10.2 Although speeches by the Bank of England's Monetary Policy Committee (MPC) members sent signals that some were willing to countenance higher interest rates, the MPC held policy rates at 0.5% for the 83rd consecutive month at its meeting in January 2016. Quantitative easing (QE) has been maintained at £375bn since July 2012.
- 10.3 The outcome of the UK general election, which was largely fought over the parties' approach to dealing with the deficit in the public finances, saw some big shifts in the political landscape and put the key issue of the UK's relationship with the EU at the heart of future politics. Uncertainty over the outcome of the forthcoming referendum could put downward pressure on UK GDP growth and interest rates.

Overseas

- 10.4 China's growth has slowed dramatically and its economy is performing below expectations, reducing global demand for commodities and contributing to emerging market weakness. US domestic growth has accelerated but the globally sensitive sectors of the US economy have slowed. Strong US labour market data and other economic indicators however suggest recent global turbulence has not knocked the American recovery off course.
- 10.5 The Federal Reserve did not raise policy rates at its meetings in October and November, but the committed to an interest rate hike in December 2015. In contrast, the European Central Bank finally embarked on QE in 2015 to counter the perils of deflation.

Credit Outlook

- 10.6 The varying fortunes of different parts of the global economy are reflected in market indicators of credit risk. UK Banks operating in the Far East and parts of mainland Europe have seen their perceived risk increase, while those with a more domestic focus continue to show improvement. The sale of most of the government's stake in Lloyds and the first sale of its shares in RBS have generally been seen as credit positive.
- 10.7 Bail-in legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully

implemented in the UK, USA and Germany. The rest of the European Union followed suit in January 2016, while Australia, Canada and Switzerland are well advanced with their own plans.

- 10.8 Meanwhile, changes to the UK Financial Services Compensation Scheme and similar European schemes in July 2015 mean that most private sector investors are now partially or fully exempt from contributing to a bail-in. The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Authority. Returns from cash deposits remain stubbornly low.

Interest Rate Forecast

- 10.9 The Authority's treasury advisor Arling Close projects the first 0.25% increase in the UK Bank Rate in the third quarter of 2016, rising by 0.5% a year thereafter, and finally settling between 2% and 3% in several years time. Persistently low inflation, subdued global growth and potential concerns over the UK's position in Europe mean that the risks to this forecast are weighted towards the downside.
- 10.10 A shallow upward path for medium term gilt yields is forecast, as continuing concerns about the Eurozone, emerging markets and other geo-political events weigh on risk appetite, while inflation expectations remain subdued. Arling Close projects the 10-year gilt yield to rise from its current 2.0% level by around 0.3% a year. The uncertainties surrounding the timing of UK and US interest rate rises are likely to prompt short-term volatility in gilt yields.