

Perna's Perspective

by Nicholas S. Perna, PhD

"It ain't over 'til it's over." –Yogi Berra

I was hoping that being a little late in writing this issue would help in sorting things out. Some are clearer while others are even more uncertain. There are signs that the U.S. economy is growing and the threat of another recession is fading. This is good news. For awhile, it looked like the European sovereign debt problem was also getting better, but then the Greek Prime Minister announced that he is calling for a popular referendum towards the end of the year on the debt issue which prolongs the anxiety.

On the domestic front, there is fresh evidence that the U.S. economy is stabilizing and not slowing further. Initial claims for unemployment insurance started looking a little better and car sales have picked up. Financial markets jumped at the report that third-quarter, real GDP rose 2.5% which is almost double the previous quarter's 1.3%. It is worth noting, however, that 2.5% growth is just about what it takes to keep the unemployment rate from rising above the recent 9% level. A real recovery that shaves a point a year from unemployment would require GDP to grow 4-5% annually. Assuming that the sovereign debt crisis and/or other "wild cards" do not push us back into recession, my own forecast is that GDP will rise 2 to 2.5% during the coming year, making little or no dent in the ranks of the unemployed.

The European debt crisis has occupied center stage for far too long. I'm getting bored. Although attention focused on Greece, concern has spread to other European nations with large outstanding government debt and to the safety and soundness of the European banking system. Despite doubts over the willingness of the wealthier nations, notably Germany and France, to come up with the funds needed to keep the European financial system afloat, an agreement was reached in late October. However, the more recent announcement of the Greek referendum questions the willingness of the troubled nations to accept the fiscal austerity measures that have become the quid pro quo for bailout funds. We'll find out when the Greeks vote.

U.S. financial institutions do not seem to have much direct exposure to Europe. Our banks hold relatively small amounts of European debt. Their exposure to default by Greece and the like via credit default swaps is less clear, but also thought to be relatively modest. The failure of ML Financial, a commodities and derivatives brokerage with \$60 billion in assets that was leveraged 30 to 1, happened because of big bets that European bonds would rally. The company, headed by former New Jersey senator/governor Jon Corzine, made the same mistakes as Long-Term Capital in 1999 and a slew of other companies in 2008. When will we ever learn?

Washington continues to generate an ample supply of hot air (cause of global warming?) and uncertainty. The "Super Committee" of Congress that is tasked with developing a plan for trimming \$1.2 trillion from the budget deficit is supposed to submit its report by November 23. Then Congress will vote on these proposals as a single package – with no amendments. If the Committee is deadlocked or if their proposals do not pass, then spending cuts automatically take place starting in 2013. Although Social Security and Medicare are exempted, defense spending and other "discretionary spending" would be hit with huge reductions. Hopefully, we can avoid these disruptions.

At the conclusion of its September 20-21 meeting, the Federal Reserve did not call for yet another installment of "Quantitative Easing." Instead of additional outright purchases of Treasury securities, the Fed announced the start of "Operation Twist" whereby it would buy long-term Treasury bonds and pay for them by selling short-term obligations. This keeps the Fed's balance sheet from expanding further. The Fed is "doing the twist" so as not to annoy further critics, both inside and outside the Fed, who worry about the substantial growth of the Fed's balance sheet over the past couple years. Interestingly, at the November

1-2 meeting, there were no objections to the announcement that “Twist” would continue. In fact, the only dissent was that the Fed was not being aggressive enough.

Didn't Bernanke promise back in August that short-term rates would remain close to zero until at least the middle of 2013? How do we reconcile this pledge with the potential for higher, short-term rates under “Operation Twist” as the Fed sells shorter term bills and notes? My thinking is that the Fed will use traditional open market operations to offset the rise in short rates that might otherwise take place. That is, the Fed will be simultaneously buying short-term securities as part of traditional “open market operations” and selling them for “Operation Twist.” Say what?

Anyway, we won't face any significant increase in short-term rates for at least another year or more. Hence, the cost of funds for credit unions and other depository institutions will stay low. Long-term interest rates are more uncertain. If the European debt situation worsens, then the flight of capital to the safety of U.S. markets will accelerate. Inflows keep long rates low. On the other hand, Congress and the presidential candidates will have ample opportunity to spook financial markets during the coming year.

Finally, I think it is remarkable that the U.S. economy has been able to keep growing since mid-2009 despite the plethora of problems of the type described above. This certainly attests to the resilience of the U.S. system – warts and all!



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