

Perna's Perspective



by Nicholas S. Perna, PhD

The budget confrontations in Washington have pushed Charlie Sheen off the front pages – at least for awhile. Sometimes the debate makes as much sense as one of Charlie's monologues. The fiscal fisticuffs have also relegated Federal Reserve policy to the back burner. For interest rates, the outcome will reflect the impact of fiscal restraint versus the unwinding of Fed policies.

FISCAL OUTLOOK: One down ... two to go.

The FY 2011 Budget: In mid-April, the House and Senate finally passed a budget for the fiscal year (FY 2011) that started last October. After keeping things going through a series of continuing resolutions, some members threatened to shut the government down unless sizable spending cuts were built into the budget. They succeeded in lowering outlays by \$38 billion.

The FY 2012 Budget: In early April, Budget Committee Chairman Paul Ryan (R-Wisconsin) submitted a "blueprint" for the coming fiscal year and beyond that reduces the deficit by cutting spending while also reducing taxes. President Obama responded with a plan that lowers deficits by cutting spending and raising taxes. The House passed Ryan's proposals, but it could take months before a budget for FY 2012 is enacted. The final product is apt to differ dramatically from Ryan's initial vision, but it is likely to include restraints on spending for the FY starting October 1.

The Debt Ceiling: Sometime in mid-May, the Treasury will bump up against the \$14.3 trillion debt ceiling. Unless the limit is raised, the Treasury will be unable to pay interest on existing debt and to roll over maturing obligations. The U.S. would default, probably by early July, with catastrophic financial results – easily a Richter 10 on the economic earthquake scale! The U.S. dollar exchange rate would collapse as investors sell U.S. holdings and interest rates soar. It is extremely unlikely that Washington would let this take place, but there could be some anxious moments.

MONETARY POLICY: The Federal Reserve is on the verge of unwinding the unprecedented stimulative programs of recent years. There are concerns about inflation, including some coming from several Fed officials. Furthermore, the Fed needs to get going well before the 2012 elections.

Short-term rates: The Fed drove short-term rates to zero in 2007-08 and they clearly need to start raising them since the economy is now growing and so is inflation. My bet is that the FOMC will begin the tightening process late this year, although many economists feel it won't be until early next year.

Long-term yields: It will soon be necessary for Mr. Bernanke and friends to figure out what to do about the more than \$1.5 trillion in mortgage-backed securities and Treasury bonds they purchased from the private financial sector as part of the "Quantitative Easing" (QE) program that had begun in late 2008. QE was implemented in order to reduce long-term interest rates and narrow the spreads between mortgages and treasuries. Phase II was implemented last year and is scheduled to end in June. I think the Fed will tread cautiously, but it will be difficult to avoid some upward pressure on bond yields. The Fed will first let the portfolio shrink by no longer reinvesting interest and principle payments, followed by announcements of a longer-term sales program of additional securities, as conditions permit.

OVERALL IMPLICATIONS: Financial markets will be watching nervously as Washington moves towards resolution of these fiscal and monetary issues, which means volatility for interest rates and stock prices.

Raising the debt ceiling and passing the FY 2012 budget are likely to include agreements for spending cuts in addition to the \$38

billion already enacted. Coming on top of fiscal restraint from state and local governments, this will moderate the pace of economic activity during much of this year. As long as oil prices subside to the vicinity of \$90 per barrel, inflation will not be much of a serious problem. Keep in mind that the Fed's inflation target is in the vicinity of 2 percent. My forecast has the total Consumer Price Index (CPI) a little above that and the more important core CPI (excluding food and energy) a little below 2 percent.

Bond yields will be drifting up throughout the year with short rates following. From a risk management point of view, credit unions should plan on a higher cost of funds across the maturity spectrum. Rising bond yields will make new investments more attractive, but decrease the portfolio value of current holdings.

U.S. Economic Forecast (4/11/11)

	2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
REAL GDP % CH	3.7	1.7	2.6	3.1	2.6	1.5	2.5	3.3
CPI % CH	2.5	2.0	1.4	1.2	2.0	2.5	2.5	2.3
UNEMPLOYMENT %	9.7	9.5	9.6	9.4	8.8	8.7	8.6	8.4
FED FUNDS %	0	0	0	0	0	0	0	0.50
10-YR TREASURY %	3.73	3.20	2.65	3.29	3.41	3.68	3.98	4.35

Note: GDP percent change is from previous quarter at annual rate. CPI rise is from 4 quarters earlier. Unemployment and interest rates are for the last month of the quarter.



Nick Perna is Resident Economist, Members United Corporate. He specializes in economic analysis, forecasting and strategy. Dr. Perna has served as an economist for the Federal Reserve Bank of New York, General Electric and a number of major banking institutions. The *Wall Street Journal* and *BusinessWeek* have each twice cited Dr. Perna as one of the top economic forecasters in the United States. He has served as an economics professor at Williams College and New York University, and currently teaches an economics course at Yale University. In addition, he has also appeared on *The NewsHour with Jim Lehrer*, CNN, CNBC, the *NBC Nightly News*, ABC Radio and NPR's *All Things Considered*.