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[Fitch: Model Shows Fast Rate Rise Would Hurt U.S. Public Finance .]

Fitch Ratings-New York-06 April 2015: U.S. Federal Reserve (the Fed) rates are likely to begin to rise in mid 2015 and to tighten gradually, Fitch Ratings says. We expect the average policy rate for 2016 to be 1.6%. However, we created an interest rate shock scenario impact to gauge how faster rate increases and a decline in the economy would impact state, local, and transportation infrastructure issuers. In the interest rate shock scenario, we assumed inflation to peak at 4.5% in 2016, forcing the Fed to raise its annual target sharply to 4.0% in 2016. We also assumed 0% real U.S. GDP growth, unemployment rising steadily to 7.0% in 2016, and the yield on 10-year Treasuries to reach 5.5%.

Under this interest rate shock scenario we would expect most state budgets to weather the interest rate changes. However, the lack of growth and rise in unemployment would trigger declines in income and consumer spending, which would reduce sales tax revenues. In 2014, sales taxes were approximately 28% total state and local tax revenues according to the U.S. Census Bureau. We also believe a spike in interest rates would cause a decline in the stock markets that would reduce capital gains tax collections in wealthier states and reduce state and local employee pension plan assets. Under this interest rate shock scenario, we would expect some level of federal intervention and states could exercise some of their flexibility in funding services.

Since funding is an important source for local governments, tightening state funding without changes to other program funding would be detrimental. However, the largest funding for most local governments is property taxes. Zero growth combined with increases in borrowing costs would likely hurt property values and their associated taxes. Many local governments are still recovering from the funding declines during (and after) the Great Recession. An interest rate shock in 2016 would lead to rating pressures on local governments with fund balances that are still recovering.

The impact on many transportation projects would be felt in declining transportation volumes. Seaport, airport, and road volumes are all tied directly to GDP changes. So, stalling US GDP would have a significant impact. The rise in unemployment would also have a broad impact. The larger international gateway airports would fare better than smaller leisure and secondary hub airports. Import volumes at ports would decline as spending falls. Export volume could also decline if the turbulence in the US economy spread to other economies. The impact of lower toll road volume could be offset by the pricing power many authorities have.

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