How the Fed is Assisting the Financial Suicide of Cities and States

To paraphrase Newton's third law of motion, for every action there is an equal and opposite reaction. Newton was talking about physical laws, but I like to think that in the world of finance and economics there are similar laws. Today, as the Fed contemplates an extension of operation twist or some other form of expansive monetary policy, it is worth pointing out one area where their actions are causing distress – in locales around the nation.

The Fed has broad mandates to maintain stable prices (low or no inflation), moderate interest rates, and full employment. Along with these goals, the Fed was given broad powers to affect money in the US. Unfortunately the goals and the tools don't exactly match. How does monetary policy lead to jobs? Only by the 3rd or 4th derivative, meaning the Fed lowers interest rates or expands money supply, hopes that these lead to increased borrowing and therefore spending, and hopes that the spending leads to business expansion, that leads to jobs. Right. As we have seen with QE1, QE2, Operation Twist, and other various programs, reality is different than theory. However, in this reality, such programs do create outcomes, even ones you don't want.

As the Fed has continued to push on the string of economic activity, it has continually worked toward a lower interest rate environment. This has pushed 30-year mortgages down to 3.53%, lowered the cost of borrowing for the US government and corporations, and even made buying a car cheaper. And then there is the other side of the coin. Not considering individual investors for the moment, large investors, like pension plans, have seen their fixed income returns fall like a rock. This means that these funds have to work hard to make up what has been lost to lower interest rates, which usually involves seeking out high return alternative investments. In the meantime, public pension funds have two all-important numbers they must keep in mind – their assumed rate of return and their discount rate.

The assumed rate of return for a pension is exactly that, the rate the fund expects to earn over the long term, smoothing out annual gyrations. The discount rate is the interest rate used to determine the present value of estimated fund balances. The higher the expected rate of return, and the higher the discount rate, the less a pension fund has to put away today in order to meet its future obligations. Of course, if interest rates are going lower, then things get dicey. If interest rates stay low, so that funds earn less than they projected and also have to determine present value with a lower discount rate, then the current funding status of pension funds fall off a cliff.

Welcome to the cliff.

We are in year five the financial crisis, where liquidity has been uneven and only financial engineering from central banks has boosted markets. Financial repression – the artificial suppression of interest rates – is the order of the day and will be with us for at least two more years. The outcome? According to a study just released from the Pew Center, state pension and healthcare funding has imploded, with the underfunded number ballooning from $1 trillion in 2009 to $1.4 trillion in 2011. Only one state, Wisconsin, has a fully funded pension. No state has fully funded healthcare. Unfortunately, states are making matters even worse. In 2010, only 19 of the 50 states made their full pension contribution.

Off Course, It's All Fantasy.

So the interest rate environment is low, and will be for years. States are reporting paltry earnings on their fixed income investments and on their overall portfolios. What do states do? Why, they continue to assume a 7.75%-8.00% rate of return, of course. If states actually dropped this number to a more realistic 4.5%-5%, then the funding gap would grow by another 40%, leading to a $1.96 trillion dollar gap!

This situation has developed at the same time that state and city revenues fell dramatically, which made the situation worse. Revenues are slowly recovering, but not nearly as quickly as required pension plan payments are going up.

None of this is exactly news. The reason for pointing out where we are is to bring up the question of, "What's next?" If states and cities do not have the funding for their pensions and healthcare, something that HS Dent has been writing about since they published the first "Death of Pensions" in 2006, then what is the outcome? On the provider side, it shows up as higher taxes, less service, more layoffs of employees, less funding for universities, etc. On the recipient side, it will require higher contributions and lower benefits.

All of this is leading to a situation where reality is finally acknowledged and these generous plans are recognized as unaffordable. Then the pain of what that reality means sets in.

It's all called austerity, and it soon will be coming to a city and state near you.

Sincerely,

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