The Interplay of Public Pensions and the Broad Economy

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- Atlanta Fed President and CEO Dennis Lockhart, in an August 24, 2015, speech to the Public Pension Funding Forum in Berkeley, California, discusses ways that public pensions and the broad economy interact.
- Lockhart says that state and local government spending cuts can become a headwind in a downturn and subsequent recovery, and pension funding gaps can exacerbate this tendency. But he doesn't see the underfunding of public pension funds as a systemic risk.
- Lockhart believes the time to address funding gaps is before the next downturn arrives.
- Lockhart says that since the recession ended, the U.S. economy has grown at an average annual rate of 2.1 percent. His baseline forecast is for moderate growth with continuing employment gains and a gradually rising rate of inflation.
- Consistent with the picture of moderate growth, Lockhart expects the normalization of monetary policy—that is, interest rates—to begin sometime this year, and to proceed gradually, in an environment of low rates for quite some time.

I want to thank the organizers of the Public Pension Funding Forum for inviting me to address this conference.

I am not going to assume you are all fully up to speed on the structure of the Federal Reserve System, the role of the Reserve Banks, and the role of a Reserve Bank president.

I am one of 12 Reserve Bank presidents. The Reserve Banks have multiple functions. We implement bank regulatory policy. We process incoming cash currency from banks and distribute currency to banks. We operate in the payments system as a provider of check clearing and settlement services as well as electronic funds transfer services. We conduct outreach programs with communities in our districts to enhance financial and economic literacy, to research issues affecting low- and moderate-income neighborhoods, and to gather anecdotal economic information to better understand ground-level economic reality.

Each Reserve Bank has its own economic research department. Our economists conduct research and support the monetary policy role of their bank presidents. All of the presidents participate with the Federal Reserve Board governors in Washington in meetings of the Federal Open Market Committee (the FOMC). The FOMC sets monetary policy, which is substantially about interest-rate policy. Policy decisions of the FOMC influence the bond market yield curve. Monetary policy also influences the macroeconomy across multiple dimensions such as aggregate demand, growth, employment, and inflation.

In my remarks today, I will explore two points of intersection between your world and mine. The first is financial stability and systemic risk. To pose a question, to what extent should pension funding levels, particularly public pension funding, be considered a risk to financial stability—a potential systemic risk?

The second point of intersection is macroeconomic performance. What is the interplay between the condition of public pension funds and macroeconomic outcomes?

My overall objective today is a rather modest one. I'll just give you a sense of how I'm thinking about the questions I've just laid out.

Before I get into it, let me initiate you to the ritual of "the Fed disclaimer." You will hear my personal views only. I am not speaking for the Federal Reserve or the FOMC. My colleagues may not agree with my views. This disclaimer is so regularly invoked in internal conferences that authors of papers and presentation slides don't even spell it out any more. We just put "Fed disclaimer" at the bottom of their title page or slide, and everyone knows what it conveys.

Financial stability and systemic risk

Following the financial crisis of 2008 and 2009, Federal Reserve System leaders were keenly aware that there were gaps in our institutional understanding of financial markets. We acknowledged some "known unknowns."

There were four key areas in which we felt we were deficient. They were (1) money market mutual funds, (2) private equity and venture capital, (3) hedge funds, and (4) state and local government public finance.

In response to the near-death experience of the financial system, the Federal Reserve mobilized research and monitoring efforts to improve our knowledge of these potential sources of risk to the financial system and the economy. Teams were organized around each of these four areas. My Reserve Bank—the Federal Reserve Bank of Atlanta—joined with the Federal Reserve Bank of Cleveland to form a team for the last area I mentioned, state and local government public finance. The team's primary focus was on the municipal bond market and public pension funds.

Let me insert here a comment on the notion of systemic risk. There's no official definition, but systemic risk is associated with financial instability, financial panic, runs on institutions, and contagion facilitated by interconnectedness in the financial world. Episodes of system-wide financial instability may impose severe costs on the broad economy and society.

The team's charge was to look at these two aspects of public finance—the municipal bond market and public pension funds—with respect to their relationship to the broader financial system. We already had many Fed economists studying the role of state and local government as a gross domestic product (GDP) component—that is, the impact of state and local government spending and employment on economic performance and growth.

In thinking about risks to financial stability, our economists applied a model with four sequential elements: shock, transmission, amplification, and feedback. Using this framework, they overlaid analysis and scenario evaluation on projections of real economy conditions with the aim of addressing questions such as:

- Could an event in the state and local government sector constitute a significant shock transmitted to the financial system, causing significant macroeconomic distress?
- Alternatively, would actions of state and local governments serve to transmit or amplify shocks from elsewhere in the financial system and exacerbate negative spillovers to the Main Street economy?
- And, closer to home for you, could events deriving from funding shortfalls and solvency crises of public pension funds play a big role in what amounts to a shock or a transmission mechanism or amplifier of a shock?

I'll give you, in my own words, my sense of the conclusions that can be drawn from the work done by our team. Public pensions are not likely to be a source of a systemic shock. The current state of underfunding of some public pensions is a serious problem, but the problem is long term in nature. By *long term* I mean two things. I mean **over** the long term—that is, a situation regarding public pension plans is likely to build gradually and not be prone to random surprises along the way. We will be able to watch the problem develop. It's unlikely a shock will come out of the blue.

Long term also means **in** the long term. By this I mean that a coming to a head, a climactic moment, if one comes, is likely to be well into the future.

In this conclusion, I'm focusing on public pension funds in isolation. As we've seen recently, there could very well be a financial crisis-like moment at the level of the sponsoring government entity. If a pension system's funding declines enough, there is a risk that a state government could at some point find itself in such financial distress that it would be forced to choose between paying bondholders and paying pension beneficiaries.

It's my view that such an occurrence is low probability as a single event, and the probability is even lower that a bunching of such occurrences would amount to a significant shock triggering contagion in the financial system.

Going a little further with this thought process, if a large state were to default on its debt, an episode of financial instability, possibly fueled by contagion, would be more likely to follow from headline effects than through the direct exposure of financial institutions. The majority of municipal debt is held directly or indirectly by households, particularly high-net-worth households. The amplifiers of leverage and complex counterparty relationships that fueled the financial crisis of 2008 are largely not in play in the municipal sector.

Recent headlines about episodes of financial distress in Detroit and Puerto Rico, for example, have not set off contagion affecting the entire municipal asset class. There was a market reaction, but repricing was consistent with credit fundamentals.

My conversations with members of the team working on municipal markets and public pensions leave me pretty sanguine about chances of a system-shaking event. That said, they were tasked with thinking about extreme scenarios. This was prudent, in my opinion, because we learned from the events of 2008 and 2009 that tail risks do sometimes materialize. I think the right posture, therefore, is one of watchful vigilance. Investors fleeing from the entire municipal bond asset class would raise the cost of debt for all state and local issuers. If prolonged, this could constitute a meaningful headwind for the broad economy.

Public pensions and macroeconomic outcomes

Picking up from that last scenario, I'll shift now to reflections on the interplay of public pensions and the broad economy. I'll organize my comments around two directions of potential impact. I'll comment first on **pensions impacting**

the economy and then conclude with thoughts on **the economy impacting pensions**.

The first question I want to explore is how pension funding problems might contribute to fiscal challenges that in turn spill over to the general economy. I will address this through the lens of the challenges created by significant cutbacks in state and local government spending.

In the wake of the Great Recession, one persistent issue—call it a headwind—was that even as private-sector employment and investment started to recover, cuts in state and local government spending, investment, and employment continued.

In particular, I note the large real declines in K–12 education (particularly school construction), highway and bridge repair, and state social programs. It is notable that while spending of this sort was falling, contributions to public pensions grew quite a lot. While the primary cause for this retrenchment in state and local spending was the decline in tax revenues, it is worth asking whether growing recognition of the extent of underfunding of public pension funds aggravated the belt-tightening experienced at the state and local government level.

This is not to suggest that states shouldn't have placed and shouldn't be placing a priority on funding their pension liabilities. Nor is it to make a judgment about the desirability of lower government spending.

My point is that ongoing public-sector spending cuts can represent a headwind to overall demand and complicate efforts aimed at supporting growth to meet the Fed's employment mandate. To the extent that funding issues with public pensions amplify fiscal stress, the longer-run problem of public funding may translate into growth challenges as the economy seeks to heal from periods of economic weakness.

Economic growth and pension funding/investments

I'll conclude by turning the lens in the other direction. I'll comment on how the macroeconomic growth environment can interact with pension funding.

I would think the macroeconomic outlook is of great interest to you as you set your investment objectives for the coming years, review your allocation, and decide how much risk you must accept.

Let me frame the topic in this way: it's about the alignment of assumptions about overall investment portfolio returns with realistic assumptions about macroeconomic momentum and trends. Not all investments in portfolios of public pension funds are correlated with broad economic outcomes, but I suspect many are. Forecast assumptions regarding GDP growth underpin, to an extent, forecasts of fixed-income portfolio returns and total returns of other asset classes.

My outlook for GDP growth (for the medium term, at least) cannot help but be influenced by recent economic history. Since the recession ended in the summer of 2009, the domestic economy has grown at an average annual rate of 2.1 percent. Compared to other post-World War II recoveries, this is slow growth.

Over this period, the economy has faced a number of headwinds and shocks. We've pushed through several domestic fiscal showdowns—including one federal government shutdown—a tsunami, two major winter weather events, geopolitical tensions, and wide swings of global energy prices. These developments slowed activity, shook confidence, and bred cautious economic behavior on the part of American consumers and businesses. These spells of cautious behavior have contributed to a slow pace of recovery. More recently, the Greek fiscal crisis was unsettling with its potential for a major financial event or worse. Currently, developments such as the appreciation of the dollar, the devaluation of the Chinese currency, and the further decline of oil prices are complicating factors in predicting the pace of growth.

Our baseline forecast at the Atlanta Fed is for moderate growth with continuing employment gains and a gradually rising rate of inflation.

The fundamentals underlying this outlook relate to consumer spending, business investment, and the related issues of wage and income growth. I'll comment on the current state of each of these.

Over the past year, consumer spending has strengthened to a pace consistent with the solid, but unspectacular, pace of growth I just predicted. This spending has been supported by reasonably good aggregate income growth, but it is important to note that aggregate income expansion has come more from employment gains in the workforce than from gains in wage rates paid to workers. Average wage growth has persisted at levels well below the prerecession pace, very likely in part due to subpar labor productivity growth over most of the recovery.

Weakness in the pace of labor productivity gains has been associated with a relatively tepid pace of business investment. For example, during the past year, business spending on equipment has merely matched the lackluster growth of the overall economy.

I am looking for some improvement in business investment spending other than energy-sector spending on wells and production infrastructure. The lower oil price has caused major cutbacks in that category of investment.

The fundamental factors underlying GDP growth are linked. Business investment supports productivity growth. Growth of productivity fuels wage growth. Wage growth fosters the acceleration of consumer activity. I'm expecting continuing improvement in all these elements of the growth outlook, but I'm not predicting sharp acceleration in the foreseeable future.

Consistent with this picture, I expect the normalization of monetary policy—that is, interest rates—to begin sometime this year. I expect normalization to proceed gradually, the implication being an environment of rather low rates for quite some time.

Let me wrap up. I've had the following basic messages for you today. I don't see the underfunding of public pension funds as a systemic risk. Nor do I see state and local government fiscal stresses, to which pension underfunding can contribute, plausibly posing systemic-event risk individually or collectively. However, state and local government spending cuts can become a headwind in a downturn and subsequent recovery. Pension funding gaps can exacerbate this tendency. Failure to shore up the funding of public pensions when times are relatively good can compound stresses on state and local budgets when economic conditions become more challenging. For the sake of the overall economy, the time to address funding gaps is before the next downturn arrives. Finally, in setting your expectations for returns, you may wish to consider the outlook for growth over the medium term. My own outlook foresees moderate growth, but not a breakout to strongly accelerating growth.