Funded pensions can strengthen European economic growth

van Ewijk, C.

Published in:
Pension Background

Citation for published version (APA):
The European Commission envisions an important role for institutional investors, including pension funds. Their longer time horizons enable them to behave in a patient, counter-cyclical manner, restraining ‘short-termism’ and reducing the need for maturity transformation.1 Recent research indicates that funded pensions tend to contribute to economic growth, indeed.2 Countries with stronger pension funding perform better in terms of economic growth than countries with less pension funding. Moreover, pension funds may contribute to more robust economies by the better diversification of risks. Having a strong private pension pillar makes citizens less vulnerable to political risks associated with domestic public finances. Also pension funds are better equipped to distribute risks over citizens than for example banks are. At the same time, pension systems face some serious challenges too. Economic growth is impossible without risk; pension contracts should be designed so as accommodate risks in an efficient and - socially - sustainable manner.

**Funded Pensions can strengthen European Economic Growth**

Now that the debt crisis seems more or less under control, Europe’s next challenge is to put the economy back on track of robust, structural growth. Important to this task is to reconsider the European financial landscape, and to see how it can be better geared to supporting the long-term investment needs with sustained growth.

b. Secondly, pension funding may contribute to growth through its focus on long-term investment. Due to the long-term and illiquid character of liabilities, pension funds feature a longer time horizon for their investments too. For this same reason pension funds and insurance companies may be particularly suited for catering illiquid investments, e.g., mortgages.

c. Third, pension funds contribute to allocation of risk in the economy, thereby lowering the price of risk and thus promoting growth. Diverting risks from banks to pension funds reduces systematic risks in the financial system. Pension funds are better able to deal with macroeconomic risks than highly leveraged banks. Moreover, participants cannot withdraw their funds on short notice, so that pension funds can adopt a truly long time horizon. One of the reasons why the recent euro zone crisis has become so serious was because much of the sovereign debt was in the hands of banks, leading to an unhealthy spiral of banking crises. This helps to stabilise the domestic economy and avoids vicious circles of deteriorating government finances and weakening consumer demand.

Impact on the financial landscape

How the pension system affects the financial landscape can be made up from an international comparison of financial systems. There is a large variety of pension systems across EU members, some countries relying almost entirely on pay-as-you-go public pensions (first pillar) whereas others feature substantial funded private pensions (second pillar), see figure 2.

These differences have consequences for the financial landscape. Figure 3 shows some key features for the financial structure for the group of countries (‘funded’) with strong private pension funding (>80% of GDP) and the group of countries (‘unfunded’) with small pension assets (<50% of GDP); the Eastern European countries are taken as a separate group.4

Figure 4 (next page) shows that total household deposits held at banks are somewhat smaller (% GDP) in funded countries, indeed. If taken relative to total bank credit to the private sector the difference is even larger, viz. 40 per cent for funded countries and almost 60 per cent for non-funded countries.5 Interestingly, also the position of banks tends to be stronger in the ‘funded’ countries, both in total assets and in foreign assets. This could indicate that also banks benefit from the stronger supply of capital in ‘funded’ countries. This is in contrast with the ‘funding gap’ view according to which banks are worse off in funded countries, as their deposit base is weaker when households save through pension funds rather than through bank deposits. This makes banks more dependent on wholesale markets for their funding, driving up their funding cost and making them more susceptible to liquidity shocks. If this is true, then one could argue that pension funding in this respect does not stabilize the economy, but may even be de-stabilizing for the banking sector. The facts do not support this argument, however. Figure 4 (next page) shows that total household deposits held at banks are somewhat smaller (% GDP) in funded countries, indeed. If taken relative to total bank credit to the private sector the difference is even larger, viz. 40 per cent for funded countries and almost 60 per cent for non-funded countries.6

4 This methodology follows M. Bijlsma & G. Zwart, 2013. The changing landscape of financial markets in Europe, the United States and Japan by Michiel Bijlsma and Gijsbert T. J. Zwart, Brueghel Working Paper 2013/02. Ferry Haaijen (CPB) helpfully assisted with applying this framework to funded pensions.
in assets indicate that trust is a serious issue in DC plans as well. How the virtue of transparency in systems with individual accounts is weighed against the loss in risk sharing capabilities, may differ between countries.

Conclusion

Funded pensions contribute to deeper capital markets and higher growth. This does not imply that funded pensions perform better in all states of the world. It is obvious funded pensions are more sensitive to shocks in financial markets than public pension schemes on PAYG basis. Recent experience with the world-wide shock of the credit crisis have put funded pensions to a serious test. The important lesson for the future is that such deep common shocks require a highly robust design of the pension system. This is essential to maintain the social contract implied in collective pension systems. But this not specific to funded systems; it is true for the first pillar as well. Just as there have been important reforms in public pension schemes, for example by raising retirement age and linking it to life expectancy, also reform in funded pensions are called for. If properly (re-)designed and managed, funded pensions can play an important role in making economies more robust by better diversification of risks at the national level as a complement to public pensions that take care of poverty alleviation and risk sharing on a national basis.