Funded pensions can strengthen European economic growth

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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.

The European Commission envisages 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.

Pension funding and economic growth

Pension funding may contribute to economic growth in a number of ways.

a. First of all, more private retirement saving increases funds available for investment. In Europe this is especially relevant, as it is clear that bank credit will be constrained for a longer period, and will never return to its pre-crisis level. Higher capital requirements will reduce the pre-existing subsidy of implicit government guarantees and therefore lead to more natural levels of bank credit to the private sector.

1 European Commission, Green Paper on LONG-TERM FINANCING OF THE EUROPEAN ECONOMY, Brussels, 25- 03- 2013.
2 M. Bijlsma, C. van Ewijk, F Haaijen (2014), Pension funding and economic growth, Discussion Paper, Netspar.

Figure 2: Large variety in pension systems among EU members

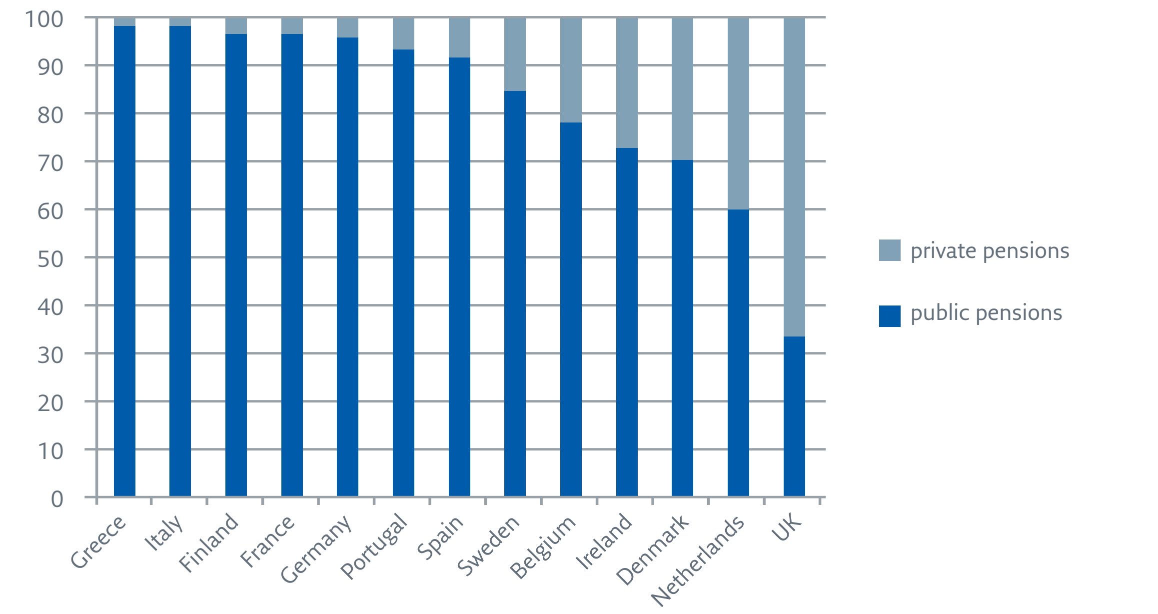
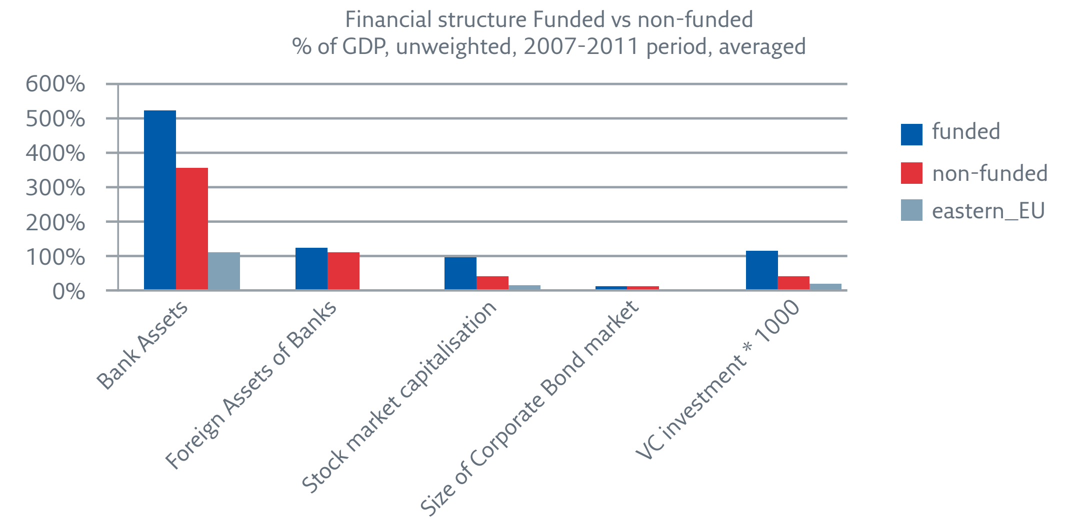


Figure 3: Financial structure in funded, unfunded and Eastern European countries



Funded = CHE, DNK, FIN, ISL, NLD, UK. Non-Funded = AUT, BEL, FRA, DEU, GRC, IRE, ITA, NOR, PRT, ESP

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 risk and sovereign risk. Non-European governments typically obtain more funding from unleveraged lenders, which makes the financial system more stable.

d. Finally, a strong private pension pillar contributes to the stability of the economy as it makes citizens less reliant on public pension schemes. The current debt crises in southern European countries and Ireland illustrate the vulnerability of the public finances to domestic circumstances. With funded private pensions, credit risks for citizens can be diversified. By holding an internationally diversified portfolio of assets, pensions and thus domestic consumption become less vulnerable for domestic shocks. This helps to stabilise the domestic economy and avoids vicious circles of deteriorating government finances and weakening consumer demand.

Impact on the financial landscape

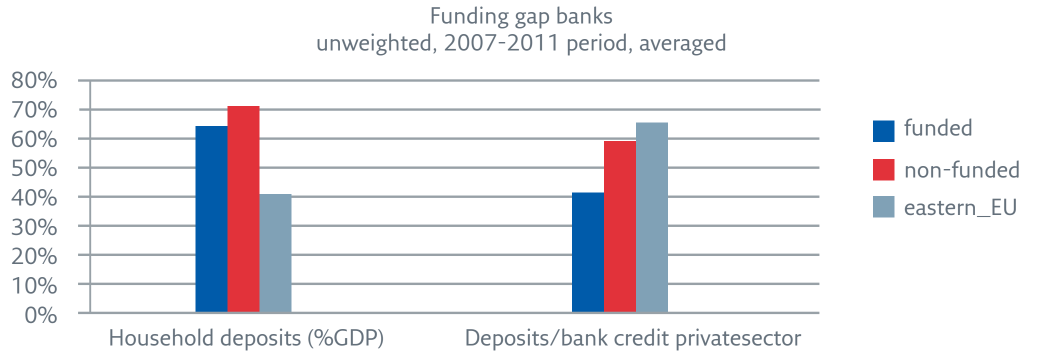
How the pension system affects the financial landscape can be made up from an international comparison of financial systems. There is a large variety of pension systems across EU members, some countries relying almost entirely on pay-as- you-go public pensions (first pillar) whereas others feature substantial funded private pensions (second pillar), see figure 2.[3]

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% GDP); the Eastern European countries are taken as a separate group.[4] Taken together, the 'funded' countries feature a stronger financial sector than the 'unfunded' countries; they have a larger stock market capitalization and also larger venture capital (VC) investment. This is as it was to be expected as funded counties have strong institutional investors and pension funds, while the 'unfunded' countries rely primarily on the public sector for old age provision.

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[5] 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

3 See also A.L. Bovenberg & C. van Ewijk, Private pensions for Europe, CPB Policy Brief 2011/07, The Hague.
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.
5 Lans Bovenberg, 2012, Naar een duurzaam financieringsmodel voor hypotheken, NEA paper 47, Netspar, Tilburg.

Figure 4: Deposits and bank credit for three groups of countries: funded, non-funded, and eastern Europe.



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unfunded countries. This should not be interpreted as an indication that deposits are constraining bank credit. On the contrary, the low ratio in 'funded' countries exactly points to the opposite: it is due to the fact that bank credit is substantially higher (% GDP) in countries with large pension funding. Apparently, banks benefit more from deeper capital markets thanks to the ample supply of capital. This positive factor dominates the possible drawback of smaller supply of households' deposits.

Requirements for pensions

Pensions are necessary for providing income when old. But pensions systems are also important for the allocation of macroeconomic risks in society. Risk taking is intrinsic to economic growth; risks cannot – and should not - be taken away but should be shared in an efficient manner. Pension systems obviously play a role here as pension saving constitutes the major source for financing investment in European economies. Pension systems should diversify risks. Optimal international and intergenerational risk sharing yields considerable welfare gains; it reduces the costs of risk, and thus helps to promote economic growth. According to Obstfeld halving the variance of macroeconomic risks through better risk sharing could increase growth from 1.7% to 2% and lead to a welfare gain of 37%.[6] With firms withdrawing as risk bearing sponsors, more risks will inevitable have to be put onto workers and pensioners. Funded pension systems can assist individuals to optimize saving and risk taking over the lifecycle. To some extent pensions systems can also share risks that cannot be shared through financial markets, e.g. systematic longevity risk, (wage) inflation risks and risk sharing with new generations. As people live longer, it becomes more important to benefit from the risk premium, also during the later phases of the life cycle. A good pension is a risk pension. Both for the individual and for the economy as a whole. This implies that unlike many traditional DC plans, pensions should not aim at seemingly 'safe' nominal pensions, but rather focus on real and variable annuities accepting risk in the portfolio also after retirement. Similarly for more DB oriented systems; these should be adjusted to trade risk in an efficient and transparent manner.

Taking risk into pensions implies that high standards have to be set with regard to property rights of the individual participant. Risk is extremely difficult to communicate to citizens, also to the better informed. Risk in pensions gives rise to serious signal extraction problems, making it hard

6 M. Obstfeld, 1994, Risk taking, global diversification, and growth, American Economic Review 84, 1310-29.

to distinguish between bad luck and bad management in investment. Trust is the key factor here. Systems with individual accounts in terms of common financial instruments - such as individual or collective DC plans - are more transparent and robust in nature than more complicated hybrid DC/DB systems. On the other hand, these hybrid systems may contribute to better risk sharing as they also can deal with risks that are not traded in financial markets. In many countries there is a tendency to favour the simple and clear property rights of individual account systems. These systems are also better geared to introduce flexibility and individual choice, than the traditional DB type pensions. However, also DC systems require delicate communication on the pensions to be expected from the investments. The history of overselling of expected returns and miss-investments 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.

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