COMMENTS ON SESSION 2
PENSION REFORM AND CAPITAL MARKETS

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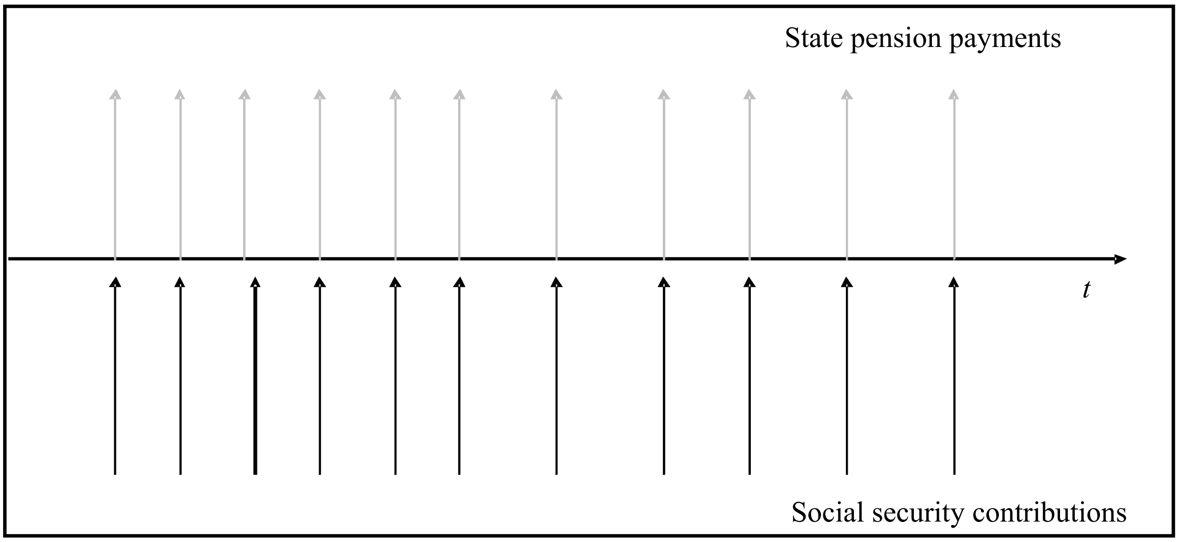
1 Comments on "Pension Privatization and Country Risk" by Alfredo Cuevas, María Gonzáles, Davide Lombardo and Arnoldo López-Marmolejo

1.1 Brief summary and motivation

The paper looks at how rating agencies factor in explicit government debt and implicit pension debt (IPD) in their assessment of country risk. The motivation for the paper is that rating agencies could change risk assessment during the transition phase from unfunded pay-as-you-go (PAYG) to funded private pensions, requiring counter-balancing actions from governments to maintain their ratings. Figure 1 illustrates the set up of the simple unfunded pay-as-you-go system.

Figure 1

A Simple Illustration of a (Sustainable) Unfunded Pay-As-You-Go Pension System



The paper argues that the issue under consideration has arisen in the context of unsustainable PAYG pension systems but the basic story holds even when the PAYG system is sustainable, as is illustrated in Figure 1. To see this, assume that the unfunded PAYG arrangement is mature and sustainable, with population stable and parameters set in a way that revenue meets spending at any point in time. In Figure 1 the black lines are the contributions to the PAYG system made by today's workers. At any point in time the inflow equals the outflow to pensioners, depicted by the grey

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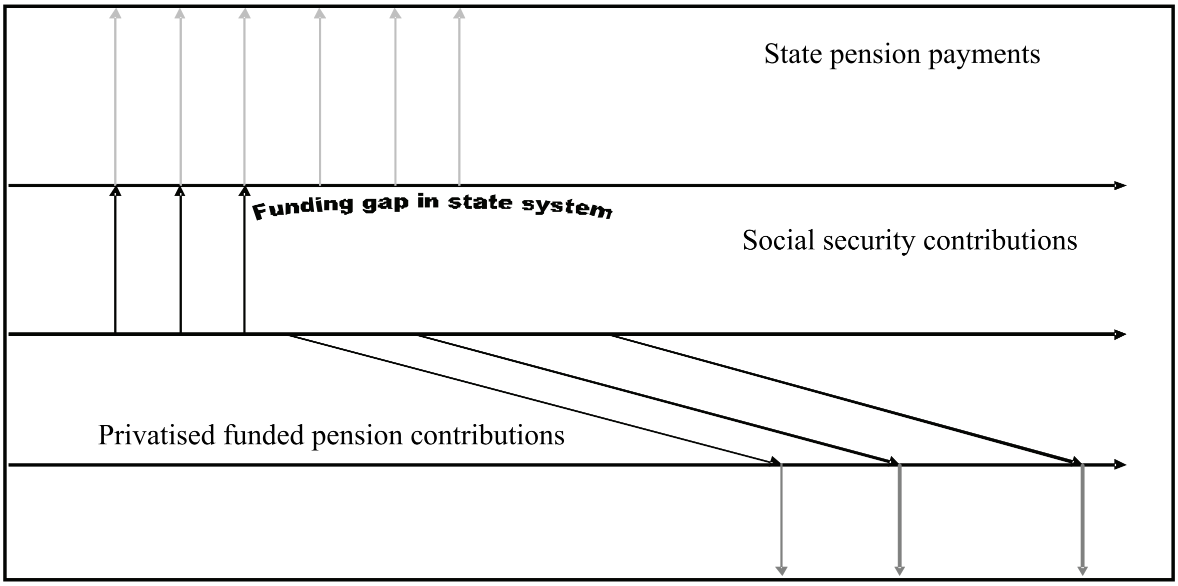
Figure 2

Transition from Unfunded PAYG to Funded Arrangements



arrows. Overall the PAYG pension system is neutral for the public finances. It could be part of general government finances or a closed system as in some countries.

Now assume that the government introduces pension reforms and closes the unfunded PAYG system in favour of a funded defined contribution scheme in the private sector. During the transition phase, the government would have to continue to pay the state pension for several cohorts of actual pensioners or those who have build up entitlements to receive a state pension in the future.

During the transition phase funds will be diverted away from financing these state pensions and a funding gap in the social security system will emerge. Everything else equal, the public finances would deteriorate. Eventually accrued liabilities in the state scheme will be unwound and there would be no longer a funding gap but in the meantime the public debt will go up. So while the pension reform reduces future government exposure to pension liabilities, in the short to medium term the government will have accumulated additional debt. Figure 2 shows the inflows and outflows into the system during the transition phase towards a funded regime.

1.2 Explicit debt versus implicit pension debt

The paper finds that rating agencies care more about explicit debt than IPD when assessing risk, which could be due to:

- myopia, with agencies focussing primarily on short term; and/or
- explicit debt being qualitatively different to implicit pension debt, reflecting hierarchy of spending commitments.

At the top of the hierarchy of spending commitments is non-discretionary spending (legal obligations) such as debt interest payments, which a government will have to honour. Breaking these commitments would generally come with an extreme loss in reputation (e.g., debt defaults).

Second are the social/moral obligations such as state pensions, which can and are being renegotiated unilaterally by government. Renegotiating these social obligations might be unpopular with the electorate – and hence might be difficult to do in practice – but unlike with non-discretionary spending, the government is at least not legally bound. Third is discretionary spending, which governments frequently alter as policy objectives and priorities change, or which are made possible by generous tax revenues (or conversely impossible by weak tax revenues).

1.3 Short-term versus long-term considerations

Rating agencies are not alone facing the challenge of translating long-term trends into an assessment of the public finances. Following the reforms of the Stability and Growth Pact, the European Commission for example has put greater emphasis on long-term budgetary developments in its assessment of EU public finances. One innovation over recent years has been to incorporate implicit pension liabilities into medium-term public finance objectives for the member states. To derive its assessment, it uses quantitative and qualitative indicators, e.g. to weigh up potential long-term benefits of reforms against potential short-term fiscal costs. Admittedly, many countries have not been very successful themselves deriving clear policy objectives from the analysis of long-term trends.

2 Comments on "Pension Funds and Financial Markets: Evidence from the New EU Member States" by Nadine Leiner-Killinger, Christiane Nickel and Michal Slavík

1.1 Brief summary and motivation

The paper studies the role of funded private pensions in pension provision in new EU member states (NMS). It finds that all NMS have funded private pension schemes and minimum pension/social assistance but only a few have occupational pensions. It shows that investment strategies vary across NMS, e.g. in Hungary private schemes have been obliged to invest in government bonds and bills. The paper seems motivated by the authors' concerns about credibility of multi-pillar pension.

1.2 Private pensions in NMS

Funded private pensions in NMS are exposed to inflation and investment risk, which:

- existed before current crisis but which latter has crystallised; and
- raises question regarding feasibility & credibility of pension strategy and regarding efficiency, fairness and sustainability of the structures created in the NMS (longevity risk important too).

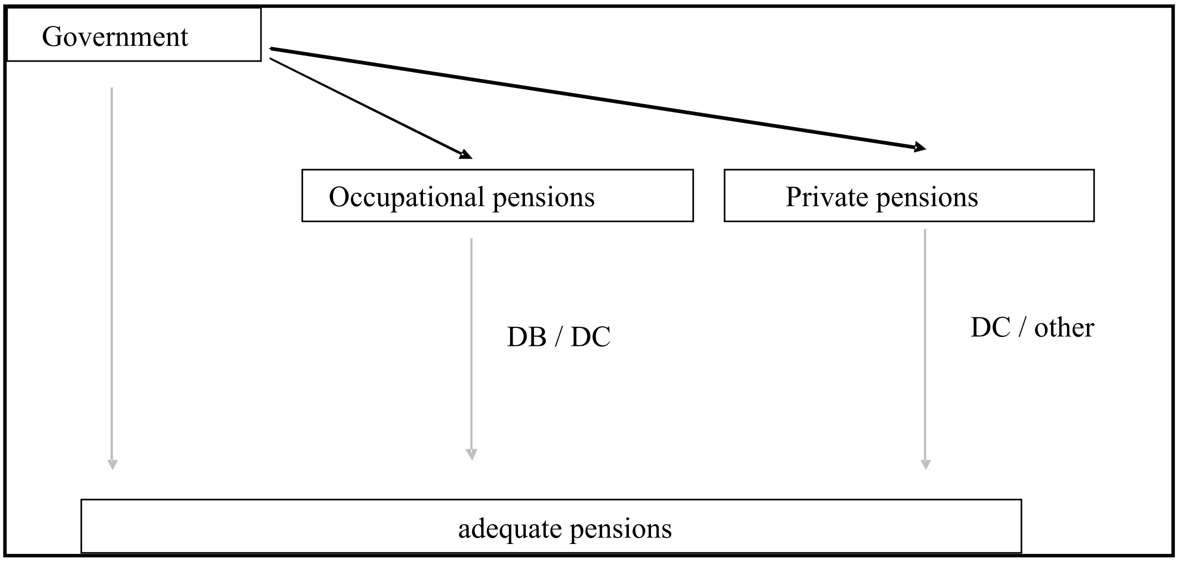
The paper concludes that shifting the burden to the private sector has not been without its problems and that an assessment of fiscal sustainability needs to take account of private sector arrangements. This is because the role of government in providing pensions in the future will to a large degree depend on the future role of occupational and private pensions. All these points seem valid for other countries too.

1.3 Some reflections on moving to three pillar pension provision…

Over the last decade governments have tried to reduce future exposure to pension spending by making state pensions less generous, for example by raising retirement age, encouraging more

Figure 3

Providing for Adequate Pensions: The Three-pillar Approach



generous occupational pensions and incentivising individuals to save more themselves for their retirement.

International organisations such as the OECD supported (or even encouraged) the move to three pillar pension provision and have assessed fiscal sustainability based on this formal allocation of responsibilities. Figure 3 shows the three-pillar approach to pension provision.

1.4 …but who really owns the future liabilities/how credible is the arrangement?

Is it realistic though for a government to disown itself from future pension spending? It might seem fine *ex ante* on paper but will the outcome look similar? This will to a large extent depend on the performance of occupational and private pensions over the coming decades.

The current economic crisis shows that occupational pensions – whether defined benefit or contributions – are under immense pressure and private pensions have also done badly in most countries. The crisis has also demonstrated the usefulness of a strong mixed system, with unfunded social security pensions complementing funded occupational or private pensions. With pensioners representing an ever larger share of the electorate (and the baby boom cohorts considered to be particularly demanding), can a government realistically assume that future pensioners would accept disappointing pension incomes if and when occupational and private pensions fail to perform as expected/hoped for? Would the electoral process not put pressure on the political system to make up for potentially disappointing pension incomes? Indeed, how efficient, fair and sustainable are these arrangements? Starting today, as a minimum it appears that governments ought to be determined to ensure that occupational and private pensions can be long-term successful.