Centraal Planbureau

Funded pensions and economic growth

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Is there a link between pension system and growth?

We have become painfully aware that the financial system matters for economic growth

Both countries with funded pensions as PAYG pensions have been affected by the crisis; mixed evidence.

Hypothesis: Funded pension systems can better cope with macroeconomic risks and therefore contribute to higher growth.

Endogenous growth: halving the variance through better risk sharing could increase growth from 1.7% to 2% and lead to a welfare gain of 37%. (Obstfeld (1994))

Groups

Funded pensions

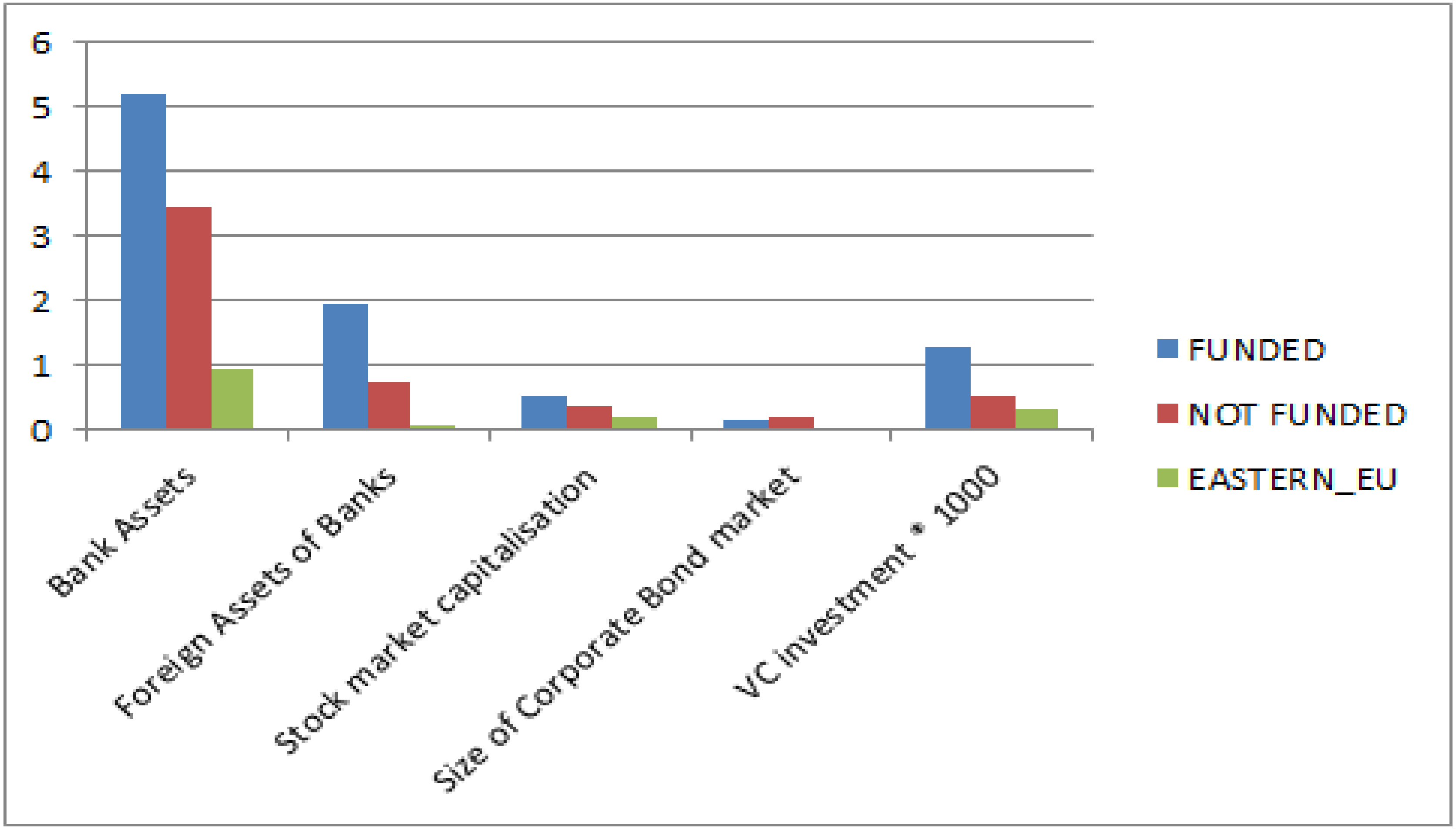
Netherlands
Finland
Denmark
UK

Not funded

France
Germany
Italy
Austria
Belgium
Greece
Ireland

See for methodology: Bijlsma, Zwart (2013), Changing landscape of financial markets CPB/Bruegel

Some key features alternative pension systems



Five mechanisms through which funded pensions promote growth

Higher national savings

Better diversified portfolios (international)

More supply of risk bearing capital

Stronger commitment to long term investment

Stabilizing impact on financial markets

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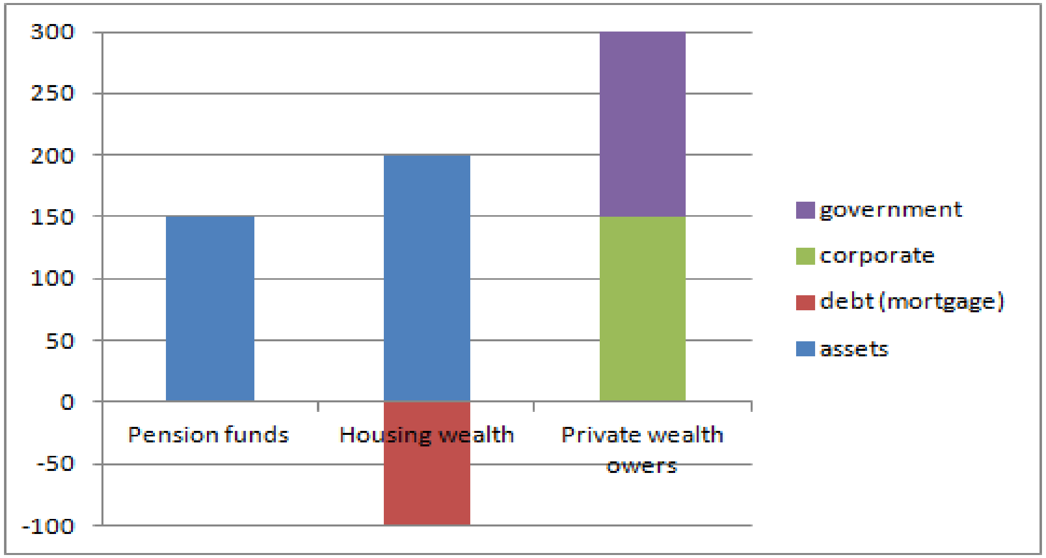
But be careful: a “model”

Funded vs PAYG: macro view (% GDP)

Funded pensions



"80% of people has no access to capital markets"

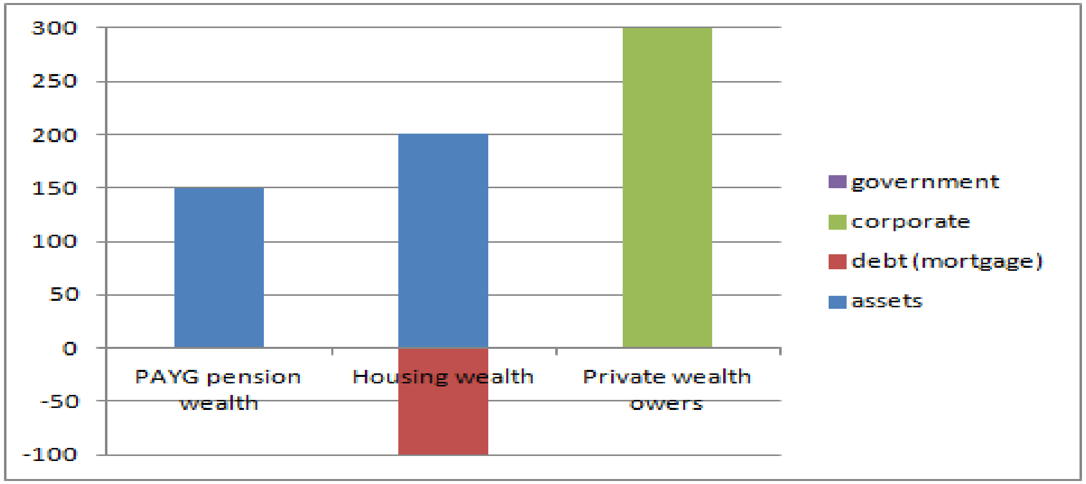
ordinary people (pension savers)

"the rich" (inheritance savers)

Funded vs PAYG: macro view % GDP

Funded pensions

PAYG pensions



Comparing funded pensions and PAYG pensions

- Equal national wealth (government balances private pensions)
- Equal distribution of wealth

- But different porfolio's

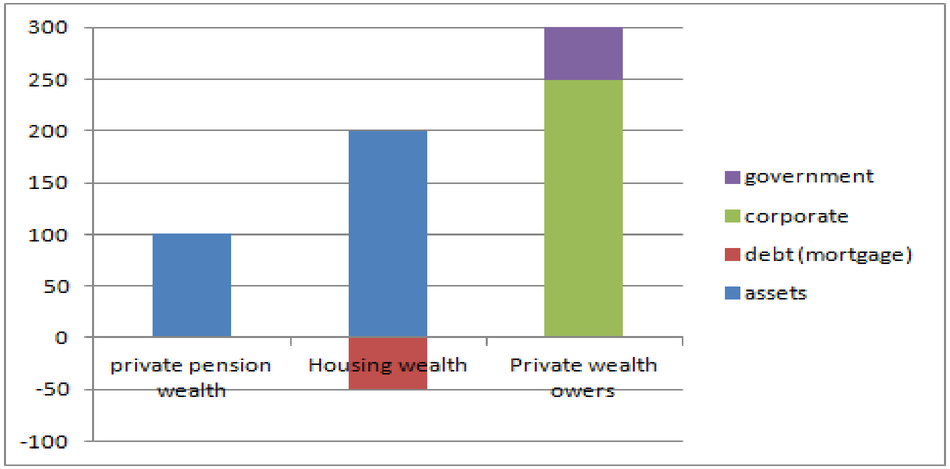
Conclusion:

- better diversification in funded system (if pension funds behave optimally)
  - less political risk, less country risk
  - therefore lower price of risk and **higher growth**
- Better commitment to long term investment

Funded vs (lower) private pensions (% GDP)

Funded pensions

Private pension savings



Comparing funded pensions and private pensions

Private pensions:

- Lower private savings
- More costly (international) diversification
- ineffciencies

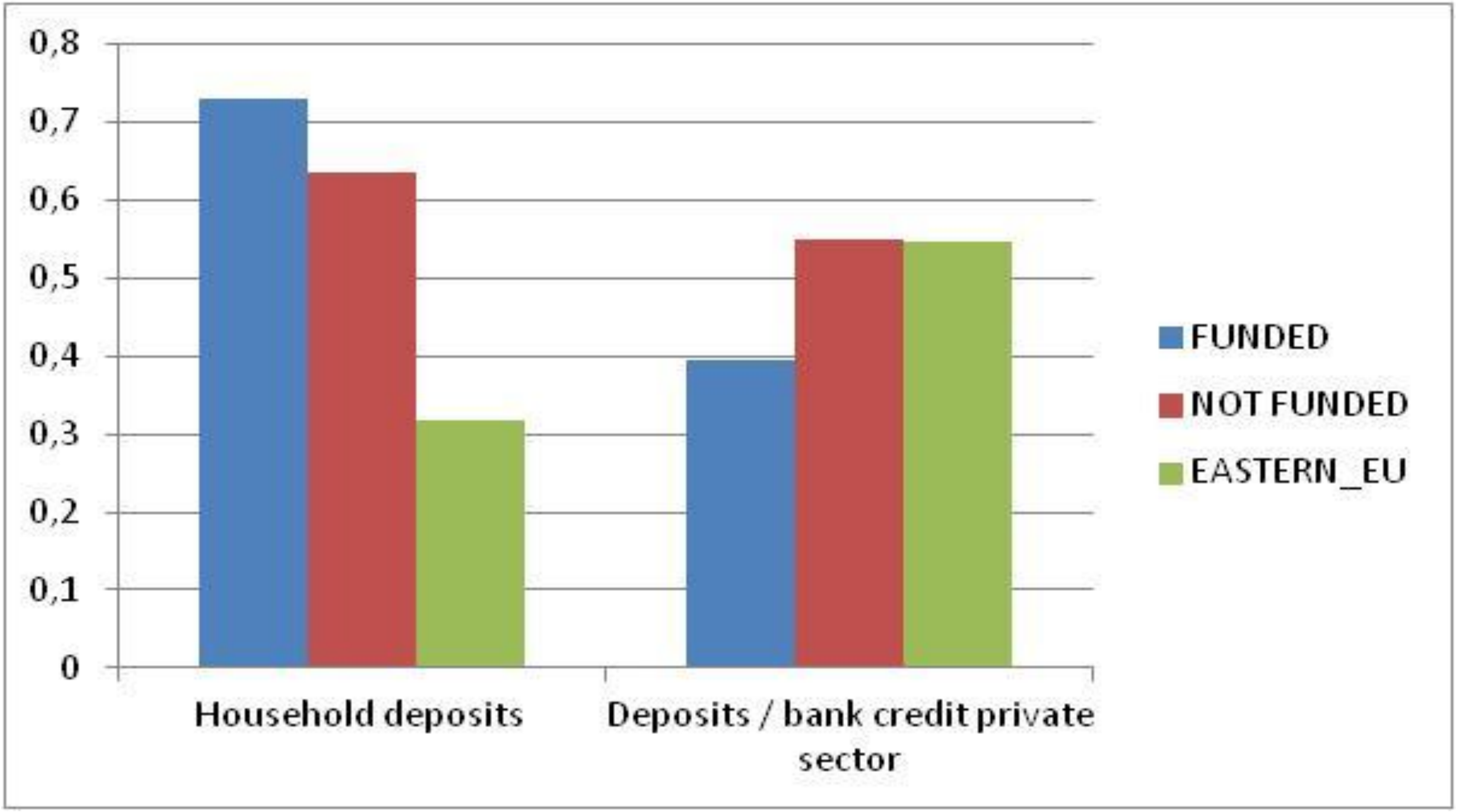
Economic growth

- loer savings and higher price of risk: lower growth

Impact on banking ?

- lower demand for deposits because lower savings
- higher share of deposits in total wealth because of limited access to capital markets
- net effect: banks worse off with private pensions

Bank deposits



Conclusions: Funded pensions and economic growth

1. Funded pensions promote growth

- Better diversification and risk sharing, and therefore lower price of risk
- Commitment to long term investment
- Higher national savings
- Funded pensions seems to go together with large banks

2. Qualifications

- Be careful in conclusions from the empirics: further analysis
- Good and bad funded pensions:
  - Pension fund should embrace risk, and not focus on “safe” (nominal) pensions
  - Pension funds should take account of housing wealth: deleveraging housing wealth
- Governments can help in regulation, insuring tail risks (housing market), issuing index bonds, …

Conclusions (2) Funded pensions and banks

- Funded pension systems tend to strengthen banks rather than to weaken them.
- Do not force pension funds to invest in domestic economy or domestic banks : Better recapitalize banks than require pension funds to "subsidize banks"
- Reduction in bank credit is natural in transition from a situation with "too much" and "too cheap" bank credit due to the government subsidy by implicit guarantees to banks: encourage role of capital markets