PENSION SYSTEM AND THE FINANCIAL CRISIS

Utureanu Simona-Luize
Universitatea Ovidius Constanta Facultatea de Stiinte Economice Alea Universitatii nr. 1 simona_utureanu@yahoo.com +40723341715
Nicodim Liliana
Universitatea Ovidius Constanta Facultatea de Stiinte Economice Alea Universitatii nr. 1 nicodimlili@yahoo.com +40744207197

The pension fund assets are affected as well by the financial crisis. It is advisable to avoid abrupt policy changes in response to the immediate conditions. Pension systems are designed to function over very long time periods. When rare circumstances are encountered, the short term responses we can get can potentially have negative consequences, on the long term, on the capacity of pension systems to reliably provide adequate levels of retirement income. Without basically modify the system design, measures to mitigate the consequences on the relatively small number of retiring individuals can be considered. The need for diversified multi-pillar pension systems, which are able to manage risks and provide protection to individuals, is strengthened by the current crisis.

Key words: pension, reform, crisis

JEL code: J11, J32

In many countries, pension reform is in the center of attention on public debates. Because of its social and macroeconomic implications, pension reform deals with policy makers, practitioners, and academia. Aging societies, stressed by the pressure of globalization determine the need of a diverse reform of the pension system. Therefore, in order to promote longer working lives, countries have to reform their pension systems. And also in order to ensure that people can actually work longer, countries have to change their labor markets. In addition, the working population, including youths, need to get motivated to start contributing to the pension scheme. These needs could be satisfied by using a multipillar pension scheme, which allow more flexibility in individual retirement decisions. Nevertheless, a well-developed financial market is required.

Population Aging and Fiscal Implications for Pension Schemes

Birth and fertility rates are drastically decreasing and the average age of the population is constantly growing, as shown by international studies. This means that the population is both decreasing and ageing in more and more states.

The effects of population ageing on a global scale start to be more and more visible after all these trends started to appear few years ago. Romania is in the same situation, even more severe than the European average. Recent international studies (carry out by the World Bank, the International Monetary Fund, the European Union, the European Bank for Reconstruction and Development, the United Nations and the Romanian research institutes) point out the same conclusions: Romania's population is rapidly decreasing and ageing. Unless adopting the crucial reforms, this will lead to the blast of the demographic bomb in a few decades.

Some statistical facts[318]:

- Romania's population has decreased by 1.8 million inhabitants during 1990-2008, from 23.2 to 21.4 million inhabitants;
- until 2050, Romania's population is set to decrease by a supplementary 4-5 million inhabitants, to achieve 16-17 million residents (according to research conducted by EU, WB, IMF and the UN);

318 The Romanian Pension Funds' Association (APAPR)

- the most pessimistic scenario shows a possible decrease to 13.3 million inhabitants by 2050 (according to research by EBRD published in 2008);
- the birth rate in Romania decreased from 13.7‰ in 1990 to 10‰ in 2008 and is set to continue declining;
- the fertility rates in Romania decreased from 2.3 new born babies per woman in 1989 to 1.0 new born babies per woman in 2008 and stagnated at this level during the last 12 years;
- the average age of mothers at their first birth giving increased 22.3 years in 1990 to roughly 26 years in 2008;
- life expectancy in Romania increased from 70 years in 1990 to 74 years in 2008 and continues to rise.

These statistical data illustrate that the population is rapidly decreasing and ageing, and this process looks quite irreversible.

The public pension budget is stressed by the decreasing and ageing population. It has to rely on fewer contributors to support more beneficiaries. Romania's demographic problems show that its public pension budget is no longer sustainable in its current form and needs a major reform, to avoid collapsing sometimes during the next decades.

For this matter, in 2007, Romania introduced the private pensions system, based on the model tested and recommended by the World Bank. The multipillar private pensions system includes the 2nd pillar – mandatory schemes - and the 3rd pillar – voluntary schemes. At the moment, over 30 countries all over the world have such a system established – most of them are in Central and Southern America and in Central and Eastern Europe. In the CEE, no less than 11 countries run such a system.

In the public pensions system, the state collects contributions from employees and redistributes the money among existing pensioners. Demographics show that this relocation logic is no longer viable, as contributor's numbers will decrease and the number of pensioners is already increasing.

A way out of this impasse takes is the private pensions system, allowing each active person to save for their own future retirement.

According to Eurostat estimations, the European Union statistic office, the Romanian population will reduce with another 4.5 millions of citizens in the period 2008-2060, reaching 16.9 millions. Romania will experience the forth percentage decrease from EU regarding this matter (-21%) after Bulgaria (-28%), Latvia (-26%) and Lithuania (-24%). Also, the dependency rate of old people (the rate between retired population and total population) will triple its amount in this period, from 21.3% this year to 65.3% in 2060; Romania is going to be one of the countries with the largest retired population from Europe. The Eurostat prediction shows that Romania will reach from the current circumstances - when for each retired person (a person older than 65 years) we have an amount of 4.7 adults with working age – to the situation in which a retired person could be supported by only 1.5 adults with working age.

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
EU-27 (1)	478.1	480.4	481.1	482.2	483.0	484.5	486.5	488.6	490.9	493.0	495.1
Euro area (1)	302.2	304.5	305.2	306.2	307.5	309.0	310.9	312.9	314.9	316.7	318.4
Belgium	10.2	10.2	10.2	10.2	10.3	10.3	10.4	10.4	10.4	10.5	10.6
Bulgaria	8.3	8.3	8.2	8.2	7.9	7.9	7.8	7.8	7.8	7.7	7.7
Czech Republic	10.3	10.3	10.3	10.3	10.3	10.2	10.2	10.2	10.2	10.3	10.3
Denmark	5.3	5.3	5.3	5.3	5.3	5.4	5.4	5.4	5.4	5.4	5.4
Germany	82.0	82.1	82.0	82.2	82.3	82.4	82.5	82.5	82.5	82.4	*82.3*
Estonia	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.3	1.3	1.3
Ireland	3.7	3.7	3.7	3.8	3.8	3.9	4.0	4.0	4.1	*4.2*	4.3
Greece	10.7	10.8	10.9	10.9	10.9	11.0	11.0	11.0	11.1	*11.1*	*11.2*
Spain	39.5	39.6	39.8	40.0	40.5	41.0	41.7	42.3	43.0	43.8	44.5
France (1)	59.7	59.9	60.2	60.5	60.9	61.3	61.7	62.1	62.5	*63.0*	*63.4*
Italy	56.9	56.9	56.9	56.9	57.0	57.0	57.3	57.9	58.5	58.8	59.1
Cyprus	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.8	*0.8*
Latvia	2.4	2.4	2.4	2.4	2.4	2.3	2.3	2.3	2.3	2.3	2.3
Lithuania	3.6	3.6	3.5	3.5	3.5	3.5	3.5	3.4	3.4	3.4	3.4
Luxembourg	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.5	*0.5*	0.5
Hungary	10.3	10.3	10.3	10.2	10.2	10.2	10.1	10.1	10.1	10.1	*10.1*
Malta	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Netherlands	15.6	15.7	15.8	15.9	16.0	16.1	16.2	16.3	16.3	16.3	16.4
Austria	8.0	8.0	8.0	8.0	8.0	8.1	8.1	8.1	8.2	8.3	*8.3*
Poland	38.6	38.7	38.7	38.7	38.3	38.2	38.2	38.2	38.2	38.2	38.1
Portugal	10.1	10.1	10.1	10.2	10.3	10.3	10.4	10.5	10.5	10.6	*10.6*
Romania	22.1	22.0	21.9	21.9	21.9	21.8	21.8	21.7	21.7	21.6	21.6
Slovenia	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Slovakia	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Finland	5.1	5.1	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.3	5.3
Sweden	8.8	8.8	8.9	8.9	8.9	8.9	8.9	9.0	9.0	9.0	9.1
United Kingdom	58.2	58.4	58.6	58.8	59.0	59.2	59.4	59.7	60.1	*60.4*	*60.8*
Croatia	4.6	4.5	4.6	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
FYR of Macedonia	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Turkey	63.5	64.6	65.8	66.9	67.9	68.8	69.8	70.7	71.6	72.5	73.4
Iceland	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Liechtenstein	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	*0.0*
Norway	4.4	4.4	4.4	4.5	4.5	4.5	4.6	4.6	4.6	4.6	4.7
Switzerland	7.1	7.1	7.1	7.2	7.2	7.3	7.3	7.4	7.4	*7.5*	*7.5*

(1) Break in series, 1998.

Source: Eurostat (tps00001)

Table 1: Total population - EUROSTAT

According to the CCD study, until 2050 Romanian population will reduce with approximately 23%, till 16.7 million citizens, in the case the fertility will remain the same as in the last years, at 1.3 children per family. These numbers are a little bit more optimistic than the ones offered by United Nations Organization, according to which, at the middle of the century, Romania would have only 14.9 million citizens. The specialists say, it is bad that the rate of old people will increase from 19.3% (the rate registered at the end of 2005), to 39% in 2050; this means there will be 85 old persons for each 100 adults, compared to 34, as it is in the current situation.

	2005	2010	2020	2030	2040	2050
EU-27	16.6	17.5	20.6	24.5	28.1	29.9
Euro area	17.5	18.5	21.4	25.6	29.6	31.1
Belgium	17.2	17.5	20.5	24.7	27.3	27.7
Bulgaria	17.2	17.8	21.7	25.6	29.2	33.5
Czech Republic	14.0	15.5	20.8	23.6	26.8	31.0
Denmark	15.0	16.3	20.0	22.6	24.7	24.1
Germany	18.6	20.4	22.6	27.5	31.1	31.5
Estonia	16.4	16.9	18.7	21.2	23.1	25.7
Ireland	11.2	11.8	14.7	18.3	22.2	26.2
Greece	18.1	18.8	21.1	24.6	29.2	32.5
Spain	16.8	17.2	19.8	24.7	31.2	35.7
France	16.5	16.8	20.7	24.2	26.8	27.3
Italy	19.5	20.5	23.3	27.5	33.1	35.3
Cyprus	12.1	13.4	17.2	21.0	22.9	26.1
Latvia	16.5	17.4	18.4	21.3	23.5	26.1
Lithuania	15.2	16.1	17.5	21.4	24.4	26.7
Luxembourg	14.2	14.6	16.5	19.8	22.3	22.1
Hungary	15.6	16.7	20.3	22.3	24.8	28.1
Malta	13.2	14.2	19.4	22.4	22.5	24.7
Netherlands	14.0	14.9	18.8	22.5	24.6	23.5
Austria	16.0	17.7	20.0	25.1	29.3	30.4
Poland	13.1	13.5	18.2	22.6	24.8	29.4
Portugal	17.0	17.7	20.3	24.3	28.5	31.9
Romania	14.7	14.8	17.1	19.8	24.9	29.6
Slovenia	15.3	16.5	20.4	25.1	28.4	31.1
Slovakia	11.6	12.3	16.3	20.8	24.1	29.3
Finland	15.8	16.9	22.6	26.1	26.7	27.0
Sweden	17.2	18.3	21.2	23.1	24.6	24.3
United Kingdom	16.1	16.6	19.5	22.9	25.9	26.6

Source: Eurostat (proj_tbp_pop)

Table 2: Proportion of the population aged 65 and over – EUROSTAT

The aging phenomena is a global one, it is not concerning only Romania. The problem is the way the population is aging. From this a series of economic and social complication are resulting, which can be pretty bad.

More clearly, the problem is the degradation of the rate between active and inactive population. CCD study forecast that at the middle of the century 62 elders will depend on the contribution of 100 adults, an increase with 130% than in our days when 100 employees support 27 elders.

Depending how the governments deal with the shortfall in revenues, they could finance pension-scheme deficits in full or, they might partially default on pension promises, by delaying pension payments or failing to index benefits. The balance between the two options will be politically determined as pensions are just one of a range of competing demands for limited public resources. The main difficulties will be observed in countries that have overall fiscal deficits and rely on external debt financing that has become increasing difficult to refinance with the global credit crunch.

In some cases (as recently occurred in Argentina) countries that have introduced funded second pillars may be tempted to re-allocate the portion of the social insurance contributions that previously went to pay-as-you-go schemes back to the public schemes. Although this might address short term cash flow issues, it does not improve the overall public net-liability position and it risks having negative long term consequences on the individual benefit position. In addition to diminishing the diversification of the overall retirement system and placing workers at the risk of future benefit reductions if the system cannot remain viable over the long term with the increased liabilities, this will also close funded account when asset values are low, locking in losses and precluding members from the opportunity to benefit from any recovery in prices.

Short-term reactions

Firstly, governments should try to avoid, in the short-term, slowing down the reform. Limiting the contributions for the private pension found, in the current period, could cancel the possibility that the member would receive larger pensions in the future.

This is valid especially for now, when the participants could buy actives for relatively low prices and as a consequence they could accumulate potentially high gains.

In the same time, investments are looking for state titles which are perceived as being the safest instruments, but having small gains which can limit the possibility of having high pensions. While, analyzing the in active investment models, from developed countries, can be concluded that despite the significant variation and the volatility of the market, a diversified portfolio can drive to a high level of savings for retirement.

Secondly, governments should recognize that the actual financial crisis is an extremely rare event. Therefore, it needs temporary measures for counteracting the crisis effects; this is more useful than structural changes in the politics. Moreover, the taken measures should be carefully designed, once applied it could be difficult to quit using them.

Thirdly, governments should not underestimate the positive potential of the institutional investors (like pension funds) which can have positive effect upon the financial system.

Developed countries, regulated and supervised the pension funds and were able in the past to get over shocks (like in Chile case) by buying commercial bonds, partially compensate by the decrease of the access to bank loans.

The following short-term measures should be considered.

A public information campaign should be established to explain the current situation and defined the benefits of different pension schemes, informing the public of the instability of investments, providing detailed information on the real and estimated effect on benefits for workers of different age groups, and describing minimum measures to protect the poorest and most vulnerable part of the population.

A limited and time-bound support program for the small group retiring in the middle of the crisis should be considered. Without a doubt, there are some, first and foremost, low income workers with lower saving levels who might, even under a phased annuity purchase or withdrawal program, be required to liquidate their reduced accounts in the short term. This group could be assisted through programs that can offer a minimum return guarantee, similar to what has been provided in the banking system in response to the crisis.

The pay-as-you-go systems should be helped to remain financial viable and keep protecting the benefits of low-income workers. As recommended above, in many cases the government may need to provide additional financing for public pension schemes to replace a decrease in the collection of workers contributions.

Medium-term reactions

The financial crisis provides a strong reason for all countries to reassess the design and implementation of policies to best achieve the core aims of retirement systems. Considering the medium term, for the following issues special care should be considered.

The management of financial and other macroeconomic risks should have a better diversification. The multi-pillar system should include elements of a well targeted social pension or minimum guaranteed benefit (a zero pillar) to make sure extensive protection against poverty; sustainable earnings based first pillar, and funded second pillar. These three strategies working together would supply core benefits to the wide population even during the low points of the economic cycle. Key aspects for governments could be: the way of setting the level of the basic pension and its eligibility conditions; and the way of allocating the contribution rate between the first pillar and second pillars.

The management of financial risks should be improved. These could include the beginning of age based/life-cycle portfolios which require low and middle income workers to switch part of their balances to more secure investments as they get closer to retirement. In light of the observed inertia of contributors, an important role has also the default age and earnings related advantage allocations.
Pay-as-you-go systems should be made more sustainable, robust and secure. For the first pillar, countries should consider the implementation of Notional Defined Contribution schemes where benefits are linked to contributions and life-expectancy at retirement. Preferably, these systems would include a reserve fund and an appropriate balancing mechanism to change to demographic and economic developments.
The zero pillar should be introduced or a minimum guaranteed revenue should be given at the retirement age which would attenuate the effects of future volatility for elder and poor population. These systems need to be carefully designed to ensure their affordability and that they do not have negative effects.
Unemployment savings and insurance options should be integrated into an overall social insurance system. Some countries need to take into consideration stronger limitations on disability claims and early retirement, while amplifying the income-protection systems for workers who lose their jobs. Policy options contain mixtures of unemployment insurance and unemployment individual savings accounts that can be accessed during spells of unemployment.

Bibliography

1. Bebczuk Ricardo N., Alberto R. Musalem, 'Can the Financial Markets Generate Sustained Returns on a Large Scale?', Holzmann Robert (ed)., *Aging Populations, Pension Funds, and Financial Markets: RegionalPerspectives and Global Challenges for Central, Eastern, and Southern Europe*, World Bank. Washington DC., in print. 2009
2. D'Addio, A.C., J. Seisdedos, E.R. Whitehouse, 'Investment risk and pensions: measuring uncertainty in returns', *Social, Employment and Migration Working Paper no. 70*, OECD., 2008
3. *Ricardo N. Bebczuk, Alberto R. Musalem,* 'Aging Population, Pension Funds, and Financial Markets: Regional Perspectives and Global Challenges for Central, Eastern and Southern Europe', Edited by Robert Holzmann Published March 2009 by World Bank ISBN-13: 978-0-8213-7732