Pouring pension savings into the international financial black hole

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Since at least this past spring, with the Greek crisis in focus, the economic policy priority of several European countries has been to sharply reduce budget deficits, implying that confidence and credibility of financial markets are all that matter. Accounting rules have become the main instrument of governing a national economy – expressed as "the balance sheet has to be in balance".

Governments push through austerity budgets with impressive speed; not least of all reducing pensions. The reductions are said to be in response to the demands of financial markets, where pension funds play a major role.

The purported logic is that reducing pensions is done to secure pensions, a paradox that I have never understood.

In my country, Sweden, there has been a remarkable shift in how we regard pensions. We have gone from social responsibility as a main priority to financial stability of the system as the main concern; we have moved from defined-benefit systems to defined-contribution systems. In reality, the driving force for about the past 20 years has been to reduce pay-as-you-go systems and replace them as far as possible by funded systems. In my opinion, the radical shift in Sweden has been possible mainly because the pension system's social function disappeared from public debate in the 1990s.

We should note that increase in funding levels have taken place parallel with a move toward increased risks in the deregulated financial sector (in Sweden, comprehensive financial deregulation took place in 1985, the argument being that this would create room for more efficient capital investments!). Today, we can discern the results of free investments heavily weighted in overvalued real estate, in 'risk-free' government bonds, and in volatile equities – but not in required production facilities and infrastructure. ***I call this whole new culture "Madoff-investments"*** (i.e., the money is thrown into Ponzi-schemes). In addition, administrative costs are much higher. The old buffer funds and restrictions on insurance company investments meant that a large proportion of investments were made in national infrastructure, in buildings, hospitals, schools, and so on.

In macroeconomic terms, long-term pensions are only possible when there is sufficient current production, combined with a redistribution vehicle so that fees on production – directly on the employers or indirectly via the employees – or through investment returns used to pay the recurrent pension benefits.

The main economic equation on an aggregate level of the national accounts is:

GDP = consumption + real investments + (export – import)

To be complete, there are three equivalent approaches of calculating the GDP. The production approach is simply the left hand side of this equation; the right hand side is the expenditure approach. The third one, in value equivalent to the previous two, is the income approach for labor and capital, i.e. adding together wages and salaries, employers´ social contribution and payroll taxes, operating surplus together.

The main issue for obtaining good pensions, as seen from the equation, is in other words a sufficient production. Pensions on the national level are about a wealth transfer system, with an honest (non-corrupt) state, a province or body that can administrate the pension system.

As we see there is close interdependence between production, consumption and incomes. There seems to be a general delusion, however, that you can reduce one of these entities without affects on the others and the consequences are seen in Europe today.

With this equation in mind, the question is why it comes as a surprise that the most visible consequence of budget cut is deteriorating performance of national economies!

Out-going pensions are highly dependent on a large production – today. That means that an immediate large production of services and goods is a necessary condition for retirees to get a fair share of it, in some way. **The larger production is (depending also on today´s employment level) the better are the possibilities for obtaining a good pension. Increasing the demand side must be by far the most efficient way of stabilizing economies – and pensions.**

It is amazing that the true economic nature of a pension system covering the whole population seldom is discussed. The fact that pensions basically represent consumption here and now is hardly touched on. Instead pension plans are almost exclusively discussed in terms of financial institutions. But you can´t put your savings into a freezer and then take them out 30 years later.

Instead, the general opinion is that the best way to secure pensions is through funding! It´s even said that the state cannot afford to continue to provide good general pensions – although as can be seen the national gross domestic product in most countries is larger than ever.

You can read or hear everywhere that you must save on your own to secure your pension – as if that were possible or even desirable from a national point of view. *A very visible result in my country is that we have a lot of ads in the newspapers and on TV almost every day – with the (tacit) message that the new public pension will be inadequate (which is true) and that is why you must yourself save for your own pension (as if it were possible).*

All this has happened in Sweden from the beginning of the 1990-ies. We have now more funding in all our pension systems, in the national system, in the labor market pension systems and more private savings as well, especially placed in funds (private accounts) without guarantees – the result will be pensions gradually lowering, despite all claims that the purpose was to secure future pensions.

Pension liabilities in Sweden compared to the total economy, which well proves full funding to be impossible

1. **National pension system**
2. **Labor market pensions, according to collective agreements between labor market parties**
3. **Individual insurance**

GDP 2010		3 301
National wealth, according to the national accounts (2005)		5 406
Level 1	Public pension system	
	Pension liability (end of 2010)	7 367
Level 2 and 3	Insurance industry, including general insurance	
	Assets (i.e. incl consolidation)	2 975
	of which	
	Life Insurance and Private accounts	2 434

There is no economic room in the Swedish economy for full funding in real assets, as is seen from this table, for the only ownership would be that of pension funds. And even that would be inadequate.

One statement you often meet is that a pay-as-you-go system is not a real pension system. The argument might be that there are no funds matching the liabilities, with exceptions maybe for some buffer funds. Because of the lack of matching funds such pension systems are insecure, it's said.

But the reality is, as can be seen from table above, *that it is impossible to form matching real funds for a whole population*. But that is never discussed in public.

Robert Brown, at the ICA in Paris 2006, said: *"Macro-economically, there is very little difference between a pay-as-you-go social security system and a funded system where the assets are all government bonds*

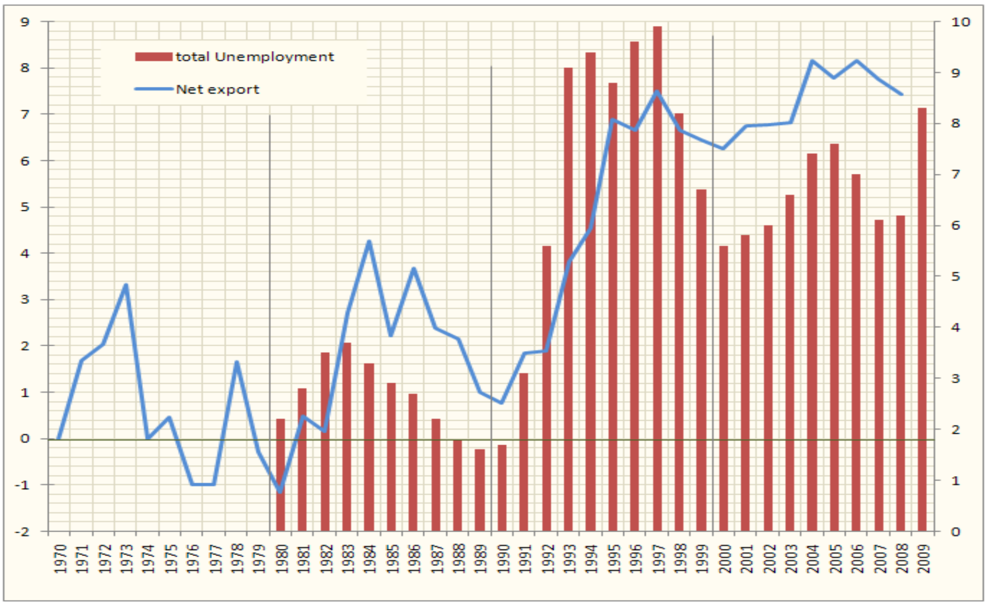
It is necessary to have a tool that confirms eligibility, a required period of service for full pension rights etc. for redistribution of production – and a pay-as-you-go system, indeed, is the means. But pensions are normally not discussed in terms of redistribution. With one exception: when you come to the alleged necessity of "raising the retirement age". Suddenly the whole argument is about redistribution! But total demand of society as a whole must then be increased, and a lot of measures taken to enable the labor market employ older people.

The obvious conclusion is that fully funded pension systems are impossible on the national level. Above a certain level no real assets can correspond to the pension liabilities. The only possibility is demands on future generations to pay interest on bonds or other similar financial instruments. This is nothing else than a redistribution of societal incomes, i.e. a system which in a sense is equivalent to a pay-as-you-go system, probably less secure however.

In the new Swedish national pension system there is a fee of 16 % to the pay-as-you-go system (the NDC-part or national income pension) and a fee of 2.5 % to the pension real savings (the FDC-part), which today gives almost nothing to retirees. The old national pension system was a pure pay-as-you-go system; with fees around 19 % (the figures are not quite comparable). These differences partly explain the deteriorating finances of the new system and successively lowered pensions, in spite of promises given by the politicians (behind whom there were economists, but no actuaries) when the system was introduced. When the FDC-system was introduced it was illustrated with examples showing a sustainable, annual investment return of between 7 and 10 %. Up until the end of last year the return was 1.6 % and since then the stock exchange has fallen heavily!

Pension systems are invested abroad due to market demands, in spite of large domestic investment needs, not least in the public sector (houses, railways etc). One consequence is a permanent surplus in the balance of payments account – accompanied by a high unemployment rate, contrary to the demands of the pension systems! Cf. the diagram below.

Unemployment and Balance of Payment
Sweden 1970 - 2009



Sweden has for many years had a surplus in its balance of payments account of about 7 % of GDP, at the same time as unemployment is about 8 %, a figure that, if the retirement age is raised, will worsen as the supply-side of the workforce increases while nothing is done on the demand-side!

To summarize, the development of pension systems in Sweden is characterized by:

1. Decreased value of the public pension system, with more risky investments instead of investments in national infrastructure.

2. An almost complete transformation of occupational pension plans to DC-systems (which will give today's younger generation future problems)

3. A greatly increased number of individual pension policies with a move from traditional guaranteed pension plans to unit linked plans.

A necessary condition for good pensions is full employment. Deregulated financial markets are however not making the kinds of investments that support the labor market.

Addendum. Since this original paper was finished it has also appeared that parts of the insurance industry with traditional guaranteed policies are under heavy pressure from heavily falling asset values, in spite of the use of prudent investments principles.