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Fiscal pressures – ageing costs still on the horizon

Pension reforms have been a constant feature of the European political landscape in the last decade as governments sought to re-weight pension provision from pay-as-you-go to funded systems. However, the current economic crisis threatens to leave the process stranded in a "twilight zone" with some governments distracted by events or losing the political will to implement further steps in the process.

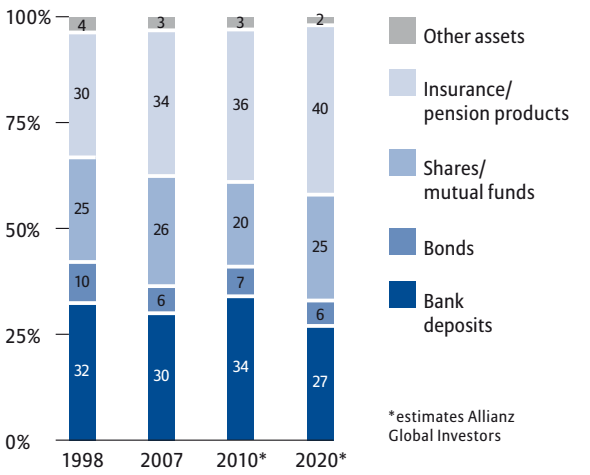
The reform process of the last decade has been particularly marked in Continental Europe and EMU countries where the introduction of tax-favored savings products for retirement triggered a build-up process in this pension segment. The growth in importance of these products can be seen within the financial assets of private households. In many countries these saving products have increased their presence within household portfolios rising from an average in Western Europe of 30% in 1998 to 34% in 2007.

However, the world financial crisis dragged down stock markets in 2008 and triggered massive losses in equity and real estate valuations. This has had a drastic effect on the financial assets of private households in Western Europe. Assets are estimated to have declined by 8.5% in 2008. But this aggregate picture hides significant variation between countries resulting from differences in investment behavior and pension systems. For example, the Swiss and Dutch authorities reported losses in pension fund assets in 2008 of almost 18%. UK losses may be even higher due to the drastic fall in real estate prices and their crossover effects to financial assets. As a result, these developments could put the role of funded pension in the overall old age provisioning system to the test in countries with mature funded pension systems. In particular, this will be a challenge for countries where second and third pillar pension provisions are still being built up.

But can governments afford a reversal or halt of pension reforms? These pension reforms were introduced primarily to ease the increasing cost of first pillar pensions stemming from the rapid ageing of society. As the IMF reported in a recent study* the impact of the financial crisis on public finances are manifold. Apart from the direct costs of rescue and stimulus packages, governments will face negative effects from the recession (lower income/capital gains tax, lower tax on profits from the financial sector, and higher cost of unemployment). In addition, they could also be affected in the pension area. This could be either ►

* INTERNATIONAL MONETARY FUND (IMF); The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis, Fiscal Affairs Department In cooperation with other departments, March 6, 2009

Structure of financial assets of private households Western Europe 1998 – 2020



Sources: Central Banks, Statistical offices, Allianz Global Investors

directly as a provider of guarantees for investments made by government pension funds or indirectly as a rescuer for participants covered by private pension plans severely hit by the crisis. All this widens budget deficits and increases debt burdens that have to be cut back in the years ahead. The end result is that governments cannot reverse pension reforms. There could even be the danger that they may become too distracted to continue their reform efforts.

Moving forward, the development of monetary wealth in many European countries will be driven by increased savings for retirement as households seek to repair the gap torn into their portfolios. This will not only occur in countries with mature funded pension systems (like the UK, the Netherlands and Switzerland), but also in states where reforms of pay-as-you-go systems will lead to lower pension levels that need to be compensated for by a build up of capital to preserve an adequate standard of living. Our projections assume most countries will have a higher savings rate than in the recent past.

However, the ratios will struggle to reach the levels of the early nineties due to two countering effects. On one hand additional retirement saving will probably be a substitute for other precautionary savings efforts. On the other, an opposite development will begin as increasing numbers of elderly people reduce their personal savings efforts as they retire.

For Western Europe we expect the structure of financial wealth of households to change further in favor of insurances and pension products. The portfolio share of these products could be extended by approximately 6 percentage points to 40 percent till the end of 2020. Capital market products, particularly shares and mutual funds, will probably regain their weight within household portfolios by 2020 after a major loss at the end of this decade. Bank products could take on a role as a buffer stock investment in the years to come.

But, as far as long-term saving processes are concerned, the climate remains difficult. The extreme swings of the capital markets in the last decade have led to a massive loss of confidence among investors and savers for old age provisioning. This is occurring at the very time when the build up of fully-funded pensions is an increasingly urgent issue in all industrial nations.

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