

## Pension deadlock: the system eats itself

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Russia faces a deadlock over pensions as the Pension Fund deficit is looming. Sooner or later, it will be impossible to fill this gap with oil and gas money. Headed by the first vice premier minister Alexey Kudrin, the Government's financial sector are desperately seeking to break the impasse. Yet, all they suggest is some lame measures consisting in raising taxes.

We talked to senator Andrey Vavilov about the pensions problem in Russia and ways to enhance the pension plan.

*Information: Andrey Vavilov is a senator, formerly deputy finance minister, secretary of state. Ph. D. in economics titleholder. Presently, Mr. Vavilov is academic director at the Institute of Financial Studies.*

**Bigness.ru: Mr. Vavilov, what major problems in the Russian pension system would you name?**

A.V.: - In the past two years, the Russian pension system has been facing operating deficit, and the costs have been pushed onto the federal budget. By 2010, the pension fund deficit might reach 0.6 percent of the GDP, growing further to 2 percent. This adverse trend might seriously destabilize the pension system. It is clear at this stage that the existing mechanisms of investing accrued portions of pensions are unable to solve the problem because investment rewards of both private management companies and state-run Vnesheconombank (95% of all funds) are substantially lower than inflation rates. These distressing dynamics of the pension system are too costly for the budget, and, moreover, can cause social unrest. All this brings to the fore the task of working out and implementing a new retirement plan in Russia.

**Bigness.ru: What is the cause of the deadlock over pensions?**

A.V.: - The pensions reform in Russia has revealed that the approach to solving the problem was erroneous.

The principle of dividing pensions into defined contribution and defined benefit portions is good. But the existing plan of accrued pension management never targeted long-term goals of the pension system. As a result, after the state stepped aside from participation in managing pension accruals and the right to take investment decisions was transferred to managers, the investment strategy proved ineffective.

The Institute of Financial Studies analyzed foreign countries' experience and studied speculative research that enabled us to formulate our own viewpoint of this problem. The pensions reform that we suggest stipulates qualitative changes in the country's financial system. The IFS-conducted mathematical analysis showed that, due to the current demographic situation, it is impossible to make a proper pensions reform without using financial instruments.

At present, the Institute is conducting a scenario analysis of the model of allocating the National Welfare Fund money for financing Russia's pension system. As part of this research, we evaluated the dynamics of the 'current workers/pensioners' ratio that illustrates the load on workers with benefit pensions prevailing and low investment rewards. The evaluation revealed that in ten years the ratio will reach 2:1, by 2020-2025 the numbers of workers and pensioners will be equal, and then the number of pensioners will exceed the number of workers. Making even most optimistic assumptions, without reforms the existing pension system will be unable to eliminate the growing deficit of funds.

**Bigness.ru: What should be done to break the impasse?**

A.V.: - The enhanced pension system is based on sizeable long-term investments needed for sustainable functioning of the system. For this purpose, state money is needed, namely the National Welfare Fund finance.

Of course, approach to managing these long-term assets should differ from the one that is used presently for managing state reserves.

**Bigness.ru: What is the difference in the approaches?**

A.V.: - Investing funds only in the developed countries' state bonds is absolutely unjustified. These are low-profit instruments that carry more risks compared to a diversified portfolio of world indices. Due to inflation fluctuations, real return on investments in 'reliable' bonds is next to zero and, also, quite volatile. Meanwhile, stock and commodity quotes correlate with inflation rates, thus inflation risks can be minimized.

The world knows a host of successful experiences of long-term asset management. These include not only state funds like Norway's Global with a return of 8 to 10% per year and widely diversified instruments, but also basic capital of universities (the so-called endowments). The Yale university endowment has provided an annual return on investments of 17.2% over the past twenty years.

The key element of efficient investments like this is setting out to reach long-term goals and global diversification of sectors and instruments. For instance, the Norwegian fund's target portfolio consists one half of stocks and bonds issued worldwide: from Europe and America to Asia and Oceania. The endowment range is yet wider and includes real estate and commodity indices. To illustrate this statement: a profit of 10% means at least 10-fold growth in initial assets - roughly from \$100 billion to 1\$ trillion within 25 years. With a 17% profitability, bridging the pension system gap would take less than 15 years.

Why is this result possible? First and foremost, it is possible because investment mechanisms are aimed at reaching long-term goals, unlike the present approach to accrued pension management. Presently, no portfolio decisions are taken and, consequently, no one is responsible for possible risks.

Russia is not alone in trying to settle the pension system issue, other countries, including the US, are also face this problem.

**Bigness.ru: What does the US experience show?**

A.V.: - At present, the US pensioners are paid their pensions from current workers' contributions and taxes. Therefore, financial stability of the social welfare system directly depends on the demographic situation. Dropping birth rates and increasing life expectancy caused the workers/pensioners ratio to step down from 16:1 in 1950 to 3.3 today; there is a forecast the ratio will be 2:1 in 2040. With the estimated inflows and payments, the US pension system will be facing deficit starting from 2018, and by 2042 its assets and provisions will be completely exhausted.

I think that cooperation with our foreign counterparts will provide us with a good experience of opinions and ideas exchange regarding this problem.

**Bigness.ru: What does the pensions reform mean for usual people? How will it affect individuals and the society?**

A.V.: - The objective of the pensions reform is to reduce taxes imposed on employees. The existing pension system cannot function without state support. Due to the demographic situation and considerable dependence of the Russian budget on the state of external raw material markets, pensions' reliance on the budget will only increase in years to come. Consequently, with no radical changes in the pension system the burden laid on the economy will be increasing. This will have both economic and social aftermath.

Here is an example: with the existing system of financing the Pension Fund and forecasted 5% return on investments, a 2050 retiree will receive a pension worth just 27% of his or her salary in 2050. In 2007, this parameter equaled to 24% and in 2000 it stood at 31%. Evidently, if the pension system continues to develop

by inertia, no considerable improvements in most people's financial state should be expected. This will result in shrinking consumer demand and growing social unrest.

Tackling the pension system problems will give an impulse for development of the financial system and accelerate operation of institutions specializing in long-term investments. A reform that is expected to improve the pension system in Russia will also enhance the population's well-being and bring the economy to a new level.

***Information:***

*Institute for Financial Studies is a private, independent, non-partisan research institute founded in 1996 by a group of well-known Russian economists led by Andrey Vavilov and Alexey Pomansky. They were united by a common goal of bridging the gap between finance theory and practice of government and corporate financial decision-making.*

**Interview by Sergey Malinin**