Pension Reforms, Capital Markets and Economic Development (II)

In my last week's articles I indicated how pensions funds reforms could be a catalyst for savings mobilization that are then invested in long-term development project, either directly or indirectly through intermediation vehicles such as capital markets--stock exchange, private equities, venture capital funds, etc.

Before I go any further, let me be clear in few aspects -- the use of pension funds to further economic development goals is one of the hottest topics across the globe. Indeed, facts are impressive – pension funds provide more than one quarter of all new capital investment available for investment (not in our case though). Even more significantly, pension funds are one of the fastest growing single sources of investment capital across the world today. As a consequence of this rapid and sustained expansion of assets, pensions funds are a growing influence in national economies, especially in the aspect of developing local capital markets, where key sectors can efficiently tap in such capital for enterprises or public sector projects -- and in the process promotes economic empowerment, financial inclusiveness, good corporate governance, transparency, efficiencies, etc. This is mainly because of the long-term nature of their financial liabilities that may not mature for decades.

I fundamentally understand that there may be challenges with investing pension funds in economic development assets and these challenges may be of twofold: (i) some of the development investment projects might impair pensions' portfolio performance; and (ii) development investments which are long term in nature might impair availability of liquidity to provide for payments of pensions benefits. To both challenges, there may be solutions: if public pension funds are to be used for providing needed capital to projects that have selective economic development impact, then investment types must be found that both meets the traditional risk return criteria and are effective in targeting unmet capital flows to selected projects, areas and/or businesses. To achieve this, and as a practical and ethical matter, pension funds should not subsidize such activities through concessions of lower returns or higher risks. Thus, it is important that we are mindful and emphasize that the potential for directing more pension capital to support our economic goals mandates, the creation of new investments or institutions that are capable of shielding the funds from loss of returns, excessive risks and possible conflicts of interests is equally imperative.

Having ticked the above, pensions can therefore participate in innovative investments or organizational investments vehicles directly or through long term intermediations (such as capital markets) that might meet criteria of unmet local capital needs such as: (i) pools of development oriented investment in sectors such as infrastructure, power, energy, mining, telecommunication, financial services, housing, etc (ii) venture capital funds (iii) small business ventures (iv) other projects that are of key priority to our economy, that could also stimulate development investment, job creation and long term capital formation.

Since our 1980s and 1990s financial liberalization, there has been significant improvement in our financial sector efficiency, however these have been tilted towards the banking sector. For example, banking sector assets as a percentage of GDP is currently almost 40%, private credit to GDP is above 20% of GDP while in the capital markets front -- combined IPOs issuances to GDP is about 1% and domestic market capitalization to GDP is currently at 13% (and this comes after more 100% market capitalization growth that we have experienced in the past one year!). Pension funds' holding of DSE listed equities is about 10%.

Now, we may wish to note that growth of pension funds as institutional investors in some cases tends to precede financial liberalization especially in countries where funded pensions are long established, but has often accelerated in the wake of it, notably where there have also been pensions reforms in the direction of funding. The case of Chile may be of reference where pension fund growth clearly accompanied and spurred liberalization where they also facilitated strong growth of the local capital market and stimulated economic growth – with the right approach and focus this could happen in our home front as well.

There is a direct link between pension assets, capital markets and GDP growth because pension assets can affect economic growth indirectly via financial market development or directly by way of wide impact through corporate engagement in a way of funding business expansions and growth, while as production increases, there is more trade, more job creation, more taxes, etc.

Since pension funds, as institutional investors are more important in capital markets development, as such pension reforms may be a catalyst for either complementing or shifting away from a bank-based financial system – which is necessarily the right thing for any country. For example, in capital market-oriented countries, the so called multiple avenues of intermediation (banks and capital markets) are more prone and said to cushion the effect of crises in either banks or securities markets on corporate financing, since the intermediation that continues to function can provide corporate finance when the other intermediation is in crisis. And pension funds have a all it takes to do with either of these.

A first key impact of pension fund growth may be via savings. It is widely suggested that pension reforms can raise overall savings in any economy, thus promoting economic development by permitting higher rates of investment. This is the case, despite an understanding that in a life cycle model of savings and investments, households that are constrained will simply substitute one form of saving (e.g. pension funds) for another (such as bank deposits) with no net effect on the overall savings increment.

Pension reforms may make them grow and be able to attract increase the rate and level of savings in the economy will see more investments mainly because pension funds in most cases hold greater proportion of equities and bonds than private individuals and households. Pension funds also tend to hold more long-term bonds than households do directly.

The difference in portfolio holdings between households and pension funds can be explained partly by time horizon, which for households are relatively short, whereas given the long term nature of liabilities, pension funds may concentrate portfolios on long term assets yielding the highest returns. But given their size, pension funds also have a comparative advantage over households in compensating for the increased risk by pooling and diversifying across assets whose returns are imperfectly correlated, an advantage linked also to lower transaction costs for large deals and ability to invest in large indivisible such as property.

I will conclude on this in my next week’s article.