

Aging and Pensions:  
A Ticking Bomb

Joint Statement

Shadow Financial Regulatory Committees of  
Asia, Europe, Japan, and the United States

Seoul, Korea  
October 31, 2005

**A Ticking Bomb**

The next fifty years will see sharp increases in the ratio of retired to working people in a number of economies: rising affluence increases life expectancy and decreases the number of children per family. For example, in some major Asia-Pacific economies, the ratio will increase from less than 1 in 5 today to about 1 in 2 in 2050.

Ratio of population 65 and over to population aged 20-64

	2000	2025	2050
Japan	27.6	53.7	79.5
Taiwan	15.5	39.9	57.6
South Korea	11.1	27.4	54.2
PRC	11.4	21.3	40.9
USA	20.9	31.8	35.8

(Source: United Nations, *World Population Prospects*)

It may be politically feasible to have five workers support one retiree via taxation, but not two workers providing the same support level to one retiree, given that they must also support the other functions of government. Even today, an ever-diminishing fraction of the population is working to fund pensions for an ever-increasing fraction of retirees. The trend is clear and unsustainable: any public pension system funded by current tax receipts (“pay-as-you-go”) will collapse if it seeks to provide the population’s main retirement benefits. However, our view is that there will always be a role for a government-funded safety net that provides modest benefits.

In this statement, we discuss the implications of ageing for the design of pension schemes and pension fund regulation. Then, we turn to the implications of demographic differences for the trade imbalances observed amongst countries.

### **Defined Benefit Schemes are Unsustainable**

In a Defined Benefit scheme, workers contribute a percentage of their income and receive a pension in a specified amount. Defined Benefit schemes can be private or public, but both can become government burdens, which become unsustainable as the population ages. In private schemes, employers have an incentive to under-fund their plans; if the employer fails, employees may be left with inadequate benefits. This creates a demand for government guarantees which eventually shifts the responsibility onto the taxpayer.

Problems can also arise in a public Defined Benefit scheme, even with favourable demographics. This is illustrated by the US Social Security system. The “assets” of this system are basically the government promise to tax as necessary to fund future pension payments. This has been masked by the Treasury bonds that the Social Security system holds; these are just another kind of promise to tax. Therefore, the Social Security system is a public pay-as-you-go Defined Benefit scheme. In such a scheme, politicians tend to authorize generous benefits and require lesser contributions, thereby deferring political problems past their term of office. In Asia, such a scheme would soon precipitate a “war of generations,” given the demographics.

### **Defined Contribution Schemes**

For reasons stated above, it is important to supplement such unsustainable schemes with a Defined Contribution scheme, in which contributions during employment are channeled into assets owned by the worker in a personal retirement investment account. Such schemes are sustainable by definition, but they also present serious issues, as most risks would be shifted onto future retirees.

With Defined Contribution schemes, citizens need access to financial intermediaries and instruments that offer reasonable returns at low levels of risk and opportunities to diversify. However, the Defined Contribution schemes require sound financial systems, with effective regulation, transparent accounting and good fund governance.

The investment alternatives available to Defined Contribution schemes may have to be constrained for several reasons. Some citizens may choose highly speculative investments if they believe that the government will compensate them if the investment performance is poor. There should be restrictions on the risk profiles of pension fund investments, profiles that might depend on the age of the citizen. Furthermore, citizens may be naïve about investment, and hence easily exploited by transaction costs and charges buried in the management contracts that they sign. The contracts must be supervised to ensure that the charges are reasonable. The government may need to mandate insurance against manager fraud.

Well-regulated Defined Contribution schemes create a stable base of investors who are managing their own investments, but are constrained to invest for the long term in assets that offer reasonable risk profiles. Some countries lack the institutions to implement these schemes successfully. In other countries, these institutions exist but investment vehicles for pension funds are restricted. In both

cases, adding international investment opportunities would increase the benefits of Defined Contribution schemes. Citizens would be able to invest in foreign funds and domestic funds would be able to diversify internationally. Then over time the domestic financial system would adjust and offer reasonable risk-adjusted rates of return and higher standards of regulation, transparency and corporate governance, lest funds drain abroad.

### **Politics, Trade and Demography**

We have begun by pointing out that looming demographic problems create a need for Defined Contribution schemes. We conclude by pointing out that some prominent macroeconomic problems today are in part a product of demographics and may be alleviated by such pension schemes, especially if they facilitate international investment. In countries with relatively youthful demographics, like the US, individuals have less need to save for retirement, which translates into balance of payment deficits. In countries with aging demographics, individuals are saving to fund their own retirement. The high savings rates, which rise to 40 percent in China, translate into current account surpluses. Large, persistent trade imbalances raise international tensions. These problems have been given a sinister interpretation because East Asians today tend not to invest abroad directly for retirement. They invest abroad indirectly when their governments hold their foreign exchange reserves in US dollar assets or their corporations buy US assets. These purchases hold down the values of their currencies.

The high profile of Asian foreign exchange reserves tempts politicians to blame the trade imbalances on Asian “manipulation” of exchange rates. Likewise, the high profile of investments by Asian companies in US corporations tempts politicians to couch them as threats to national security. On the other hand, the US attempt to drive down the US dollar value could be couched as “robbing” Asian countries of their hard-earned savings that were invested in the US bonds to fund “profligate” US consumers. Such grandstanding destabilizes the global economy.

Suppose that the same trade imbalances were accompanied, not by country-to-country bond purchases, but by flows of retirement funds from Asia into the US. That would make it more obvious when the current account imbalances are the result of market-driven flows of investment and savings, like those due to demographic differences. This would put global imbalances in a more benign light and thus make them less vulnerable to dangerous political grandstanding.

### **Conclusion**

The ticking bomb can be defused but it requires the political will to implement sustainable pension schemes, hence wider adoption of Defined Contribution schemes.