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Economic insights
Emerging markets need action to close pension savings gaps

Key takeaways

- Emerging economies face a pension savings gap totalling USD 106 trillion, three times their GDP, as their populations age rapidly.
- Well-funded pension systems benefit the broader economy, for example through capital market development.
- Pension reforms can lead to higher economic growth and lower government debt-to-GDP ratios.
- Insurance can support individuals in emerging economies to accumulate and decumulate assets over their lifecycles more smoothly.

About Economic Insights
Analysis of key economic developments and their implications for the global re/insurance industry.

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In a nutshell

Well-funded pension systems benefit both individuals' retirement incomes and the broader economy. Yet emerging markets face an unfunded pension savings gap of about three times their aggregate GDP over workers' retirements. Strong public and private sector partnership is needed to address the shortfall.

The benefits of well-funded pension systems go beyond financing household retirement years. The resources within pension systems can also be put to good use for the broader economy, for example, by allocating savings towards sustainable investments. They can also foster development of capital markets, critical priority for emerging economies in particular, as their workforces and economies mature. As of today, however, indications are that emerging market pension systems are heavily underfunded. We estimate a pensions savings gap for the retirement life of emerging economies' working populations of USD 5.4 trillion per year.[1] This is equivalent to USD 106 trillion cumulatively over full retirements, or about three times emerging markets' aggregate GDP, as high as estimates for advanced markets like the US and Australia. The world's formerly young emerging economies are ageing fast, raising the challenge of how to sustainably fund adequate quality of life over longer retirements. The COVID-19 crisis has also exacerbated structural challenges to the sustainability of emerging market pensions, for example by reducing governments' fiscal room for manoeuvre and lowering interest rates.

Well-funded pension systems can offer higher post-retirement income at the household level, while fostering the development of capital markets at the macro level. Growing pension assets can create a virtuous circle in which institutional asset managers funnel funds to local stock and bond markets, promote market liquidity, help modernise market infrastructure and support best-practice financial regulation.[2] In Chile, the creation of a fully-funded pension system contributed to earlier development of a domestic institutional investor base and financial markets than in other emerging economies (see Figure 1). Additionally, promoting household pension savings can help boost the national savings rate and thus support economic growth, as pension funds are the largest institutional investors with nearly half of global assets.[3]

Pension reforms can have positive spillovers for growth in the short and long-run. An IMF study shows that raising the retirement age by two years could raise GDP by almost 1% in the short to medium run, and by 4.25% over a 30- to 40-year period, by boosting consumption stemming from an increase in lifetime horizons (see Figure 2). Reform can also reduce the debt-to-GDP ratio

[1] *sigma* 2/2021 - Emerging markets: the drive for sustainable retirements in an ageing world, Swiss Re Institute, 2021.
[2] Y. Hu, *Growth of Asian pension assets: Implications for financial and capital markets*, ADB, May 2012.
[3] *sigma* 2/2021, op. cit.; *Global aging and retirement security in emerging markets*, Global Aging Institute, 2015.

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by 30 percentage points over the long-run. As the number of years over which pensions are paid are reduced, so too is public spending on pensions.[4]

Pension funds can also play a role in combating climate change risks by allocating savings towards sustainable investments. A recent study by the World Bank urges pension funds to take into consideration investing in assets certified under Environmental, Social and Governance criteria.[5] Helping to accelerate changes that mitigate climate risks is very relevant for emerging economies, as many emerging economies are both heavily exposed and poorly resourced to adapt to climate change effects.[6]

Figure 1: Financial development indices, average 1980-2018

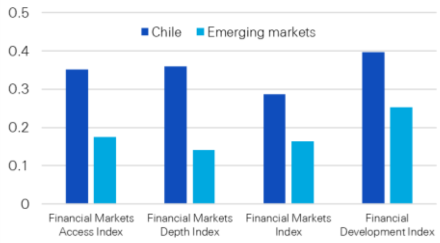
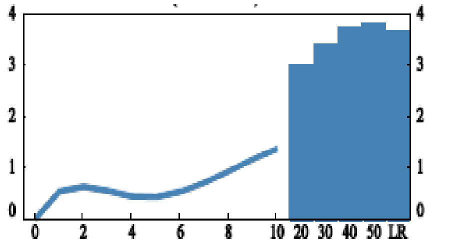


Figure 2: Estimated impact of a two-year increase in retirement age on US real GDP growth (% difference)



Note: LR = long-run.
Source: IMF, Swiss Re Institute

Both the public and the private sectors should work together to close the emerging markets pension gap. The public sector should create sustainable retirement terms and conditions that allow the private sector and individuals to achieve greater retirement savings and returns. Specific areas of policy action include raising the retirement age, reducing investment restrictions, promoting competitiveness and transparency, incentivising voluntary savings (eg, tax exemptions) and expanding the formal labour sector.

As for the re/insurance industry, it can support individuals in emerging economies to accumulate and decumulate assets more smoothly and mitigate life, health and disability risks. The industry has a key role to play in offering mortality, medical, disability and critical illness covers. Some solutions exist already: in Chile, for example, compulsory protection has been embedded in pension schemes with wide success. Other solutions need to be developed. Bundled products are a key opportunity: insurers can explore and trial composites of mortality, morbidity and long-term care protection with a savings component to provide flexible and responsive life-long covers.

[4] *Macroeconomic Effects of Public Pension Reforms*, IMF, 2010
[5] *Pension systems and climate risk: measurement and mitigation*. World Bank, 2020.
[6] *The economics of climate change: no action not an option*, Swiss Re Institute, 2021.