Pensions under the Recession Burden

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This paper highlights how the impact of the global economic recession delays "social Europe" with different intensity across Member States, and discusses the steps taken by European institutions to mitigate that impact. Revealing the weak macro-economic performance of some Euro Area Member States, it underlines the most affected sectors of social life, asking questions and trying to answer them. The second part of the paper will explain the way the crisis affects European pension systems. Based on statistical analysis, the paper demonstrates that both the fully funded pensions and the pay-as-you-go pension plans are negatively affected by the recession. It concludes that any therapy must also include accountability and even so, it does not prevent a real "social crisis" from occurring in the future.

Key words: *global economic crisis, social impact, pensions, social Europe, deficit.*

JEL classification: *E21; Wealth; G01.*

The European Union is learning its lessons from the current economic and financial crisis in order to avoid its recurrence in the future. Among the most dramatic effects, the social one will be prolonged even after the GDP begins to grow again. The European Parliament plans to assess the efficiency of the measures implemented by Member States for combating the impact of the economic crisis.

If the global unemployment rate returns to the low pre-crisis level only after 2013, according to the estimates of the International Labour Organisation (ILO), then the delay of the social impact of the crisis compared to the GDP will become obvious. About 212 million unemployed people have been registered world-wide in 2010, which means 34 million more than in 2009. Although ILO saved 11 million jobs in

2008, its measures are not yet sufficient for mitigating the impact of the crisis.

Sharp crisis involves social pain

"*What crisis? A rather nervous attack than an economic crisis*" – this assertion, issued by the end of 2008, seemed to affirm Romania's immunity against the looming social crisis and recession in Europe. It proved to be wrong! The social pain is here; we will see who and how will heal it. About a year ago, some economists argued that Romania's low dependence on external markets protects the country from the hurricane of recession. They were wrong!

Neurotic attacks (crisis) are not excluded, but they are not replacing an economic crisis. In the context of global economic depression, some nervous depressions ended in suicides, like Rene – Thierry Magon de la Villechuchet, in December 2008, troubled by banker Bernard Madoff's swindles. But these are just collateral effects.

The social impact of the crisis across the EU deserves a much larger analysis. Indeed, it is dealt with by the new European commissioner for social affairs, László Andor, by the European Parliament and by Member States. Here, we are making only some remarks based on observations of the first economic crisis under the spectrum of globalization. In the second part of the paper, we will focus on the impact of the recession on pension plans in the EU.

The social impact of the crisis seems to be less sharp than anticipated, for the moment being. The most difficult social effects have not yet arrived and they are expected to continue for a longer time. Furthermore, the danger of a double deep crisis is not yet over, since Germany and France have registered economic growth slowdown in the fourth quarter of 2009.

Social impact differs from country to country. Below, poor performers are grouped together under the acronym PIIGS (table no. 1).

Table no.1

Statistics of PIIGS					
	GDP growth	**Budget balance % of GDP**		**Public debt (% of GDP)**	**Debt growth (% of GDP)**
	2009	**2009**	**2010**	**2010**	**2007-2011**
Portugal	-2,9	-9,3	-8,3	84,6	27,5
Ireland	-7,5	-11,7	-11,6	82,9	71,1
Italy	-4,7	-5,3	5	116,7	14,3
Greece	-1,1	-12,7	-9,1	124,9	39,8
Spain	-3,7	-11,4	-9,8	66,3	34,4
Euro area	*-4*	*-6,9*	*-7,5*	*84*	*22,2*

Source: *http://www1.stratfor.com*

High deficits and deep indebtedness characterise these countries, accompanied by weak growth prospects in 2010.

Recent Eurostat data on the social budgets, labour market, social assistance, cohesion and, overall, what is generically called "Social Europe" would reveal even more about the impact of the global crisis, but we leave such profound analysis for the sociologists.

Nevertheless, statistical analysis will be used in the second part of this paper, regarding pensions, to show the impact of the crisis on this specific social sector.

The state's role as a socio-economic player is increasing. Steadily, states intervene more in the economy, sometimes bailing out banks and companies for the sake of citizens' protection. Some other times states pump cash into the markets in the form of *quantitative easing* to stimulate the economy and create jobs. Thus, the traditional "right – left" political spectrum is re-configured and the revived Keynesian theory is widely applied. On one hand, the "right" is proposing and implementing strong measures of social protection, and on the other hand "leftist" governments, under the pressure of the budget deficits,

are forced to apply austerity measures causing demonstrations and strikes, such as the case of Greece. What can Greece do to become more competitive and to pay its debts? It has lost the monetary devaluation tool, as well as the inflation tool, while adopting the single currency. As such, the only available measure to reduce labour costs is, painfully, the reduction of salaries.

Aiming to re-balance state budgets, governments are losing their usual political tools, benefitting now from only one with variable geometry: a combination between cutting expenses and increasing taxes.

Small and medium sized enterprises are affected as well. When European budgets are shrinking and the banks are not offering any more credits, SMEs are lacking risk capital and some of them go bankrupt. Entrepreneurship is damaged and the ranks of self-employed individuals diminish.

Social assistance suffers as well because of lack of funds. Health budgets are looking for more efficient formulas, targeting the same results with less money. Education, research and culture are deprived of needed funds, being pushed to survive under austerity status.

Who is to generate revenues for national budgets? A boosted economic activity would mean more taxes and more budget revenues. The value added tax is steadily increasing in different states, being levied more and more, for basic food as well, even in Great Britain where traditionally food was exempted from VAT.

The sharpening social impact of the crisis is expected to expand taxes on labour, to cover specific deficits. The same objective of improving the budgetary situation will push towards monetary devaluation, stimulating exports and creating jobs. Indebted states are exposed to new risks, such as speculative attacks on their currencies or speculative transactions with sovereign bonds.

On the labour market, the public sector is shrinking, to diminish the expenses, causing a certain state reform based on an increased effi-

ciency. Public administration is losing weight, paradoxically, some employees become redundant and others are forced to accept lower wages. This weakens the overall purchasing power, negatively impacting on the retail market. The smaller amount of liquidity among populations and the propensity to save are boosting the sales of cheap products. The low cost supermarkets are prospering. Tesco in the UK, for instance, registering historically high receipts, has decided to open a banking branch, offering loans[1].

More vulnerable under the pressure of the crisis, employees become less demanding and more flexible to the needs of the labour market, accepting difficult jobs with modest salaries.

Labour migration within the EU is shrinking. The recipient countries are enjoying the return to the origin countries of the redundant labour, thus saving money in their social budgets. The prudence and selectivity in accepting immigrant labour are increasing.

On a European scale, something will happen in the money flows, against the background of re-drawing the post-crisis international financial architecture. The need of liquidity for Greece, within the eurozone, is generating debates on setting up a European Monetary Fund shaped in the form of the IMF. If the Bretton Woods currency system has disappeared, it doesn't mean that the need for a global anchor currency disappeared too. The economic world is almost out of Bretton Woods, but is not yet out of the woods of the global crisis, with some unforeseeable threats still lurking.

The time of deficits

[1] http://www.tescofinance.com

Registering a *deficit of social immunity* in front of the economic crisis, the European Union is reshaping its strategies and social policies under the pressure of the new conditions created by the Lisbon Treaty, the recession and the now-expired Lisbon Strategy. Launched on the 3rd of March 2010, the "Europe 2020" strategy defines 5 headline targets for the next 10 years:

- 75 % of the population aged 20-64 should be employed.
- 3% of the EU's GDP should be invested in R&D.
- The "20/20/20" climate/energy targets should be met (including an increase to 30% of emissions reduction if the conditions are right).
- The share of early school leavers should be under 10% and at least 40% of the younger generation should have a tertiary degree.
- 20 million less people should be at risk of poverty.

Will this strategy succeed in removing the *deficit of social cohesion* which is keeping Greece under the tension of strikes, with its budget deficit of almost 13 % of GDP?

A *deficit of content* seems to register the theory of capitalism itself, since the virtues of the free markets are seriously questioned. The criterion of "functioning free market economy", strictly imposed on Romania during its pre-accession to the EU as a condition for closing different chapters of negotiations, becomes today more volatile and irrelevant. The *social* market economy is strongly re-vitalised without conceptualisation. The role of the market is shrinking, while the role of the state in the economy is boosting. Regulation becomes stronger.

Deficits in social budgets are registered, threatening welfare systems.

With *deficits in the balance sheets*, many companies have gone bankrupt. Some big European banks were bailed out with taxpayers' money, deepening state deficits. At the same time, hedge funds registering big

deficits have not been bailed out by any means, thus simply going bankrupt. The *deficits in household finances* ended, in extreme cases, with losses of houses and properties under unbearable mortgages.

A *deficit of prudence* has been registered before the crisis as well, inducing some disastrous *deficits in the budgets* of companies and individuals.

Different kinds of deficits of trust are registered, too. The banks are manifesting a lack of trust in states, and vice-versa, states do not trust the banks. The United Kingdom has pumped liquidity in banks, but paradoxically banks are not keen to offer loans to companies in need. Customers are registering a *deficit of trust* in banks, understandably, as demonstrated the case if Icesave in Iceland.

States and banks are inheriting a post-crisis *deficit of trust* in credit rating agencies, blaming them for not warning enough and timely, while granting unjustifiably high grades to some failing banks and companies.

A serious *deficit of competitiveness* emerged in the European Union and in the world as compared to the emerging economies, projecting a not very bright perspective for the old continent.

Strictly speaking, the long term budget deficits will force governments to devaluate their currencies, in their efforts to erode debts. Such a step is followed, usually, by inflation, higher interest rates, wage erosion and weakening of the purchasing power, depreciation of the accumulated savings and finally the decrease in the overall social comfort.

The massive *commercial deficits* in some countries are compensated by surpluses in the trade balances of others, like China or Germany. Too much saving on the one edge is compensated by too much indebtedness on the other, thus inducing more tension in the global financial system. Against such a background, the solution of clearing house is obvious.[1]

[1] Jeremy Grant, "*Big clearing houses set for OTC boost*", Financial Times, 23 March 2010

By the end of such an avalanche of deficits, I am reaching a pleonastic and even absurd "*deficit of deficit*". The criterion of the "deficit", as defined in the Maastricht Treaty, manifests itself in a *deficit of substance* in front of the crisis, losing its relevance when some Member States are ignoring it.

Are the convergence criteria becoming irrelevant?

The Maastricht criteria referring to the budget deficit and public debt are no longer fulfilled by Member States, and sanctions are not applied. Some states' deficits, including those in the Euro area, are growing much beyond the ceiling of 3 % of the GDP, raising in time the public debt to well over 60 % of GDP.

The budget deficit in Greece, for instance, reached 12.7% of GDP, and in Great Britain 12.8 %, being totally disconnected from the convergence obligation of 3 %. Nevertheless, it would be wrong to draw a parallel between the two countries, only based on statistics. With its strong capacity and resources, the British economy is capable of rolling over some loans and of carrying on an independent monetary and banking policy, positioning itself in the EU much better than Greece.

Referring to another criterion of convergence, the *public debt* in Germany will reach 83 % of GDP in 2014, with the prospect of cutting back under the ceiling of 60 % only after 25 years. Some Member States were already registering excessive debt before the crisis, like Belgium, Italy and Greece going beyond 100 %.

The lack of money in government coffers will have an impact on social budgets. Be they European or national, social programmes for citizens in need will be built only on available amounts of money.

In the new environment we could foresee a reshaping of the Maastricht convergence criteria, with a potential impact on Romania's accession to the euro zone.

<u>Resetting the social Europe</u>

All the objectives of the "Europe 2020" strategy have social components, giving serious reasons to believe that the EU already has a solid programme of fighting the social impact of the global economic crisis.

Within the European Parliament a special Committee on the financial – economic crisis, known by the acronym of CRIS and established for a 12-month mandate which started in October 2008, assessed the impact of the crisis and drafted recommendations for restoring a sustainable financial market.

According to Eurostat, unemployment in the EU has reached the record level of the last 10 years, the higher rates being registered in December 2008 by Latvia (22.8 %) and Spain (19.5 %), and the lowest by Netherlands (4 %) and Austria (%.4 %), with Romania at an average level of 7.8 % in 2009.

As a responsible government, the European Commission (EC) is looking to invest in major infrastructure projects, creating new jobs. By now already, before the future "financial perspective 2014 – 2021" has been launched, the EC is reserving additional funds for the energy sector.

In February 2010, the Commission has announced the allotment of 2.3 bn. € for 31 European projects in the gas sector, and 12 in the electricity sector. It is the second financial decision within the economic recovery package worth almost 4 bn. €, the biggest amount of money ever invested by the EU in energy infrastructure. It is a real prerequisite for re-orienting the budget on new priorities starting with 2014. The EU is keen to finance smart investments, by granting short term stimulus with a long term impact – according to the statement made by José Manuel Barroso, the President of the European Commission.

The investments in the critical energy infrastructure are multiplying the effects all over the economy and creating new jobs. Furthermore,

they contribute to the energy security, granting European citizens electricity and home heating, even in cases of supply disruptions. Strategic investment projects like diversification of sources and routes of supply, as well as the storage of energy resources for longer periods, will have a long term impact. Contributing with modest amounts to start the Nabucco gas pipeline project, for instance, the EC is laying a brick at the foundation of a long term objective.

European pensions under the crisis burden

The pension systems in the European Union vary from country to country, combining in different proportions the two main categories: *funded pensions* and *pay-as-you-go pensions*. In Romania, the first category is just incipient.

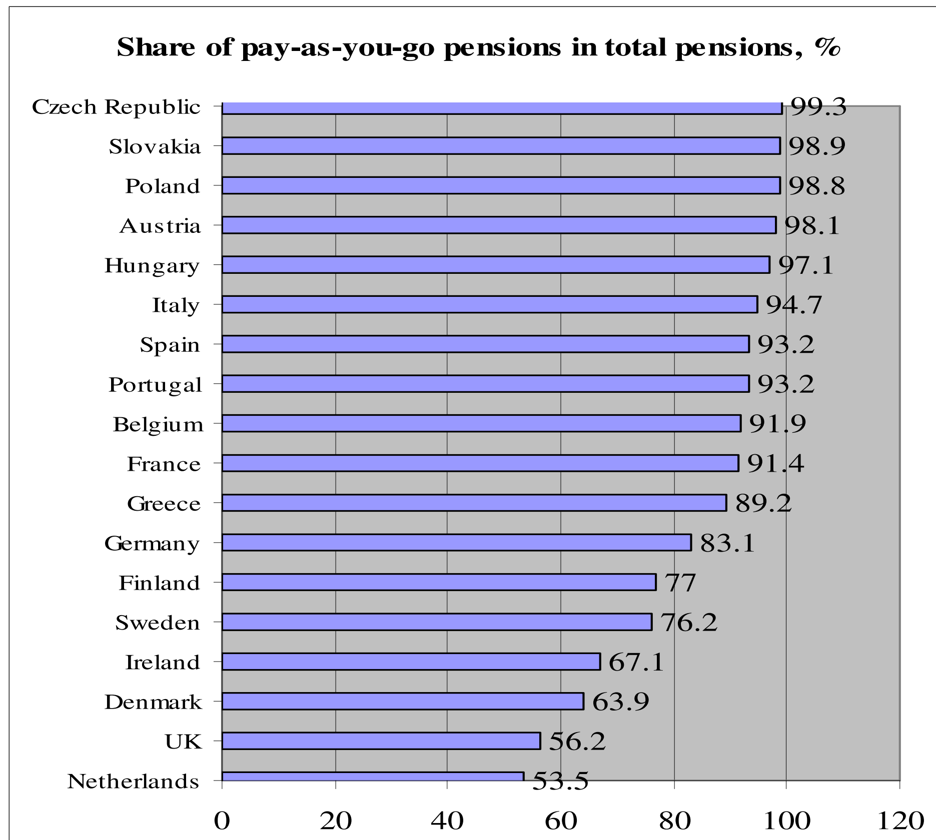
In short, funded pensions are paid by amounts of money accumulated year by year, during a life time period, by previous contributions in specific funds. In this case, the pensioners are using their own money, saved during the time when they were employed. The second category, *pay-as-you-go pensions*, is paying the pensioners directly from the contributions of the present employees, who are depositing a share of their own salary for the future pension. The money flow is almost instantaneous, from the depositor to the pensioner, through the pension system. In Romania, a country with no tradition and practice in private pensions, the second category prevails, but the two are already coexisting.

Apparently, only the funded pensions are affected by the crisis. We will briefly show that such a conclusion is incorrect.

Statistics are relative, the most recent example of Greece's reporting to Eurostat being a telling one. Nevertheless, lacking some other tools of measuring the economic and social realities, we will refer to some statistics (Graph 1). In the Czech Republic, for example, the pay-as-you-

go pension system represents 99.3 % of the total, while in Netherlands only 53.5 %.

Graph 1

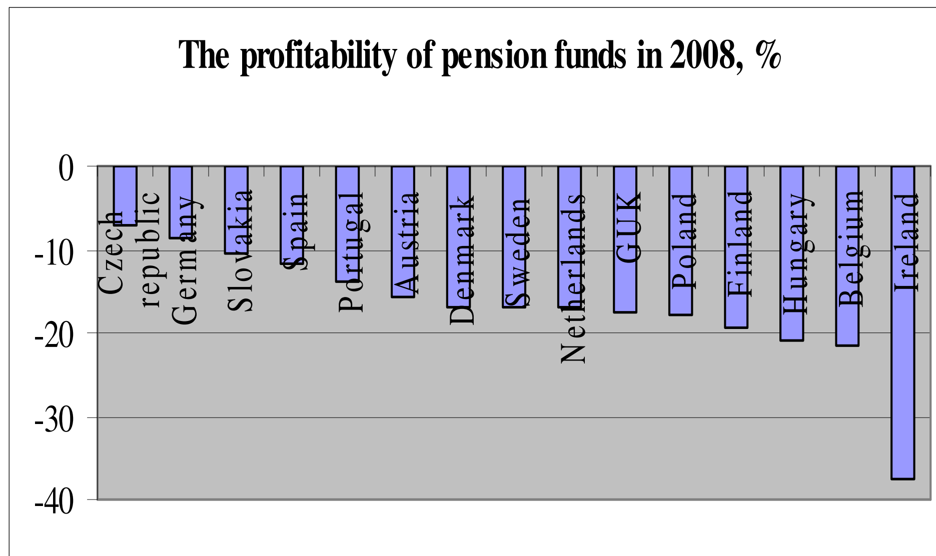


Source OECD 2009

The negative impact of the crisis on the *funded pensions* is proved by the devaluation of the amounts of money accumulated in the pre-crisis period. The degree of such devaluation varies by the type of portfolio. For instance, the stocks have lost about 50 % of the value in some states, while the bonds' depreciation was more moderate.

The negative profitability rate was also heterogeneous in 2009 (Graph no.2).

Graph no.2



Source: OECD, Pensions at a glance, September 2009

The graph shows that all the countries have registered losses, not profits, with differences between the Czech Republic (-7.2 %) and Republic of Ireland (-37.5 %). Romania is not mentioned in the graph, not being an OECD member, but the statistics would be irrelevant, due to the small amount of the private pensions in this country.

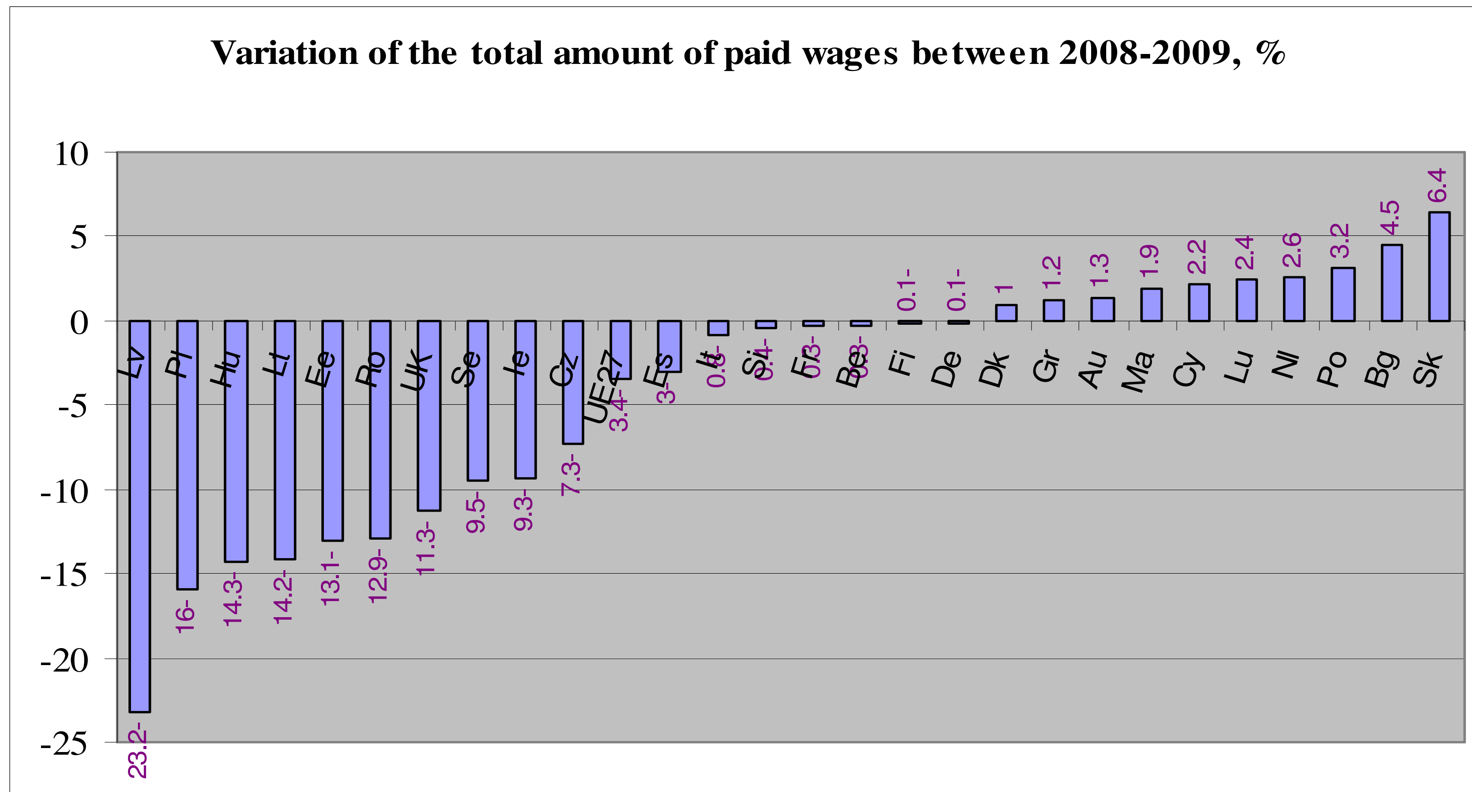
After such negative developments, by prudence proportional to the risks, the profits of the pension funds will shrink in the future, in order to protect the depositors. This is one of the lessons of the crisis.

The second category of the pensions, "*pay-as-you-go*", de-coupled from the market developments, seems not to be affected by the crisis, since the employees are further paying their taxes and contributions. Nevertheless, the number of employees is reduced while unemployment

rises and the population is aging. If the total amount of wages in a country is shrinking, the contributions to the pensions are shrinking as well. Furthermore, if some states have promised the indexation of the pensions with the inflation, the deficits will enlarge, in order to pay the current pensions.

The total amount of wages has been diminished by the crisis, with 23.2 % in Latvia and 12.9 % in Romania, during 2008-2009, according to "Eurostat National Accounts" (Graph no.3).

Graph no.3

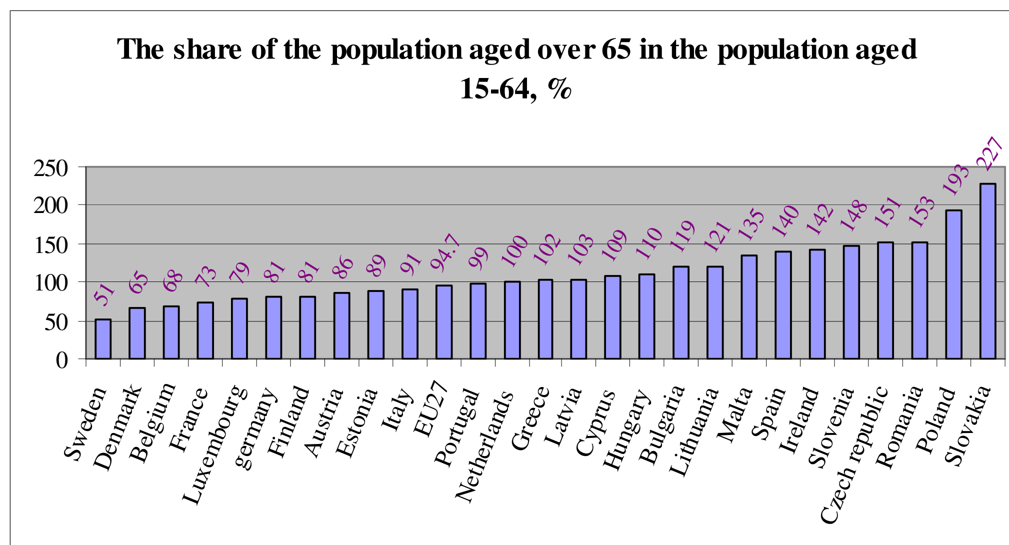


Source Eurostat National Accounts

This graph proves through statistics that the pay-as-you-go pensions are affected as well by the crisis. Only a few countries registered growth, but with insignificant percentages. As a result, at the EU level the total amount of paid salaries diminished by 3.4 %. It is remarkable that in Poland, the only EU country not falling in recession, the total paid wages were reduced by 16 %. Obviously, a lower labour cost contributed to a higher competitiveness.

The graph reflects also the heterogeneity of the labour conditions in different states of the EU, making difficult a compact approach to the "social Europe".

To such an image one can add the phenomenon of aging population. Statistics are relative again, explicitly by the different reporting procedures in different countries, by different retiring age and by different employment rates of the active population. Nevertheless, a fraction between the total population aged over 65 and the population aged between 15 – 64 years will result in an image of dependency (graph no. 4).



Source: Eurostat

The wide scale, with an average of 94.7 % in EU-27, includes the extremes of 51 % in Sweden and 227 % in Slovakia, while Romania stands in third place, with 153 %. Adding to this picture the EU demographic projections, one can realise how much pension systems reform is needed. In fact, the aging population affects pension funds in the long run, even more than the crisis as such. The systems risk of becoming non-functional, if they avoid tough measures.

Therapy and accountability

The post-crisis social Europe will show, in my opinion, more accountability and more solidarity, according to the challenges ahead, out of which I would mention two, on the top of the pyramid: the competition of the emerging economies and the aging population. The European institutions will be requested more and more to draft and implement sustainable social policies.

"Every bad is good for something" sounds a Romanian saying: the crisis is pushing the reforms in the European social environment, especially in the pension systems. After the convalescence, the governments have the chance to come out of the crisis more efficient, more flexible.

Instead of conclusions, thinking about the minimisation of the social impact of the economic recession, I am haunted by a single word: *accountability*. From the responsibility of the European institutions and governments, up to the corporate social responsibility and our responsibility, as European citizens, a wide spectrum of accountability comes to mitigate the assumed risks and to boost the solidarity in front of the dangers. The accountability could be the right word for those who compared the crisis, about two years ago, with rather a nervous attack.

As is the case with every crisis, be it economic, financial, or "nervous ", the therapy depends on the patient, but also on the therapist treat-

ing him, offering immunization to the future crisis or even some more vigour.

Looking to the hard core of the European integration, to a certain segment of the Euro area, more specific to Greece, another question arises: beyond therapy, don't we need a new diagnosis? Are we facing only a "social impact" of the economic recession or even a real "social crisis"? Will we encounter a true economic heterodoxy in the future, new paradigms and new economic theories?

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