6TH ANNUAL RESEARCH CONFERENCE
Central Banking under Prolonged Global Uncertainty:
The Latest Lessons while Searching for the "New Normal"

Pension funds and their contribution to long-term investment: the case of infrastructure

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Pension funds and infrastructure investment

Outline of presentation

The “infrastructure gap”

Why pension funds?

Experience from OECD world

The case of CEE and SEE and of the FYRoM

Why is it not happening?

Should it happen at all?

Pension funds and infrastructure investment

The “infrastructure gap”

Infrastructure as *sine qua non* for development

- longstanding concern of G20, OECD, WB, IMF, WEF, EU

1) expend on basic infrastructure (transport, power, water and communications) currently $2.7trn p. a. but $3.7trn needed (WEF)

2) S. Asia’s $2.5trn “gap” (WB on needs for next 10 years)

3) EU needs public investments worth €700 billion over the next five years (Polish finance minister Szczure, 2014)

4) EC’s Connecting Europe Facility - a budget of €50bn for 2014-2020

5) “CEE infrastructure gap hits €500bn” (EIB 2014, amount needed to bring infrastructure up to WE standards)

Pension funds and infrastructure investment

The “infrastructure gap” (2)

6) “In terms of overall quality of infrastructure, Croatia ranks better than its NMS peers ..the largest gaps exist in BiH and Serbia. All W Balkan countries, except Croatia, lag behind the EU by a wide margin.” (IMF 2015)

7) “Local infrastructure across the W. Balkans suffers from a significant backlog of investments. Between 2008 and 2013, public investments in the Western Balkans substantially decreased by more than 30%.” (MIDF)

This is physical infrastructure

- but also health, education, housing (social), administrative capacity

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The Infrastructure gap (3)

The case Macedonia

- recognised needs

1) roads and railways (corridors 8 and 10)
2) energy inc. “clean” energy
3) local water and waste water
4) “social infrastructure”

- current financing

1) govt. expenditure (especially PSER)
2) EBRD/EIB, (“fiscally neutral”) + MIDF
3) WB, China EXIM Bank (foreign currency denominated)
4) “low tax regime” encouraging private FDI

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Why pension funds?

Rationale

- fiscal constraints upon governments

1) Maastricht rules (new EU countries and accession candidates)

2) IFI conditionality

- Basel III rules

1) tighter limits on long-term loans

2) enhanced provisioning costs

- pension funds

Sutton’s law (when diagnosing, one should first consider the obvious)

“where the money is”*

* Sutton, W.: *Where the Money Was: The Memoirs of a Bank Robber*. Viking Press (1976)

Pension funds and infrastructure investment

Why pension funds? (2)

- rationale in general

1) pension privatisation (WB “model”)
2) long term saving matching long term investments
3) quest for yield in new environment
4) “steady and inflation linked”
5) “for the good of the nation and for pension fund members”

- CEE/West Balkans specific

1) funded schemes in SEE: Bulgaria, Croatia, BiH, Kosovo
2) FRYoM pillar II since 2005
3) 2013 EBRD “wooing” pension funds and SWFs

Pension funds and infrastructure investment

Experience from the OECD world

Size and nature of involvement

- often recorded under "alternatives" and not identifiable

1) Australia does most (5-8% of assets) mainly domestic
2) Canada (4% of assets) much N Am / W Europe
3) UK low (1% of assets), USS does most
4) Netherlands, putting toe in water
5) Denmark, Finland, esp. in renewable energy

- establishment of "platforms"

1) aggregating money available / building up expertise

- nature of investments

1) preference for large, mature assets ("brownfield" not "greenfield")
2) mainly defined benefit (DB) not defined contribution (DC) funds

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Experiences of CEE, SEE and the W. Balkans

- Poland

1) PFs should allocate more to road projects in the country as and therefore reduce their exposure to the fluctuation of stock markets

2) national broadband network to tap into second pillar PF? (2013)

- Croatia

1) new Mandatory Pension Act in 2014 enabled pension funds to invest directly in infrastructure projects

2) the Jadranski Naftovod (JANAF) oil pipeline to Hungary and Serbia, owned by INA (16%) and the state (62%) through the Pension Fund

- Romania

1) PF of the Hungarian Reformed Church min. owner of an hydroelectric power plant

- Macedonia

1) oil refining privatised (holders inc. employees, employees’ funds and PF)

Pension funds and infrastructure investment

The case of Macedonia

The second pillar pension system

- characteristics

1) “incomplete privatisation” – only 3% in domestic equities*
2) importance of MK govt. bonds – 61% of holdings
3) ….. so, effectively, financing current/capital spending
4) ….. with “transition costs” c1% of GDP**
5) but assets c7% of GDP

- Macedonia’s infrastructure expenditure

1) PESR (off budget road building entity) expenditure 2+% of GDP
2) PESR debt 5-6% of GDP

* 2/3rds of this in 3 companies and 90% in 6 companies

** deficit ex transition costs -2.6% not -3.5% (2015)

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Why is it not happening?

Pension funds (too) conservative

- infrastructure construction recognised as “risky”

1) EC-EIB offers project bond guarantees

2) see also other IFIs, ESIF, UK govt. etc.

- fund preference for government bonds

1) limited match with liabilities (if liquidity and market values required)

Lack of financial “infrastructure”

- specific emerging markets issues

1) memories of financial collapses and fraud

2) PPP and PFI little more than aspiration

3) lack of experience/capacity (actual investors from outside)

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Why is it not happening? (2)

Questions of governance

- administrative capacity (WB, IMF, WEF)

1) red tape and corruption hampering economic activity
2) contract enforcement

- political uncertainty

1) Croatia and the highways monetisation scheme
2) Poland and Hungary and “unreform” of mandatory second pillar
3) Netherland and N33 motorway scheme
4) “regulatory uncertainty” is not just and emerging markets problem

Pension funds and infrastructure investment

Should it happen at all?

The purpose of pension funds

- the provision of stable and adequate income in retirement
- the compatibility of unlisted investments with the need for liquidity (problem for DC funds)
- is this the latest fad? (“defensive stocks”, commodities, etc)

There is a need for more infrastructure

- but not necessarily mega projects

The costs that have to be borne

- gov’ts can finance infrastructure directly via own borrowing
- is this what Macedonia is already doing?