The Georgian Pension System Reformation Challenges

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Abstract

In 2019, the Government of Georgia launched implementing the private contributory pension scheme project in order to grow the welfare of pensioners, on the one hand, and shape a steady fiscal system, on the other hand. Simultaneously, the reform aims to stimulate the economic growth through investing pension savings in reliable instruments. Reliable and reasonable investing of the accumulated financial resources is one of the biggest and priority challenges for all pension schemes in the world, including for the recently-established Pension Agency of Georgia. Notably, there is a long-term positive correlation between the pension scheme reformation and the economic growth. But it should also be noted that the mentioned reform positively affects the economies with well-developed domestic financial markets and diversified investment opportunities. This very factor is one of the key challenges for the Pension Agency of Georgia, because Georgia's capital market remains undeveloped, in practice (the exchange capitalization in GDP accounts for 3.5%), where 92% of the finance sector's assets are owned by commercial banks. The Pension Agency has already accumulated more than GEL 900 million in 19 months, since the commencement of the reform. The accumulated resources have been entirely deposited into bank instruments. The analysis below aims to identify whether a placement of pension savings into bank accounts brings positive or negative effects and to outline the best opportunities and sources for making investments in.

Keywords: Pension Reform, Financial Markets, Securities, Investment

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Relevance of the pension system reformation

There were many factors necessitating an introduction of the private contributory pension scheme, including the expected growth in fiscal burden in the coming years. Namely, the current statistics proves that the state budget expenditures for serving pension obligations grow year on year. For example, these expenditures exceeded GEL 2 billion in 2020, that is, 16% of the total state budget assignments(mof.ge).

Notably, the number of old age pensioners constantly grows by annual 2%, on average. Furthermore, according to the UN indicators, by 2030, Georgia will be populated by 950,000 old age pensioners, that is, 25% of total population (UN. World population aging report 2019).

Today, old age pensioners constitute 20% of the total population, whilst the birth rate constantly drops. After the 2014 general census[2], the birth rate shrinks by 4% year on year. The number of the productive age population is forecast to decline by 2030, whilst the number of old age pensioners is forecast to increase. This signifies that the Georgian Authorities will have to increase and multiply taxes to serve the growing social obligations. At the same time, the growth in the coefficient of replacement, that is, one of the important indictors for assessment of the current pension system remains an unresolved task, in practice. The coefficient of replacement measures a correlation between the average salary and the pension amount. To put it more exactly, the current pension amount constitutes only GEL 200, that is, 19% of the average salary of GEL 1,068. This signifies that, in Georgia, the coefficient of replacement accounts for 19% and this is a very low indicator and an essentially lower figure compared to EU countries (78%) and OECD countries (63%).

It is undeniable that the current pension system, following the principle of solidarity, cannot generate an adequate coefficient of replacement in the future. Considering that the salaries in 2012-2019 grew by average 8% and assuming that, under the optimistic scenario, the average salary keeps rising in the same percent, assuming that the inflation rate remains approximate to the 3% target rate determined by the National Bank of Georgia (NBG) (4% under our scenario) and assuming that the growth in basic pension amount is subjected to indexation, the basic pension payments of GEL 560 will constitute only a 9.6% coefficient of replacement by 2040, with the average salary of GEL 5,800. This signifies that we will receive much worse situation, instead of having improved the environment. According to the mentioned scenario, citizens with average salary of GEL 5,800 will receive 10 times less pension amounts after retirement.

[2] https://www.geostat.ge/en/modules/categories/568/2014-general-population-census

Correlation between the Private Contributory Pension Scheme and Capital Market Development

The private contributory pension scheme is expected to develop the Georgian capital market too. These suppositions have real grounds, because the collected financial resources should be invested in the financial instruments that are primarily accumulated in the capital market. Remarkably, the capital market industry is a quite sophisticated phenomenon and only the Pension Agency cannot precondition the capital market development in the environment, where independent brokerage companies, not affiliated with commercial banks, do not exist, in practice, and where there are a very few responsible companies. Nonetheless, the Pension Agency can play an important role to stimulate positive trends on the capital market.

As various influential studies report, there is a positive correlation between the growth in the Pension Agency scales and the capital market development, because the Agency generates long-term investment resources and the greatest part of these resources is invested in the domestic capital market.

Economic growth is stimulated through this channel, because savings grow into productive investments and investments grow the output.

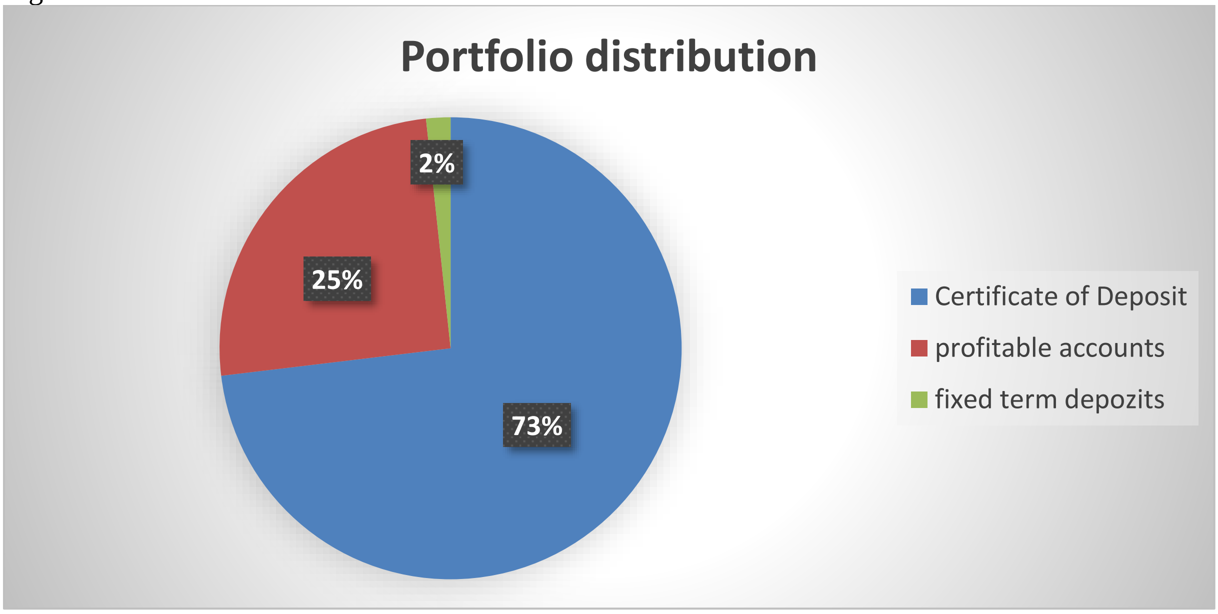
The fact that pension reform has a positive impact on the development of the capital market is confirmed by numerous studies (Davis E. P., 1998). According to literature, there is a positive feedback between the growth of pension fund assets and financial development (Levine & Zervos, 1998). In turn, financial development has a positive impact on economic growth. (Beck & Levine, 2004)

As noted above, the Agency-accumulated pension savings have been fully placed into deposits of Georgia-based commercial banks. (Figure N1) Naturally, these resources earn certain interest; however it is not desirable to keep pension savings on the bank deposits endlessly. Nor hastiness is recommended, because the reform follows the long-term purposes and the Investment Board has no right to make mistakes. Though, a timely commencement of the investment process is more desirable and important than keeping the savings on bank deposits for a long period. According to the law on Contributory Pension Scheme, the Agency is authorized to make investments in the following financial instruments: Bank accounts;

- Treasury Obligations of Georgia;
- Domestic corporate bonds;
- Domestic corporate shares;
- Foreign government securities;
- Securities of international finacnial institutions;
- Foreign corporate bonds;
- Foreign corporate shares;
- Other assets

Let’s see what opportunities the Georgian Stock Exchange (GSE) provides in this regard and what situation we have there. It should be stressed that the current financial indicators of the Georgian Stock Exchange (GSE) give no grounds for positive expectations. The number of companies operating on the GSE declines constantly. According to the June 2020 indicators, the Georgian Stock Exchange (GSE) trading system registers securities of 28 companies and their total market capitalization amounts to GEL 1,834 million. The 2020 forecast indicator constituted 3.8% of GDP, while the average daily turnover marked 41 GEL.

Figure N1.



Source: pensions.ge.

The listing of Category A registers securities of 9 companies, 8 bonds and 1 share (Bank of Georgia). The listing of Category B registers securities of 8 companies, of which 6 ones have issued bonds and 2 ones have issued shares. As for the unlisted category, 8 companies have issued shares[3].

Under the law[4], the Pension Agency is authorized to make investments in both low-risk and medium- and high-risk financial instruments, based on certain proportions. At the same time, the Agency is entitled to make investments only in low-risk and highly-liquid securities for the initial five years. As for securities on the Georgian Stock Exchange (GSE), only securities of the companies enlisted in Category A satisfy the sound liquidity requirements, and they primarily represent GEL-denominated bonds issued by global financial organizations (IFC; EBRD; ADB) on a one-off basis and the secondary market records no activity on them. As for the shares of the only and most successful Georgian company – Bank of Georgia enlisted in Category A of the Georgian Stock Exchange: deals on its shares are made 2-3 times a month, on average. This fact signifies that the Georgian Stock Exchange (GSE) exists absolutely on paper only; it does not reflect the current economic developments and the business sector does not consider it as an alternative attractive source for making in or attracting investments.

In this situation, it is very difficult for the Investment Board to find reliable domestic financial instruments to invest essential amounts in. The situation will not change without carrying out radical reforms on the Georgian Stock Exchange (GSE). There is not a large variety

[3] https://gse.ge/en/securities
[4] https://pensions.ge/legislation/georgian-law-about-cumulative-pensions

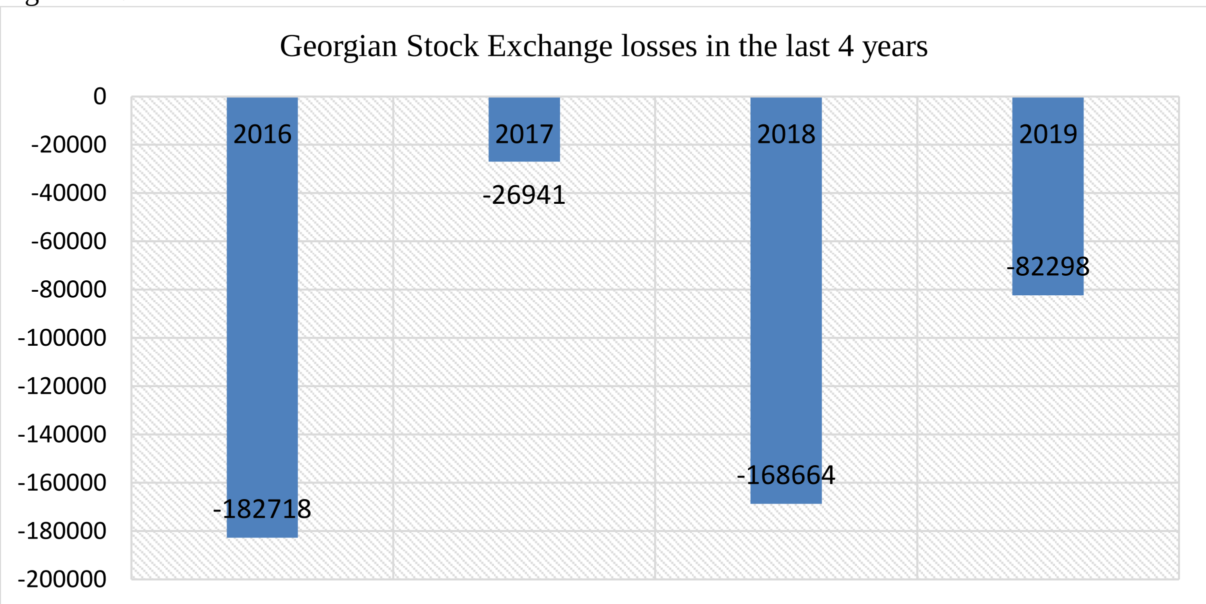
of domestic corporate bonds, whilst highly-liquid shares are absolutely absent. Government's Treasury Notes are an exception, however, the legislation obliges the Agency to diversify assets and the Investment Board cannot rely only on the mentioned instrument.

According to various studies (Meng & Pfau. 2010) growing pension assets have positive correlation with capital markets in the countries with a high financial development level, whilst a lower development makes this correlation weaker. Therefore, this factor will become a serious obstacle for successful implementation of the mentioned reforms.

Since the Fund has not started making real investments in securities and the portfolio has not been fully diversified, the investment policy cannot be appraised, because, under the Law on Contributory Pension Scheme, for the initial 5 years, the accumulated resources must be invested only in low-risk and highly-liquid financial instruments, such as Certificates of Deposits of commercial banks and Term Deposits, Treasury Notes, however, the Pension Agency has not invested its resources in the last instrument.

Another issue is why the Georgian Stock Exchange stays unprofitable (Figure N2). Anyway, we are able to make a simple conclusion regarding the Pension Agency: it will be very difficult to enliven and revive the unprofitable stock exchange through the pension savings of Georgian citizens unless necessary reforms are carried out at the Georgian Stock Exchange.

Figure N2.



Source: Georgian Stock exchange. Gse.ge.

If the situation on the capital market changes and the Pension Agency starts making investments in securities of the GSE-enlisted companies, then we will have an evident progress. If the Pension Agency invests even 15% of assets (after 5 years) in the domestic exchange, the GSE capitalization will rise approximately by 30% in a first year (according to the author's estimations). After the investment process continues, the growth of Georgian stock market capitalization to GDP will be impressive as never before. This statement is confirmed by Yu-Wei, based on empirical data from the OECD and EME, that both long-term and short-term growth of pension fund assets increases the stock market.

Summery

Georgian government has launched implementing private contributory pension scheme project from the beginning of 2019. To the extant that the reform is novelty for Georgians and Georgian economic and social system, it faces many challenges. Among them are:

- Less trust in population to the system;
- Political risks;
- Risk of inflation;
- Low level of financial development;
- Less opportunities for investments in local markets;

According to the mentioned challenges, one of the most important obstructive circumstance is the low level of financial system and it's concentration only on commercial banks, which weakens the link between pension reform and economic growth.

Mention should be made, that existing situation, when 100% of pension fund assets are denominated on commercial banks accounts, is not caused not only for minimizing risks, but also because there are no high liquid financial instruments inside the country, except bank accounts and treasury bonds.

Accordingly, if appropriate and relevant reforms aren't made in Georgian financial sector, the pension reform will have less impact on the economic development and it won't cause the development of capital market of it's own. It should happen on the contrary.

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