Pension Funds and Economic Recovery

Remarks by **Governor Cleviston Haynes** at the Eckler Annual Pension Investment Conference

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I welcome this opportunity to once more address your Annual Pension Investment Conference.

The Central Bank of Barbados is not the primary regulator for pensions, but under its revised Act, it has explicit responsibility for promoting financial stability, with the goal of achieving the orderly and sustainable development of Barbados. Our mandate requires us to take a holistic view of the financial system, including pension funds. The link between the pension funds sector and financial stability is undeniable as well-managed pension funds contribute to overall stability of the financial system and pension funds can benefit from such stability.

Pension funds represent an instrument of long-term savings, intermediating between individuals and their retirement benefits. Global experience indicates that a vibrant pensions fund sector has the potential to play a significant role in the growth and development of the economy, enhancing the efficiency of the capital market in mobilising resources and creating opportunities for enfranchisement of small investors. Given their long-term horizon, pension funds are suited for investment in domestic infrastructure projects.

This morning, therefore, I wish to share with you some thoughts on the transformative potential for the pensions sector in the post-COVID recovery. In my presentation, I will provide an overview of recent economic developments, with a brief outline of the prospects for a gradual sustained recovery. Secondly, I will examine the importance of the pensions sector in the context of an aging society. Finally, I will discuss how the sector's investment strategies can contribute to transformative growth and development in the domestic economy.

Macroeconomic Environment

As I shared with you last year, 2020 was very challenging for the Barbados economy, the result of the disruptive effects of COVID-19, particularly on the key tourism sector. The impact is well-known with a loss in output of 18%, elevated levels of unemployment and reduced revenue for government. Towards year-end, we began to witness some recovery and, with the anticipation of vaccines, the promise of a robust recovery this year seemed realistic.

Sadly, COVID has proven to be a persistent lethal foe. Spikes in infections at home and abroad erased the upturn as the imposition of the National Pause and a slower resumption in global travel than anticipated brought tourism to a virtual halt. Over the last eight months, activity has improved relative to the low level in 2020 but the performance remains well below the pre-COVID period. The spread of the delta variant and reinstatement of curfews have dampened the pace of the embryonic recovery.

The fiscal impact of the crisis remains severe. Government's revenues were 14% lower than in FY 2019/21, a situation attenuated by windfall receipts from corporate taxes. This year, there has been a modest recovery in revenue, but the combined effects of fighting COVID and addressing the challenges presented by a set of rare climatic events have raised demands on the public purse. Government has had to alter its committed fiscal consolidation stance away from a primary surplus of six percent to a deficit of one percent. This unavoidable adjustment has been funded by international financial institutions, temporarily raising the stock of debt. The debt ratio has also risen, principally because of the reduced economic activity but, with the recent improved economic performance, it has started to trend downwards.

The borrowing has helped to support the international reserves in the wake of falling tourism earnings. The reserves have also been boosted by the receipt of the proceeds of an SDR (Special Drawing Rights) allocation by the International Monetary Fund in August, enabling the import reserve cover to exceed 40 weeks, a historic high. For the uninitiated, the SDR represents a reserve asset created by the Fund and periodically allocations are made to all member countries when it appears that there is a global shortage of reserves. In addition to raising reserve levels, countries may use their SDRs to cope with the fiscal pressures created by COVID.

As anticipated, demand for foreign exchange has increased in recent months as the incipient recovery is taking shape in advance of a strong tourism recovery. This demand partly reflects the impact of rising international prices, including for oil and freight costs. These developments, together with the effects of the global supply chain disruptions, have begun to put pressure on domestic prices, a trend being observed in our key source market, the United States.

Government intervention, supported by the financial sector, has played an influential role in maintaining economic activity over the past 20 months. But how quickly can normalcy return to overall activity? It is evident that the revival of the tourism sector is critical. Already there are signs of improved airlift, market diversification and pick-up in demand for tourism services that will enable a gradual return to pre-COVID levels of tourist activity. Enhanced use of digital technologies that improve efficiency and competitiveness also have the potential to strengthen growth prospects.

Forecasting growth within the current environment remains challenging because of the on-going uncertainty associated with the continued persistence of the virus but a return to 2019 output levels cannot be expected before 2023. However, building on our strengths in the services sectors, sustained implementation of structural reforms, particularly to improve the ease of doing business and enhance competitiveness, together with the accelerated implementation of planned investment projects in the public and private sectors can raise growth rates. Over the medium term a targeted growth rate of three percent per annum on average after the initial restoration of economic activity should be within our capacity to achieve.

Pensions Sector

Over time, Barbados has developed a varied framework for pensions evidenced by what is essentially a three-tier system. First, the broad population is enrolled in the contributory public system managed by the National Insurance, currently with an asset base approaching $4 billion. Secondly, there is an unfunded system for public servants financed out of the consolidated fund, and thirdly there are private pension funds which are regulated by the Financial Services Commission.

At December 2020, private pension funds registered reported assets of $2.4 billion or approximately 9.5% of all financial sector assets. This represented a modest decline from a year earlier, as rising pension payments and lower contributions resulting from the depressed economic conditions slowed the growth of the sector. The sector remains heavily invested abroad while direct exposure to the Government of Barbados is approximately 20%.

The critical role of Pension Fund management in the society is underscored by the fact that Barbados is confronting the challenges associated with an ageing population, a reflection of declining fertility and mortality rates. Improved healthcare management and living conditions have raised life expectancy and, in the 2019 report prepared by the Barbados Population Commission, it was estimated that 16.5% of the population was 65 and over. This is anticipated to rise to 21.7% in 2030 and 26.3% by 2050. In contrast, on current trends, the population, and by extension, the workforce will contract.

These are sobering forecasts, particularly as it relates to the implications for a reduction in the number of working age persons. It brings with it the risk that the size of the workforce available to provide the goods and services will not be sufficient to sustain the economy and maintain or raise living standards. Accelerated use of technology and a policy of managed migration are two of the policies that have been suggested to address this development but, even if these strategies are successful, we cannot overlook the economic and social implications of aging on the older segment of the population.

For many, retirement is seen as a new phase of life in which we have time to smell the roses and to do things that we were unable to do in our busy work lives when we were focused on the care of the next generation. However, with retirement comes other concerns. We have to be mindful that rising health care and property maintenance costs and the need for more elderly persons to take care of themselves, because of the changing structure of families, will place increased pressure on retirement savings. For the state sector, as persons live longer, healthcare costs will rise and there is the potential for increased demand for assisted living quarters for the elderly where the market is unable to provide supply at affordable prices.

A strong well-managed pension system will therefore be crucial to supplementing the National Insurance scheme. Workers need to consider enhancing their pensions through voluntary but consistent savings during their work life. Pension plans, whether defined benefit or defined contribution need to be managed effectively to ensure retirees can enjoy their retirement without pressure. At present there are only 259 registered pension plans, suggesting that there is scope for broadening the sector. As the economy recovers, the sector, through contributions and investment income, should target growth of more than 5% per annum.

Transformative Investments

To maximise the impact of the potential of the sector, pension funds need to increase their local investments. At present, investors are coping with a low interest rate environment and a dearth of investment instruments in domestic bond and equity markets. Persistence of these trends may create incentives for pension funds to want to invest abroad rather than promote domestic economic activity.

I wish to suggest two areas in which the sector can contribute to accelerated growth in the Barbados economy.

First, historically, government debt issues have served as the prime instruments for long term investors. However, post the debt service suspension in 2018, Government has withdrawn from new debt issuance, apart from the BOSS bonds that were specifically targeted to public servants. The focus has been on retiring debt and this has contributed to the build-up of excess liquidity in the financial system.

Over the last few days, however, government announced issuance of its first major debt instrument post the debt restructuring. The proceeds from this bond issue are intended to help finance the economic recovery from the COVID shock. The bond is targeted to all investors and represents the first step towards restoring normality to the domestic capital market, while creating greater balance between new domestic and external funding. Potential investors should note that the new debt issuance is consistent with the macroeconomic framework under the programme with the IMF and is in line with the medium-term debt trajectory which aims to reach 60% by FY 2035/36. In this regard, as the economy recovers, government will revert to its programme of fiscal consolidation through primary surpluses, enabling the temporary increase in the debt-ratio to taper off as government continues to honour its debt obligations.

Secondly, Government has set the goal to achieve a fossil-fuel-free economy and to reduce Green House Gas emissions across all sectors by 70% by 2030. This creates the opportunity for pension funds to engage in investments that prioritise optimal environmental, social, and governance (ESG) factors or outcomes. ESG investing is now widely seen as a way of investing "sustainably"—where investments are made with consideration of the environment and human wellbeing, as well as the economy.

The need to transition towards a lower-carbon economy presents opportunities in emerging technologies, renewable energy and carbon reduction in conventional industries. Sustainable investing can enhance investment performance and evidence shows that it increases long-term investment performance by reducing volatility, -augmenting risk-adjusted returns and enhancing opportunities for asset diversification. This outcome has been shown in both favourable market conditions and during times of crisis, such as those currently being faced as a result of the COVID-19 pandemic.

The local pension plans can assist with achieving these targets by investing some of their available funds in green bonds. Green bonds raise funds for new and existing projects that deliver environmental benefits, and a more sustainable economy. 'Green' can include renewable energy, sustainable resource use, conservation, and adaptation to climate change. At present, the green bond market is thin but these bonds will become more common in the future. Investing in green bonds would offer attractive returns on a risk adjusted basis. Such an investment by defined benefit schemes would result in a stable, sustainable and long-term approach which can provide more certainty on the funds invested and more predictability for trustees to plan their scheme's investment strategy and cashflow. For DC schemes, it can strengthen trustee fulfilment of their fiduciary duty by offering members access to a wider choice of more sustainable investment funds aligned with employee values.

Conclusion

Sustaining financial stability requires a stable economic environment that facilitates growth and job creation and encourages new investments. The pensions sector has a pivotal role to play by transforming savings into long term investments, facilitating diversification and creating opportunities for enfranchisement. As fund managers, you need to consider how you can contribute to this process. I have shared a few ideas. Let us now work to build this sector so that it can help us to keep the financial system stable.