Pension Reform and Political Risk

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“…the good news is that defined-contribution pensions can readily be made compatible with labour mobility, fluid family structures, and internationalism. The bad news is that the individual faces more risk than under a defined-benefit scheme.” (Barr 2001).

Introduction

During the wave of pension reform that took place in Latin America during the 1990s, many argued that private, defined contribution pension plans would be better insulated from political manipulation than was the case with pay-as-you-go pensions (see Diamond and Valdés-Prieto 1994). Prior to recent reforms, state-run pension funds were often administered inefficiently and subject to political manipulation (Mesa-Lago 1978 and Borzutzky 2002). Proponents of private funded pensions argued that private funded systems would be both more efficient and equitable¹ (World Bank 1994). However as recent events in Argentina have demonstrated, transferring pension management and investment to the private sector does not necessarily eliminate the threat of political manipulation of pension funds.

This paper describes the range of political risks that systems featuring individual pension savings accounts face, with specific reference to Argentina, where political failure helped undermine the finances of the recently reformed pension system. The paper concludes that funded pension plans do not in fact reduce political risk because markets (and in turn, pension fund investment performance) are also subject to political risk as the Argentine case demonstrates.

Political Risk

Pension funds are subject to a several types of risks. Nicholas Barr (2002 p.5) describes a range of uncertainties that all pension programs are subject to, including macroeconomic shocks, demographic shocks, and political risk. He adds that funded pension programs are also subject to management risk, investment risk, and annuities market risk. Barr makes the distinction between risk, where the probability of potential outcomes is known or estimable, and uncertainty, where outcomes are neither known nor estimable.²

Political risk can be defined narrowly as the risk of ineffective governance with respect to pension funds, or more broadly as any government action (or inaction) that adversely affect the interests of pension fund account holders. For example, governments can fail to provide adequate supervision and regulation of funds, or they can initiate inflationary macroeconomic policies that erode the value of pension fund investments. More directly, governments can default on bonds that compose a significant portion of pension fund investment portfolios, or they can seize pension fund assets in order to finance government spending.

That pension funds remain subject to political risk and uncertainty should not come as too much of a surprise, because the same governments that have historically mismanaged their public PAYG systems are now called upon to effectively regulate

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¹ For a critique see Barr 2002, Orszag and Stiglitz 2001).
² While he uses the term “risk” when discussing politics, Barr classifies political risk as being uncertainty rather than risk (2002 p.5).
private pension funds and insure that funds will be adequate when individuals begin to retire under the new systems. Pension funds remain subject to political risk to the extent that governments fail to exercise these responsibilities.

Political risk is ameliorated to the extent that governments act as the guarantors of the new private pension systems. In the event that for any reason pension funds prove to be inadequate, pension fund regulations or political pressure is likely to compel governments to provide some form of protection to pensioners. In the case of Chile, the government will be responsible for topping up pensions for individuals who fail to accumulate sufficient funds to qualify for a minimum pension. In the case where such protections are not codified into law, it is still likely that governments will provide some form of compensation if pensioners experience severe losses. As Barr put it,

….the larger the share of the population with private pensions and the greater the fraction of pension income deriving from private sources, the greater the pressure on government in the face of disaster. If PAYG is argued to represent implicit debt, the analogous argument is that mandatory private pensions have an implicit state guarantee. (2002 p.20).

This paper examines the ways in which private pension funds are subject to political risk and uncertainty (which are lumped together given that some political risks are unknowable or inestimable), and uses the Argentine case to describe the risk and consequences of political failure. The paper describes how even after privatization, pension funds depend upon governments for prudent macroeconomic policy, supervision and regulation responsibilities, and for the issuance of securities that compose the bulk of pension fund portfolios. In the case of Argentina, pension funds were essentially used as a last resort source of financing after markets had abandoned Argentine government paper, even though prudent regulation would dictate that pensions funds should diversify exposure to risk. The paper concludes that political risk is present in a range of policy areas associated with funded pensions, and that privatization does not reduce such risk and uncertainty.

Privatization and Political Risk

One of the principal justifications for individual investment accounts is that the region’s state-run pay-as-you-go (PAYG) pension systems were traditionally subject to manipulation by politicians who placed political gain over financial logic in establishing benefits. In "young" PAYG systems where contributions from workers exceed payments to beneficiaries, politicians with short time horizons have an incentive to extend benefits regardless of the long-term costs, or to invest social security surpluses in projects with low financial returns but high political payoffs. For example, the first Juan Perón government in Argentina and the Getúlio Vargas government in Brazil expanded promised benefits and coverage at little cost since the bulk of the benefits would not be paid until the following decades. The same process took place under successive governments in Chile, which promised benefits to various subsets of workers in return for votes. This process resulted in a fragmented and deficit-ridden pension system that was difficult to reform given the strong support it received from beneficiaries (Borzutzky
As deficits in the PAYG systems mounted in the 1990s, several countries in the region adopted individually-capitalized pension plans that were inspired by Chile’s 1981 reform (see Kay and Kritzer 2001). Advocates of private pension funds argued that the new private systems would remove social security from the political arena because benefits would no longer depend on the decisions of politicians (Piñera 1999). As Acuña and Iglesias put it “The protection of mandatory social contributions from the risk represented by short-term politico-economic cycles thus became a central objective of the reform” (2001 p.9). In other words, a key advantage of privatization is that the role of the market would supplant the role of politics in determining pension benefits. This definition of political risk relies upon the assumption that after privatization, property rights will be inviolate and that privately managed pension funds will remain beyond the reach of government intervention.

Others were less optimistic about the impact of the reforms upon political risk. Beattie and McGillivray argued that "in a situation of financial adversity it is difficult to believe that government would not find a method of exerting control over the investments of these institutions" (1995 p.17). Kay (1998) argued that while private management would mean that governments would not have direct access to funds, it did not preclude the possibility of other forms of political manipulation (such as confiscation or the imposition of new taxes on pension funds). Orszag and Stiglitz (2001) asked why a government that administers public systems inefficiently would suddenly become efficient and honest when it came to private pensions. As is described in further detail below, these concerns were well founded as pension funds in Argentina (and elsewhere) were subject to political manipulation that threatened the fundamental health of the new funded pension system. The various risks discussed below are described as the risk of expropriation, governance risk, default risk, and inflation risk. The collapse of the Argentine pension system will be described with reference to these sets of risks.

Argentina: A Worst-Case scenario

Only 7 years after its creation, the Argentine economy, and by extension the pension system, entered into a severe financial crisis that remains unresolved. The origins of the financial crisis lie in part with the Convertibility plan, which linked the peso to the dollar at one-to-one parity. Convertibility provided the government with credibility that it would no longer engage in monetary expansion to finance deficits, a policy that had led to hyperinflation in the past. It was accompanied by a series of structural reforms, and led to an inflow of investment associated with privatization and trade liberalization. Privatizations enabled the government to run fiscal surpluses in 1992 and 1993, but in 1994 the fiscal deficit began to rise, and hit 55 percent of GDP in 2001 (up from 33 percent of GDP in 1991). As confidence in the government eroded in 2001 following a long recession and political crisis, the government turned to pension funds as a source of financing as part of a desperate (and ultimately unsuccessful) effort to stave off default and devaluation (for a summary of the collapse see Quispe-Agnoli and Kay 2002).

The origins of the Argentine crisis are complex, and certainly part of the blame can be placed on exogenous factors, such as Brazil’s 1999 devaluation which worsened the Argentine recession, or the strengthening of the U.S. dollar in the 1990s, which made
Argentine exports less competitive. The lack of fiscal restraint in Argentina in the 1990s aggravated the crisis (López Murphy 2002), as did a weak leadership that was unable to convince local and foreign investors that it could contain the crisis and turn things around. The chronology below summarizes the series of events that led to the collapse of the pension system.

Table 1: Select Chronology of the Argentine Social Security in Crisis

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>06/13/01</td>
<td>Finance Minister Cavallo announces cuts in worker social security contributions</td>
</tr>
<tr>
<td>07/29/01</td>
<td>Senate approves “Zero Deficit” bill – cuts pensions, salaries by 13%</td>
</tr>
<tr>
<td>09/21/01</td>
<td>Government postpones paying pensions to comply with fiscal target</td>
</tr>
<tr>
<td>09/23/01</td>
<td>Government pressures pension funds to accept a debt swap</td>
</tr>
<tr>
<td>10/24/01</td>
<td>Negotiations with government over debt swap paralyzed</td>
</tr>
<tr>
<td>11/01/01</td>
<td>Pension contributions drop from 11% to 5% of income</td>
</tr>
<tr>
<td>11/20/01</td>
<td>Govt. announces that it will not pay court-ordered pension adjustments</td>
</tr>
<tr>
<td>11/27/01</td>
<td>Pension funds reject govt. swap of $8 billion in provincial debt</td>
</tr>
<tr>
<td>12/01/01</td>
<td>Number of AFJP affiliates paying contributions drops to 29.5%</td>
</tr>
<tr>
<td>12/06/01</td>
<td>$3,1 billion of pension fund deposits expropriated - converted to Treasury Notes</td>
</tr>
<tr>
<td>12/27/01</td>
<td>Interim President Rodríguez Saá restores 13% pension/salary cut</td>
</tr>
<tr>
<td>01/03/02</td>
<td>Argentina defaults on international debt</td>
</tr>
<tr>
<td>01/05/02</td>
<td>President Duhalde announces intent to devalue the peso</td>
</tr>
<tr>
<td>02/07/02</td>
<td>Pension Funds protest pesification of bonds and dollar loans to govt</td>
</tr>
<tr>
<td>04/15/02</td>
<td>Number of pension fund contributors drops 26% from prior year</td>
</tr>
<tr>
<td>08/23/02</td>
<td>Supreme Court rules July 2001 13% pension cut unconstitutional</td>
</tr>
<tr>
<td>10/30/02</td>
<td>Worker contribution to be raised back to 11% by October 2003</td>
</tr>
<tr>
<td>12/13/02</td>
<td>Pension funds continue to demand redollarization of pesified assets</td>
</tr>
</tbody>
</table>

As discussed earlier, some analysts have suggested that privatization creates political insulation, which lessens the chances that social security will be subject to short-term budgetary considerations (Diamond and Valdés-Prieto 1994 p.307). This was clearly not the case in Argentina, where the government intervened in pension funds in a series of actions prior to the default and devaluation of January 2002 in an attempt to reverse the deteriorating economic and financial climate. The government first cut mandatory contributions to pension funds in an effort to raise salaries and stimulate the economy. It then cut pension benefits by 13 percent and halted court-ordered pension adjustments in an effort to improve deteriorating fiscal accounts. Next, the government pressured pension funds to accept a debt swap in an attempt to address its short and medium term financing needs. When these measures proved to be insufficient, and the market had no alternative sources of financing, the government expropriated pension funds by forcibly converting deposits to treasury notes.

After the default and devaluation in January 2002, the value of pension fund investments plummeted as government dollar-denominated debt was converted to pesos, and the government defaulted on its debt payments. Pension funds continue to demand the redollarization of their holdings, and like other bondholders, still await renegotiation with the government. The government does not want to address the issue of redollarizing the forced loans until after it has renegotiated its debt, since any compromise with the
pension funds could be used as leverage by Argentina’s creditors in future negotiations.

The Range of Political Risks Associated With Pensions

Four distinct types of political risk are described below. As we have seen, pensions can be seized outright by governments desperate for financing (expropriation risk). Funds are also at risk when governments provide inadequate supervision and regulation of the pension system. Systems of individual pension savings accounts require a host of government regulation to insure prudent investment policies, as well as government action to insure compliance by workers and firms. All of this can be termed governance risk. Furthermore, pension funds are subject to default risk since pension funds tend to be heavily invested in government bonds, and governments might default on their payments. Finally, there is the risk of inflation, which is in part a political risk because only governments are capable of insuring pension funds against the risk of inflation through issuing inflation-indexed bonds (Barr 1987).

Risk of Expropriation. During crises, governments may elect to seize pension funds (of course a corrupt leadership could choose to seize assets at any time). This is precisely what happened in Argentina when it was closed out of the international bond markets in 2001. The government reacted by forcing pension funds to accept a debt swap that prolonged maturities and paid lower interest. Pension fund managers complained that the government was forcing it to act against the best interests of their clients because they would be forced to accept lower overall returns (Clarín 2001). Negotiations with the pension funds bogged down, and in December 2001, just prior to the default, the government ordered pension funds to transfer $2.3 billion to the national treasury in exchange for treasury bills (which raised total investments in government paper to 70%).

Table 2: Percentage of Pension Fund Investments in Government Paper (year-end)

<table>
<thead>
<tr>
<th>Year</th>
<th>Investment Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>53.5</td>
</tr>
<tr>
<td>1996</td>
<td>52.7</td>
</tr>
<tr>
<td>1997</td>
<td>53.3</td>
</tr>
<tr>
<td>1998</td>
<td>50</td>
</tr>
<tr>
<td>1999</td>
<td>52.3</td>
</tr>
<tr>
<td>2000</td>
<td>54.6</td>
</tr>
<tr>
<td>2001</td>
<td>70</td>
</tr>
<tr>
<td>2002</td>
<td>76.7</td>
</tr>
</tbody>
</table>

Source: SAFJP web site (www.safjp.gov.ar)

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3 There are precedents in the region for seizing assets during crises. For example, prior to the recent Argentine crisis, the government had frozen savings in 1989. Brazil’s president Fernando Collor froze bank accounts upon taking office in 1990.
Yet governments may also seize pension assets even without a broad crisis, as was the case recently in Bolivia. In the mid-1970s, Bolivian President Gonzalo Sanchez de Lozada promised pensioners an annual payment called the *bonosol* for all citizens 65 and older, which was to be funded with the receipts from the privatization of state-owned firms. In 1997, an average of $248 per person was paid out. However as the value of the shares of the firms used to fund the benefit fell during the next administration, the *bonosol* shrank. When running again for office in 2002 Sanchez de Lozada promised to expand the benefit to $240 per person, and after winning, passed a new law which forces the pension funds to purchase the government’s shares in the former state-owned firms in order to fund the *bonosol*. Workers’ pension funds had been netting nominal returns of 17 percent in local currency while the stock portfolio that the pension funds were forced to purchase to fund the *bonosol* had returns that never exceeded 4 percent. Bolivia’s two private pension fund companies objected that the forced purchase was an expropriation, but the government went ahead with the plan.

These are examples of how governments may at times be unable to resist the temptation to violate property rights and seize pension funds. In the case of the Argentine pension funds, the forced loans were converted from dollars to pesos, so unless the loans are redollarized, all payment will be made in devalued pesos.

*Governance risk* refers to the degree to which governments provide effective supervision and regulation of the pension system. This refers not only to the pension funds themselves, but also to the overall functioning of the pension system, which includes enforcing compliance among workers and providing subsidies and guarantees when necessary (Mesa-Lago 2002 p.1318).

The main purpose of social security is to maintain income levels when individuals can no longer work. There is general agreement that compulsory social security is necessary to ensure income due to shortsightedness, inadequate savings mechanisms, or inability to save. The efficiency argument for compulsory social security is that uninsured losses would otherwise impose losses upon others (Barr 1987 p.191). Therefore one of the basic functions of government with respect to social security is to compel individuals to participate in the social security system.

The large informal sector in Latin America (approximately half of the labor force) means that a significant portion of the labor market is outside government jurisdiction. However, evasion is also high in the formal sector, where enforcement of labor laws is lax. Workers and employers have an incentive to collude in underreporting wages if both parties share the gains from avoiding taxes. A poor economy will also lead to a drop in contributions as employment levels erode. Finally, workers may face disincentives to comply that are built into a program. For example, in the Chilean case, workers need to contribute for twenty years in order to qualify for a subsidized minimum pension. Low-income workers have no incentive to contribute beyond the 20-year minimum requirement.
The above chart measures the extent to which individuals affiliated with private pension funds in Argentina contributed to pension funds as the economic crisis deteriorated. In January 2001, 41 percent of contributors were making regular contributions to their pension funds, however this figure dropped to 29 percent in November 2001 as the recession worsened. The ratio of contributors to affiliates increased to 33 percent by the end of 2002. Essentially these numbers indicate that only 1 of 3 people who have signed up with a pension fund are making contributions to private pension funds. These 3 million people, along with approximately 700,000 who have remained in the old state-run system, mean that only about 25 percent of the Argentine labor force of approximately 14 million are covered by social security. In this sense, government has failed to compel a majority of workers to participate in the social security system.

For private funded systems to function well, they must also be well-regulated by supervisory institutions that can insure that management and investment guidelines are followed, and that poorly performing pension funds are properly sanctioned. For example in Chile, government regulations require private pension funds known as AFPs to have a rate of return not 2% lower than the average rate of return of the other AFPs over a 12 month period (or less than half the return of the others, whichever is lowest). Firms that fail to meet these requirements are subject to takeover by the state. Similar regulations exist in Argentina and Uruguay. For example in Chile, government regulations require private pension funds known as AFPs to have a rate of return not 2% lower than the average rate of return of the other AFPs over a 12 month period (or less than half the return of the others, whichever is lowest). Firms that fail to meet these requirements are subject to takeover by the state. Similar regulations exist in Argentina and Uruguay.
investment-grade paper, and limits are put in place to promote diversification. Regulatory institutions must be staffed by well-trained professionals and every effort must be made to avoid corruption. In short, countries with a less than stellar public administration record – a record which would in part drive them to privatize – are now expected to achieve similar success in regulating pension funds (see Isuani, Rofman, and San Martino 1996 p.100).

Pension funds based upon individual capitalization create a supply of new capital that is expected to lead to the development of a domestic capital market. However creating a steady source of investment capital alone is not sufficient to create a new capital market. As Barrientos (1998 p.143) notes, “it is only the combination of pension reform, privatization of public utilities, and effective regulation, against the background of very favorable macroeconomic conditions, that can explain the rapid development of capital markets in Chile.” However, all of the region’s financial markets (including Chile’s) suffer from a lack of diversification in investment-grade instruments and the dominance of government-issued paper (Uthoff 1997).

It was originally hoped that pension funds would stimulate the creation of capital markets (Saavedra 2002). In Argentina pension reform was intended to create capital markets that would benefit local firms, however, cheaper sources of financing were available elsewhere, leaving pension funds without many investment-grade options for diversification (interview with Riavitz 2002). Firms with high credit ratings found it cheaper to borrow funds from banks, either domestically or from abroad, than to rely upon capital markets to raise funds. Meanwhile, investment in non-investment grade rated firms was off-limits.

Furthermore, in Chile pension funds came into existence prior to massive government privatizations, so investments in former state-owned firms were attractive and profitable investments. In contrast, in Argentina, many large state-owned firms were sold off prior to pension reform. Finally, Chile developed instruments that allowed for investment in the housing market. In Argentina, high levels of bank liquidity gave banks less of an incentive to securitize lending. Banks in Argentina did create new investment instruments for the pension fund markets, including “Fideicomisos Estructurados”. These investments proved to be highly profitable banks, but there was little demand for them for investors besides the AFJPs themselves.

Diversification is important in order to ameliorate investment risk. The most effective way to diversify is to permit pension fund investment abroad. However for political reasons, such investments are very unpopular because of the sentiment that investment should be directed to pressing national priorities. In Chile, no investment abroad was permitted in the early years of the new system, but has grown since the mid-1980s, and in March 2004 the ceiling on foreign investment will be raised from 25 to 30 percent. In December 2001, 1.84 percent of Argentine pension fund investments were in foreign securities. However after the devaluation, the total investment in foreign instruments had grown to 8.73 percent. In May of 2002 Mexican pension funds had 86 percent of its investments in government bonds. In the wake of the Argentine crisis, Mexican regulators will now encourage diversification by permitting pension fund

half the return of the others, whichever is lowest). Firms that fail to meet these requirements are subject to takeover by the state. Similar regulations exist in Argentina and Uruguay.
investment in a new range of corporate-issued securities, and it will permit foreign investment (eventually allowing up to 20 percent of assets to be invested abroad). The President of Uruguay’s largest pension fund recently asked for regulators to consider allowing foreign investment there as well (Búsqueda 2003). The lesson from this is that diversification abroad is essential to prudent regulation, however political sentiment against foreign investment can inhibit such measures. The Argentine crisis – with its clear lessons about the dangers of over-reliance on corporate bonds - provided Mexican authorities with an opportunity to enact regulations promoting diversification.

**Default Risk.** Defaulting on government obligations is another way for governments to seize assets. Default is a political risk to the extent that poor policy decisions or poor leadership (often in conjunction with a domestic or international shock) may lead to a government default.

If a government defaults on its financial obligations, it faces a clear conflict of interest when it comes to restructuring debt held by pension funds. As a debtor, the government has a clear interest to arrive at terms that will enable it to reschedule its obligations while at the same time ensuring that it can meet its ongoing financial obligations. Governments in default have an incentive to ask for terms that are generous enough to allow this. However, pension fund administrators have an incentive to reach a deal that comes as close to full repayment as possible. Governments also have an obligation to enact policies seek to protect the pensions of retired persons, which means that regulations require pension fund administrators to pursue policies that safeguard pension fund investments. In this case, the pensions fund interest in maximizing the value of their clients’ accounts conflicts with the government’s incentive to receive as generous a debt restructuring as possible.

Default can be considered a political risk since ineffective leadership can lower a country’s credibility, elevate country risk levels, and result in a loss of access to international capital. The loss of confidence in Argentina and its leadership can be measured by the widening of bond spreads in 2000 and 2001.
As is evident from the above chart, there is a strong correlation between the widening of sovereign bond spreads and political crisis in Argentina. There was an initial spike in country risk when Vice-president “Chacho” Alvarez resigned in October 2000, and yet another spike when Economy Minister Machinea resigned in March 2001. Bond spreads spiked again in April 2001 when the new Economy Minister Domingo Cavallo proposed changing the convertibility law to link the peso to both the dollar and the euro. Cavallo’s euro proposal spooked the financial markets because it implied tinkering with convertibility. Since the convertibility plan rested on the premise that the link between the dollar and peso was sacrosanct, the unexpected proposal (in the midst of a financial crisis) to change convertibility at some unspecified future date only raised uncertainty (and the country risk premium). When the economy failed to revive and tax revenue fell, confidence continued to erode. The government initiated a debt swap, and then began work on a second debt swap, but when the IMF refused to provide additional funding in December 2001, the fate of convertibility was sealed. While Argentina faced a series of external shocks, including the appreciation of the dollar in the 1990s and the 1999 Brazilian devaluation, lack of confidence in country’s leadership contributed to a jump in country risk, which is reflected in widening bond spreads.

As discussed earlier, capital markets in Latin American countries are not very diversified and are dominated by government-issued paper, which constitute between 52 and 97 percent of government assets (Mesa-Lago 2002). With few investment-grade options to choose from and restrictions on investment abroad, pension funds have little choice other than to invest in government bonds (Uthoff 1997). This places pension funds at great risk if the government defaults on its obligations. At the time of the default in January 2002, 80% of Argentine pension fund investments were in government paper. While debt renegotiation has yet to take place, as will be described below, pension funds face the possibility of significant financial losses.

The recent debacle in Argentina illustrates just how the conflict between...
government interests as a debtor, and government obligations to protect pensioners can come into conflict. As discussed earlier, the government defaulted on its debt, devalued its currency, and then converted dollar-denominated obligations into pesos. The status of the defaulted debt has yet to be determined – the current government has left the task of debt renegotiation to the next government. These negotiations will determine the ultimate fate of the defaulted bonds.

The conflict over the funds that were confiscated by the government in November 2001 is more clear-cut. The government seized pension fund deposits and converted them to guaranteed loans. The loans were then pesified at the below-market rate of 1.4 pesos to the dollar and then indexed to inflation (in late February 2003 the peso was trading at 3.2 pesos to the dollar). Pension funds have sued the government to redollarize the loans, arguing that both the forced loans and their pesification were illegal. The government position is reportedly sympathetic, but that granting such concessions would hurt Argentina’s position in front of international creditors (interview with Saumell 2002).

**Inflation.** The final political risk, which threatens funded systems more than PAYG systems, is inflation. Inflation can be driven by external shocks, however monetary and fiscal policy will also have a direct impact on the inflation rate. Monetary and fiscal policies are also driven in part by political considerations. Inflation is more of a threat in countries like Argentina and Brazil with relatively underdeveloped capital markets (see Barr 1994 p.217). Government economic policies resulted in high or hyperinflation in Argentina and Brazil in the 1980s and 1990s, and inflation poses a constant risk to funded pension plans. Public PAYG systems can better resist inflation if taxes and benefits are indexed.

Only government is capable of insuring against inflation through prudent fiscal policy and the issuing of government-indexed bonds, the only inflation-proof financial instruments (Barr 1992). The risk of inflation is uninsurable (it is not an independent risk that can be pooled) providing an efficiency argument for government guarantees (Barr 1987 p.214). For example, in the Chilean system, the only government guarantees against inflation are provided for life annuities that can be purchased upon retirement. Until workers purchase annuities they are exposed to the risk that a market downturn or inflation could diminish their capital just when it is needed to purchase an annuity. In short, inflation is a political risk to the extent that government economic policies affect price stability and to the extent that governments provide instruments to safeguard pensions against the impact of inflation.

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*Upon retirement, the contributor may use accumulated pension funds to purchase a lifetime annuity which guarantees a monthly lifetime benefit that is required to be indexed against inflation. In order to keep this guarantee, insurance companies invest in government indexed bonds. Pensioners can also elect to receive a programmed pension paid directly by the *AFP* based on the accumulated funds in an amount that is reassessed every year based on *AFP* performance. These funds are only indexed between assessments (the benefits for that year are indexed). Pensioners now have the option to draw on a programmed pension for a number of years and then purchase an annuity.*
Conclusion: Political Risk and Uncertainty Remain Pervasive

During debates over social security reform in the 1990s, proponents of individual defined-contribution accounts argued that political risk would be reduced under such a system. Critics pointed out that political risk would still be present even after privatization. The current crisis in the Argentine pension system exemplifies why political risk does not diminish under systems of individual accounts. As Nicholas Barr (2002) points out, all pension systems face political risks because all pension schemes depend upon effective government. In the case of Latin America, ineffective government was a primary argument for privatization. Yet as we have witnessed, private pension funds have been subject to expropriation, poor governance, default, and the risk of inflation. As has been discussed in this paper, all of these risks have a political dimension.

In this respect, the arguments that placing pension funds in the hands of private administrators reduces political risk do not take into consider the full range of political risks. Political risk entails more than politicians doling out overly generous pension benefits to loyal supporters. Political risk includes the possibility that the government may seize pension funds in a crisis, or that government supervision and regulation of pension funds and capital markets might be inadequate, or that weak worker and employer compliance may lead to evasion. As the Argentine case demonstrates, political risk and uncertainty is a real threat to pension funds, and can have a potentially devastating impact on returns and benefit levels.\(^7\) Any assessment of pension reform must take into consider the redistribution of risk that is an inherent component of recent pension reforms in the region.

\(^7\) Salomon Smith Barney (2002) cut its projection of pension fund capital in the year 2015 by 62% after the default and devaluation
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