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The financial industry in a still young emerging economy:
Demographic and other long-term trends in Brazil

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Introduction

1. Good morning, ladies and gentlemen, it is a pleasure to be here and to address this distinguished audience. My special thanks to the IMC Secretariat for having invited me, and especially to Sir John Bond, President of the Conference.
2. My role in this panel is to bring you some elements of the very singular experience of my country, Brazil, in the field of the relationship between demographics and the financial services industry. In Brazil, the issue of ageing population has been mixed with several others – all pertaining to the domain of fiscal sustainability – already overcrowding the country's reform agenda. It would be nice if we had plenty of time to address the problems created by ageing, notably in the field of pensions. Indeed, the comparative analysis of the pensions problem in Brazil and other OECD countries would indeed suggest that our problem is considerably smaller. Even though Brazil's age profile would reach OECD's average only in 40 or 50 years, considerable urgency has been given to the issue in view of its wide implications to fiscal equilibrium.
3. What follows put the Brazilian pensions problem into perspective and lay down the basic demographic trends in order to offer insights into the financial services industry under these circumstances.

Facts

4. Recently released census results of 2000 Brazil's population show a total of 169.8 Million, growing less than 2%, with approximately 57 Million under 15 and 14.5 Million (8.56%) over 60. Working population estimated at 79.3 Million out of around 100 Million at working age. A continuous slowdown in growth is expected in view of: (i) fertility rates falling from 3.3 in 1985 to 2.18 today (long term projections are this to stabilize at 2.1); (ii) life expectancy increased to 68.5 today from 64 in 1985, still to increase to OECD levels (70-74); (iii) child mortality was reduced to 32.7 per 1000 in 2000 from 65 in 1985.
5. Other important facts: (i) medical science progress affect the young and the old, an reduction in child mortality works just like an increase in fertility and an expansion in life expectancy works towards increasing the share of the elderly in total population; (ii) the issue is not only the advancement of science frontier but access to it to underprivileged in Brazil; (iii) long term IBGE projections show an age profile for 2030 such as 15- with 21.5%, 15-59 with 62.4% and **60+** with 16.1% (25% dependency). In 2050 these percentages should move to 20.0%, 58.0% and 22.0% (38% dependency ratio); (iv) only sometime between 2030 and 2050 Brazil is expected to have the elderly on proportions similar to those of OECD countries in the 1990s!
6. According to UN projections (reported in the G-10 study, see below) for 2050 the "dependency ratio" (population **65+** divided by 15-64 group will reach 28.9% (18.2% in 2030) in Brazil. It would be 42.6% for the G-10 (37.8% in 2030).

7. It is argued the, in many OECD countries with aging populations the present value of the public pension liability would be the equivalent to 60% to 100% of GDP. This is also true to Brazil even though the proportion of population over 60 in such countries is 2.5 times higher than in Brazil now. Hard conclusion: there is something highly dysfunctional in the Brazilian public pensions landscape. Maybe a feature of young economies facing the first signs of aging, combined with excess demand for savings (debt prone society), as natural in emerging economies, and also, to some degree, some populist leanings and mismanagement.

8. In emerging economies like Brazil, in contrast to mature economies, demographic factors are not the only influence to the size and scope of the financial services industry, as argued later in this summary.

Established wisdom on pensions

9. Pensions have received a great deal of attention in emerging economies, from academia and governments in the last decade, after the landmark World Development Report study in 1994 on the issue of the economic consequences of population ageing, whose language was somewhat appealing: "Averting the Old Age Crisis" was the title. Shortly after, also voicing similar concerns, the G-10 Denver Summit in 1997, proposed a study, completed in 1998, on the "Macroeconomic and financial implications of ageing populations". The study emphasized that "Currently, there are about 2 people aged 65 and older for every 10 people aged 15-64 in the G-10 countries. By 2040, this ratio is projected to reach 4 to 10 on average and more than 5 to 10 in some countries". Furthermore, "Decreases in labor force participation rates associated with projected demographic trends alone would depress the growth of GDP by as much as ½ to 1 percentage point per year in many of the G-10 countries between 2010 and 2030".

10. More recently, the 1994 World Bank study was revisited in a 2001 volume edited, and partly written by, Robert Holzman and Joseph Stiglitz ("New Ideas about Old Age Security: towards sustainable pension systems in the 21st century"). Several attempts at reforming pension systems world wide, plus further developments in demographics, all made interesting to revisit the issue and examine attempts at pension reform during these years.

11. The 1994 World Bank study, as the 1998 G-10 Study, both had as motivations: ageing, pensions and (mis) management, both to be found in varying degrees in developing and developed countries. The WB study indeed created a "benchmark" (its inspiration was academic literature on optimal pensions) not a formula to be applied everywhere, as later recognized both by the 2001 study and the WB practice, based on a "three pillar approach": (i) a mandatory PAYG, redistributive, tax financed first pillar; (ii) a mandatory "occupational", fully funded, defined contribution, privately managed though highly regulated second pillar, with these two systems dividing the burden of offering health care, disability and unemployment insurance; and (iii) a voluntary, privately offered "third pillar".

12. Implementation proved difficult as inherited features and existing obligations could not be simply overridden. The 2001 study revised many of earlier criticisms on PAYG systems and also found new unpleasant features in fully funded defined contribution systems and especially in the transition from defined benefit systems. Politics and the complexity of inherited institutions were ultimately at the root of such problems.

Brazilian realities

13. Before we get into the pensions problem in Brazil it is useful to lay a few basic facts about the labor market. As of 2000, the working population was of 79.3 Million, of which 71.7 Million were "occupied" (10.6% minus the ones unoccupied for less than 4 months, 6.7% unemployed). The occupation is distributed as follows: (i) the "employed", or the so-called "formal" employment, are 36.8 Million or 46.4%; (ii) the "autonomous" are 16.6 Million (20.9%); (iii) the employers are 2.9 Million (3.4%); and (iv) the "domestic" and other are 15.3 Million (20.0%).

14. It goes without saying that structure of occupation, in the presence of high "informality", is tantamount to capacity to sustain (with contributions) any pensions' system. We start with a population at working age of nearly 100 Million that, with a participation rate of 80%, result in a working population of 79,3 Million. But with since only approximately half that number is of contributors to the pensions' system, the "effective" dependency ratio is actually twice what it appears, thanks to informality. Thus, addressing labor laws is an important part of solving the pensions problem.

15. The Brazilian pensions landscape comprises 5 elements worth observing separately: (i) INSS (the National Institute for Social Security), the mandatory PAYG, redistributive, tax financed, providing entitlement to public health care; (ii) the PAYG public employees system; (iii) the pension funds; (iv) the voluntary "open" retirement plans with myriad features; and (v) the public "forced savings" schemes (known by their acronyms FGTS[1] and FAT[2] funds) designed to address job security and unemployment.

16. Strictly speaking (i) and (ii) compose the World Bank "first pillar", pension funds and retirement plans are more like the "third pillar", insofar they are voluntary arrangements. The mandatory "second pillar" is not geared at old age security but job security as offered by FGTS in individual accounts; it is a surrogate but not the same thing. One wonder how useful it could be if both systems were merged.

17. In fact, FGTS and FAT have always been seen more as "forced savings" to be deployed as development finance, in the form of subsidized lending by BNDES (The National Economic and Social Development Bank) and CEF (the national mortgage bank); their mentioning here is very much because they draw their financing from sources traditionally tapped for pensions financing and use the resources intensively for other public policy objectives.

The "first pillar" (1): the private sector workers

18. The INSS, in the year 2000, had revenues of R$ 59.5 Billion and expenditures of R$ 77.1 Billion (7.3% of GDP), with a deficit of R$ 17.6 Billion equivalent to 1.5% of GDP. Revenues are mostly collected by firms (84%) referring to a wage bill composed of 27.2 Million workers (the true contributors); i. e. this being the collection coming form the "formal" employment segment of the labor market. Approximately 6.4 Million "autonomous" contributors from "informal" labor relations provide additional R$ 2.8 Billion in revenues. The INSS has, therefore, 33.6 Million contributors to sustain approximately 19.8 Million receiving pensions, 13 Million of whom receiving the "minimum wage" (approximately US$ 90.0 per month).

19. It seems clear that "informality" subtracts much more contributors from INSS than unemployment. One has to inquiry on the causes of "informality" and there is no

explanation other than excessive costs involved in "formal" labor relations, as opposed to "informal". Labor Courts plus the contributions to FGTS and FAT, among other disguised forms of taxation of labor costs, are very expensive to corporations.

20. To make matters worse, INSS is also subject to obligations (such as disability insurance, poverty alleviation programs) that should belong in the budget. It is true that, even in the World Bank model, one considers "redistributive" mechanisms in the "first pillar", so that the presence of such programs should not be that much of a problem. Indeed, even with such obligations, in view of Brazil's age profile, INSS should be producing surpluses, so as, for instance, to finance health care, as it was the case in the mid 1980s.

21. It is interesting to reflect a bit on how and why Brazil used the INSS notional surplus. No question, generosity as regards benefits, the entitlements and minimum retirement age definitively were crucial factors especially after the 1988 Constitution. In this respect Brazil is no different than other countries with distressed PAYG pension systems. What is uniquely Brazilian is the indirect though painful way through which development finance was materialized through mechanisms like FGTS and FAT whose collateral damage was labor "informality" and a blow into the base of contributors to the pensions system. As they stand, FGTS and FAT are "competitors" to the INSS insofar they tap the same resource base, though they are also "complements" to the extent they pretend to offer similar benefits. It is indeed interesting to consider collapsing these systems into one, brand new, bound to be the Brazilian version of the missing "Second Pillar", i. e. a mandatory, fully funded, "retirement with features" plan, based on individual accounts and, more importantly, with management chosen by savers. This reform should be at the top of priorities of the next president to be empowered in 2003.

The "first pillar" (2): the public sector workers

22. The landscape as regards public employees is a true disaster. Estimates for 2002 are of 4.5 Million such workers in active service to produce contributions of around R$ 10 Billion while expenditure with the less than 2 Million pensioners is expected to reach R$ 54 Billion; thus an astonishing deficit of R$ 43.3% Billion, or 4.5% of GDP.

23. The comparison of numbers of the two components of the "first pillar" is a sad picture of income redistribution upside down: 2.0 Million pensioners of the public sector cost R$ 54 Billion, while 20 Million pensioners at the private sector cost R$ 77 Billion. As aptly put by Amadeo, "the per capita deficit at INSS is R$ 565 and of R$ 21,700 at the federal public service [respectively US$ 226 and US$ 8,680 per capita on an annual basis]. These are the values of the subsidies that the Brazilian society pays to the individual beneficiaries of both sub-systems".

24. Absurd as it may appear, the issue of "grandfather rights" had blocked changes in courts of law (judges are not unrelated parties to these cases!). In any event, it is true for Brazil that capitalizing the public pension liability would imply an increase in domestic debt surely larger than one entire GDP, not to mention the coordination difficulties in joining together the Federal Government, 27 states and more than 8,000 municipalities.

Pension funds and retirement plans

25. Pension funds and privately offered retirement plans are growing industries in Brazil. The initial impulse to the former came from state enterprises. Of 360 pension funds

with R$ 127.7 Billion in assets (11.3% of GDP) in the year 2000, 87 are sponsored by such enterprises though with roughly 2/3 of the assets. Total population covered is 6.5 Million. Open retirement plans have assets of R$ 11 Billion with 1.6 Million people covered.

26. Even first generation state enterprises' sponsored pension funds are moving into the defined contribution model. Moral hazard had been a key problem generating mismanagement and political interference. Privatized enterprises helped changing the industry for the better (of 123 privatized enterprises in the last 10 years, a similar number of pension funds moves also to private sponsorship and, usually, defined contribution mode); pension funds today are at the forefront of corporate governance activism and capital markets development.

27. "Funding" of PAYG systems, as well as pension funds' development, should come hand in hand with capital markets' and financial markets development in every sense. Sound regulatory framework is crucial, especially in view of past developments in Brazil.

The market for financial services

28. Along with demographics, inequality and continued macroeconomic disequilibria were important elements to set boundaries to the financial services industry. In a 1995 McKinsey Global Institute study it was shown that the "bankable population" in Brazil was between 20% and 23% of the total, even if adding a 9% to 12% "semi-bankable" group, the "non-bankable" reach something between 65% to 81% of the population, against something between 20% to 25% in the USA, The Netherlands and Korea. Age and income are the key factors here, and very clearly Brazil has a huge growth potential as we converge to proportions of "bankable population" seen elsewhere..

29. The long years under high inflation "specialized" financial intermediaries in defending economic agents from inflation, partnering with government in the collection of the "inflation tax" and manufacturing indexation synthetics and derivatives. As % to GDP bank credit reaches only 27% as late as 2000, after the removal of several "financial repression" instruments and a phenomenal increase in consumer credit, factoring and credit card transactions following the onset of stabilization. It is 36% in Mexico, 66% in Chile, 82% in the US, 124% in Spain.

30. Brazil still lives a classic "crowding out" plus financial repression situation, thus maintaining an overly high real rate of interest combined with an domestic public debt both large and with a very short duration. This environment is hostile to capital markets' products and services (stocks, mortgages, insurance, everything with a long horizon); the government finance bias continues, for the time being, in ways strangely similar to those of the high inflation years.

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[1] FGTS – *Fundo de Garantia de Tempo de Serviço,* is a job security fund formed of contributions directly levied on companies with "formal" employers at the rate of 8% of their total wage bill. Funds are deposited in individual accounts in favor of workers and can be withdrawn in cases of unjustified lay-off, home financing and retirement. FGTS is managed by CEF (*Caixa Econômica Federal)* the state owned national mortgage bank, which charges a 2% management fee and remunerates the resources at TR (time deposits' based referential rate, less a "reduction factor") plus 3%.

[2] FAT – *Fundo de Amparo ao Trabalhador,* is a fund formed by the collection of a contribution levied of every firms gross sales at the rate of 2,0%. The fund is designed to provide for extra income for low-income workers and for unemployment insurance. The fund is managed by BNDES, and similar to FGTS, FAT is paid a below-the-market interest rate allowing the fund to lend at subsidized rates without depleting BNDES capital.