Monetary Policy and Pension Systems in the EMU

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Scope

Several European countries with large accumulated pension assets (including the Netherlands, the United Kingdom, Ireland, Denmark) are concerned about the safety of these assets in an EMU in which most other countries finance their pension commitments on the basis of pay-as-you-go financing. Among other things, they fear that the latter group of countries, which supposedly have less of an interest in low inflation, may put pressure on the European Central Bank to relax monetary policy. This pressure may become particularly large if the budgetary costs associated with aging get out of hand. These impacts on monetary policy have implications for the design of pension systems (the trade-off between pay-as-you-go and funding) and the investment strategies of the pension funds (the trade-offs among nominal debt, indexed debt and equity).

Research Goals

This project investigates the interaction between countries with different pension systems (especially involving differences in the degree of funding) in a monetary union.

To that end, a multi-country dynamic general equilibrium model with overlapping generations, initial differences in accumulated pension assets, differences in pension systems and a common monetary policy is constructed.

The project can clarify conflicts of interest between countries and between different generations within a single country. As regards the international conflicts, with the ECB trading off stabilizing inflation and catering to the countries' fiscal needs, the equilibrium inflation rate will be a weighted average of the Euro-members' net nominal asset positions. Hence, if the European scene is dominated by some large, influential countries with pay-as-you-go pension systems and a large outstanding public debt (much of it held abroad), then there is serious danger that inflation erodes a substantial part of the accumulated nominal pension assets of other countries.

Extensions

In later years, this project will be extended to incorporate optimal investment decisions of the pension funds (in particular, the trade-off between equity and nominal bonds) aimed at reducing the exposure of pensioners to the relaxation of monetary policy. Moreover, if data availability on nominal asset holdings permits, the plan is to compute the net benefits to various European countries from a rise in inflation. This would help to assess the pressures that countries might put on the ECB to relax its monetary policy.