

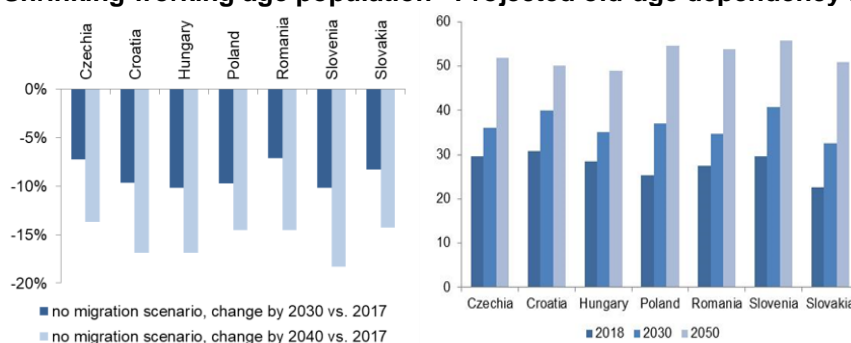
Downsizing of private pension pillar

Given the demographic challenges, reliance on the PAYG system implies lower benefits for pensioners, a need to increase social contributions or retirement age in the future. As a decision is needed in a matter for decades rather than immediately, the government is focused on maximizing current consumption through fiscal easing increasing contingent liabilities.

Katarzyna Rzentarzewska
 Senior Analyst, Macro/FI Research
katarzyna.rzentarzewska@erstegroup.com

The introduction of private pension schemes in the late 1990s and early 2000s was aimed at enhancing pension savings and reducing reliance on state pension schemes. Inflow of social contributions would fall short of financing a growing number of retirees in face of the shrinking working age population. In most cases, contributions to private pension funds were carved out from contributions to mandatory pension systems, frontloading the costs on expense of current fiscal balances. While the Pay As You Go system (PAYG) was kept alive, its role was to be reduced over time and the pension entitlements from the private pillar were supposed to replace part of the PAYG. The new scheme, with all its flaws, such as high management costs or portfolios inadequately adjusted to life cycle, was supposed to address the demographic challenge, be less prone to political intervention and assure high enough pension savings for future generations, as the old-age dependency ratio is expected to double within 30 years. In other words, in a few decades there will be twice as many elders per 100 working persons. Relying on the PAYG system would thus imply either lower benefits for pensioners (lower replacement ratio or indexation of pensions), higher social contributions paid by the working population, or increased retirement age.

Shrinking working age population Projected old-age dependency ratio

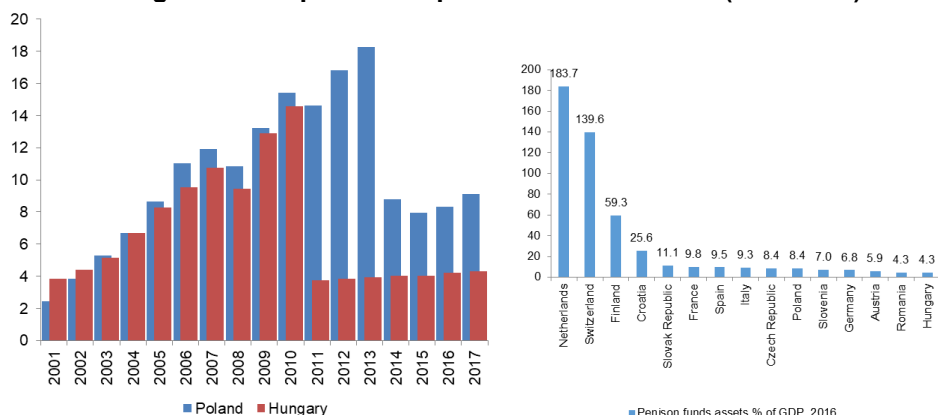


Source: Eurostat, Erste Group Research

The first country to introduce the private pension system, Hungary, was also the first to dismantle it in the aftermath of global financial crisis that exposed the Hungarian government to a difficult situation – a need to consolidate during the downturn. First, the global recession revealed the extreme sensitivity of pension funds to financial market volatility and exposure of the pension assets to the recent financial market performance. Further, the transition costs of the pension reform burdened public finances and the global recession only challenged their sustainability. Fiscal austerity and need for deficit reduction became an

excuse for governments to dismantle the private pension system.

Change and comparison of pension funds' assets (% of GDP)



Source: OECD, World Bank, Erste Group Research

In 2010, Hungary diverted the private pension funds contribution back to the state and seized the assets of pension funds. In Poland, the downsizing of the private pension pillar was carried out in a couple of steps. First, the government bonds held in portfolios of pension funds were transferred to PAYG and exchanged for inflation-linked deposit (unfunded) at virtual accounts in the social security system. Now, the rest of the funds held mostly in equity are to be transferred either to individual pension accounts at a 15% fee or to virtual accounts in the social security system. The most recent change serves the purpose of financing election induced fiscal stimulus that would otherwise put public finances under pressure. The drawback of this solution is that the government increases contingent liabilities which will be due at the most difficult time, when ageing-related costs will put enormous pressure on public finances.

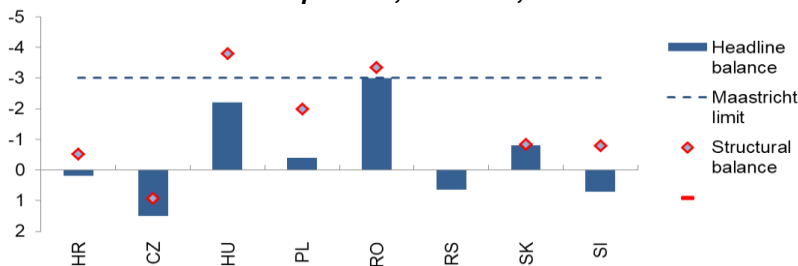
Box 1: How (not) to do fiscal easing

The fiscal stimulus in Romania (increase in public wages, VAT cuts) boosted the economy, but put the headline budget deficit just shy of 3% of GDP in 2017. The fiscal adjustments seem to be questions of 'when' and 'how', as Romania's public finances remain fragile. The risk of Romania exceeding the limit of 3% in 2018 and/or 2019 remain considerable. It would put Romania under the Excessive Deficit Procedure (it is currently under the Significant Deviation Procedure together with Hungary, due to high structural deficits).

Hungary is about to announce fiscal easing in the weeks to come. Despite a structural balance well above MTO, the headline deficit is visibly below the limit of 3%. Slovakia seems to be next in the "fiscal easing" line, with proposals to lower taxes, increase the minimum wage or extend maternity benefits. A significant deviation from MTO results in more severe consequences in the case of Slovakia, as a Eurozone member (even a 0.2% GDP penalty).

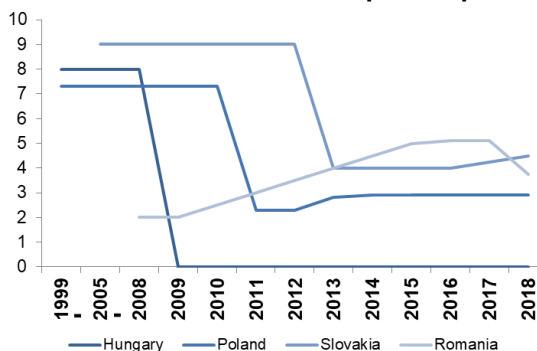
Due to the upcoming elections, Poland showed all its cards. Financing the generous fiscal package without breaching the 3% deficit limit was questionable until the government revealed plans to overhaul the pension system. Dissolving Open Pension Funds (along with improvement in collection of taxes and social contributions) will generate a budget surplus in 2020, according to the latest stability and convergence program. All in all, public finances should remain in good condition, with lower borrowing needs and a downward trend in public debt, at least in the short term.

Fiscal position, % of GDP, 2018



Source: Eurostat, AMECO, Erste Group Research

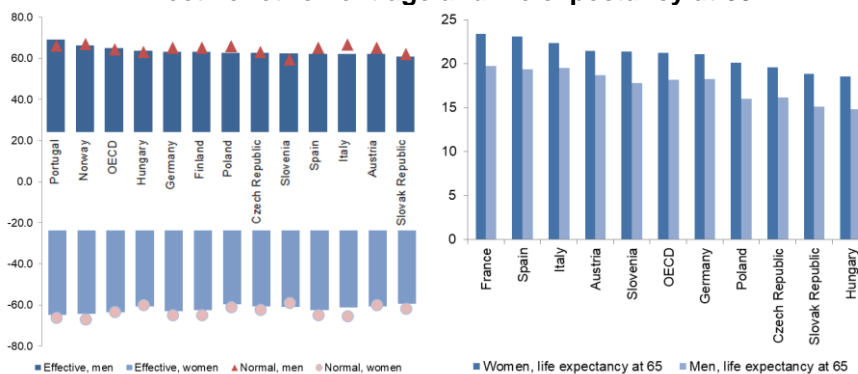
Development of contributions to the private pension system



Source: Erste Group Research

In Romania, the private pension system was introduced at a relatively late stage (2008). It is based on three pillars: PAYG, mandatory second pillar and voluntary third pillar. It underwent changes only recently, facing sector taxes, increase in capital requirements and capping the fees for pension funds or the possibility to invest in PPP. It also opened up the opportunity to leave the system. Slovakia has a similar structure for its pension system. Slovakia faced a reduction in contributions to pension funds, similar to those seen in Poland in the first phase but began to raise them in 2016, while in Romania contributions have been gradually growing until 2018. Moreover, as an aftermath of global financial crisis, regulations required the sale of almost the entire equity portfolio, which resulted in the booking of huge capital losses and cut off pension funds from being able to participate in the recovery of equities, as all funds had to be invested only in instruments with low volatility (fixed income products).

Effective retirement age and life expectancy at 65



Source: European Commission, AMECO, CSO, Erste Group Research

On top of that, there is an increasingly worrying trend in CEE to reduce or cap the retirement age, even while life expectancy is increasing. In most CEE countries, the effective retirement age is in any case lower than the legal one. Women already retire in their 60s, which leaves them with another 20 years of life as a pensioner. Men work only few years more and could expect another 15 years of life. Increasing life expectancy will lead to growing healthcare costs, especially as the share of the population over 65 will keep rising in the decades to come. While in Hungary and Slovakia the net pension replacement rate is relatively high, at above 80% of net earnings, in Poland the ratio has been halved.

Contacts

Group Research

Head of Group Research
Friedrich Mostböck, CEFA +43 (0)5 0100 11902

Major Markets & Credit Research

Head: Gudrun Egger, CEFA +43 (0)5 0100 11909
Ralf Burchert, CEFA (Agency Analyst) +43 (0)5 0100 16314
Hans Engel (Senior Analyst Global Equities) +43 (0)5 0100 19835
Margarita Grushanina (Economist AT, Quant Analyst) +43 (0)5 0100 11957
Peter Kaufmann, CFA (Corporate Bonds) +43 (0)5 0100 11183
Heiko Langer (Covered Bonds/Financials) +43 (0)5 0100 85509
Stephan Lingnau (Global Equities) +43 (0)5 0100 16574
Carmen Riefler-Kowarsch (Covered Bonds/Financials) +43 (0)5 0100 19632
Rainer Singer (Senior Economist Euro, US) +43 (0)5 0100 17331
Bernadett Povaszai-Römhild, CEFA (Corporate Bonds) +43 (0)5 0100 17203
Elena Statelov, CIIA (Corporate Bonds) +43 (0)5 0100 19641
Gerald Walek, CFA (Economist Euro, CHF) +43 (0)5 0100 16360

Macro/Fixed Income Research CEE

Head CEE: Juraj Kotian (Macro/FI) +43 (0)5 0100 17357
Zoltan Arokszallasi, CFA (Fixed income) +43 (0)5 0100 18781
Katarzyna Rzentarzewska (Fixed income) +43 (0)5 0100 17356
Malgorzata Krzywicka (Fixed income) +43 (0)5 0100 17338

CEE Equity Research

Head: Henning Eßkuchen +43 (0)5 0100 19634
Daniel Lion, CIIA (Technology, Ind. Goods&Services) +43 (0)5 0100 17420
Michael Marschallinger +43 (0)5 0100 17906
Christoph Schultes, MBA, CIIA (Real Estate) +43 (0)5 0100 11523
Vera Sutedja, CFA, MBA (Telecom, Steel) +43 (0)5 0100 11905
Thomas Unger, CFA (Banks, Insurance) +43 (0)5 0100 17344
Vladimira Urbankova, MBA (Pharma) +43 (0)5 0100 17343
Martina Valenta, MBA +43 (0)5 0100 11913

Editor Research CEE

Brett Aarons +420 956 711 014

Research Croatia/Serbia

Head: Mladen Dodig (Equity) +381 11 22 09178
Head: Alen Kovac (Fixed income) +385 72 37 1383
Anto Augustinovic (Equity) +385 72 37 2833
Mate Jelić (Fixed income) +385 72 37 1443
Magdalena Dolenc (Equity) +385 72 37 1407
Ivana Rogic (Fixed income) +385 72 37 2419
Davor Spoljar, CFA (Equity) +385 72 37 2825

Research Czech Republic

Head: David Navratil (Fixed income) +420 956 765 439
Head: Petr Bartek (Equity) +420 956 765 227
Jiri Polansky (Fixed income) +420 956 765 192
Michal Skorepa (Fixed income) +420 956 765 172
Jan Sumbera (Equity) +420 956 765 218
Jan Žemlička (Fixed income) +420 956 765 456

Research Hungary

Head: József Miró (Equity) +361 235 5131
András Nagy (Equity) +361 235 5132
Orsolya Nyeste (Fixed income) +361 268 4428
Zsombor Varga (Fixed income) +361 373 2830
Tamás Pletser, CFA (Oil&Gas) +361 235 5135

Research Poland

Director of Research: Tomasz Duda (Equity) +48 22 330 6253
Cezary Bernatek (Equity) +48 22 538 6256
Konrad Grygo (Equity) +48 22 330 6254
Mateusz Krupa (Equity) +48 22 330 6251
Michał Pilch (Equity) +48 22 330 6255
Emil Poplawski (Equity) +48 22 330 6252

Research Romania

Head: Horia Braun-Erdei +40 3735 10424
Caius Rapanu (Equity) +40 3735 10441
Eugen Sinca (Fixed income) +40 3735 10435
Dorina Ilasco (Fixed Income) +40 3735 10436

Research Slovakia

Head: Maria Valachyova, (Fixed income) +421 2 4862 4185
Katarina Muchova (Fixed income) +421 2 4862 4762

Research Turkey

Umut Cebir (Equity) +90 212 371 2537

Treasury – Erste Bank Vienna

Group Markets Retail Sales

Head: Christian Reiss +43 (0)5 0100 84012

Markets Retail Sales AT

Head: Markus Kaller +43 (0)5 0100 84239

Group Markets Execution

Head: Kurt Gerhold +43 (0)5 0100 84232

Retail & Sparkassen Sales

Head: Uwe Kolar +43 (0)5 0100 83214

Corporate Treasury Product Distribution AT

Head: Christian Skopek +43 (0)5 0100 84146

Fixed Income Institutional Sales

Institutional Distribution non CEE

Head: Jaromir Malak +43 (0)5 0100 84254
Karin Rattay +43 (0)5 0100 84118
Christian Kienesberger +43 (0)5 0100 84323
Bernd Bollhof +49 (0)30 8105800 5525
Rene Klasen +49 (0)30 8105800 5521
Christopher Lampe-Traupe +49 (0)30 8105800-5507
Charles-Henry La Coste de Fontenilles +43 (0)5 0100 84115
Bernd Thaler +43 (0)5 0100 84119

Bank Distribution

Head: Marc Friebertshäuser +49 (0)711 810400 5540
Sven Kienzle +49 (0)711 810400 5541
Michael Schmotz +43 (0)5 0100 85542
Ulrich Inhofner +43 (0)5 0100 85544
Klaus Vosseler +49 (0)711 810400 5560
Andreas Goll +49 (0)711 810400 5561
Mathias Gindale +49 (0)711 810400 5562

Institutional Distribution CEE

Head: Jaromir Malak +43 (0)5 0100 84254

Institutional Distribution PL and CIS

Pawel Kielek +48 22 538 6223
Michał Jarmakowicz +43 50100 85611

Institutional Distribution Slovakia

Head: Sarlota Sipulova +421 2 4862 5619
Monika Smelikova +421 2 4862 5629

Institutional Distribution Czech Republic

Head: Ondrej Cech +420 2 2499 5577
Milan Bartos +420 2 2499 5562
Barbara Suvadova +420 2 2499 5590

Institutional Asset Management Czech Republic

Head: Petr Holecek +420 956 765 453
Martin Perina +420 956 765 106
Petr Valenta +420 956 765 140
David Petracek +420 956 765 809
Blanca Weinerova +420 956 765 317

Institutional Distribution Croatia

Head: Antun Buric +385 (0)7237 2439
Zvonimir Tukač +385 (0)7237 1787
Natalija Zujic +385 (0)7237 1638

Institutional Distribution Hungary

Head: Peter Csizmadia +36 1 237 8211
Attila Hollo +36 1 237 8209
Gabor Balint +36 1 237 8205

Institutional Distribution Romania and Bulgaria

Head: Ciprian Mitu +43 (0)50100 85612
Crisitan Adascalita +40 373 516 531

Group Institutional Equity Sales

Head: Brigitte Zeitberger-Schmid +43 (0)50100 83123
Werner Fürst +43 (0)50100 83121
Josef Kerekes +43 (0)50100 83125
Cormac Lyden +43 (0)50100 83120

Business Support

Bettina Mahoric +43 (0)50100 86441

Disclaimer

This publication was prepared by Erste Group Bank AG or any of its consolidated subsidiaries (together with consolidated subsidiaries "Erste Group") independently and objectively as other information pursuant to the Circular of the Austrian Financial Market Authority regarding information including marketing communication pursuant to the Austrian Securities Supervision Act. This publication serves interested investors as additional source of information and provides general information, information about product features or macroeconomic information without emphasizing product selling marketing statements. This publication does not constitute marketing communication pursuant to Art. 36 (2) Austrian Securities Supervision Act as no direct buying incentives were included in this publication, which is of information character. This publication does not constitute investment research pursuant to § 36 (1) Austrian Securities Supervision Act. It has not been prepared in accordance with legal requirements designed to promote the independence of investment research and it is not subject to the prohibition on dealing ahead of the dissemination of investment research. The information only serves as non-binding and additional information and is based on the level of knowledge of the person in charge of drawing up the information on the respective date of its preparation. The content of the publication can be changed at any time without notice. This publication does not constitute or form part of, and should not be construed as, an offer, recommendation or invitation to subscribe for or purchase any securities, and neither this publication nor anything contained herein shall form the basis of or be relied on in connection with or act as an inducement to enter into any contract or inclusion of a security or financial product in a trading strategy. Information provided in this publication are based on publicly available sources which Erste Group considers as reliable, however, without verifying any such information by independent third persons. While all reasonable care has been taken to ensure that the facts stated herein are accurate and that the forecasts, opinions and expectations contained herein are fair and reasonable, Erste Group (including its representatives and employees) neither expressly nor tacitly makes any guarantee as to or assumes any liability for the up-to-dateness, completeness and correctness of the content of this publication. Erste Group may provide hyperlinks to websites of entities mentioned in this document, however the inclusion of a link does not imply that Erste Group endorses, recommends or approves any material on the linked page or accessible from it. Neither a company of Erste Group nor any of its respective managing directors, supervisory board members, executive board members, directors, officers or other employees shall be in any way liable for any costs, losses or damages (including subsequent damages, indirect damages and loss of profit) howsoever arising from the use of or reliance on this publication. Any opinion, estimate or projection expressed in this publication reflects the current judgment of the author(s) on the date of publication of this document and do not necessarily reflect the opinions of Erste Group. They are subject to change without prior notice. Erste Group has no obligation to update, modify or amend this publication or to otherwise notify a reader thereof in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate. The past performance of securities or financial instruments is not indicative for future results. No assurance can be given that any financial instrument or issuer described herein would yield favorable investment results or that particular price levels may be reached. Forecasts in this publication are based on assumptions which are supported by objective data. However, the used forecasts are not indicative for future performance of securities or financial instrument. Erste Group, its affiliates, principals or employees may have a long or short position or may transact in the financial instrument(s) referred to herein or may trade in such financial instruments with other customers on a principal basis. Erste Group may act as a market maker in the financial instruments or companies discussed herein and may also perform or seek to perform investment services for those companies. Erste Group may act upon or use the information or conclusion contained in this publication before it is distributed to other persons. This publication is subject to the copyright of Erste Group and may not be copied, distributed or partially or in total provided or transmitted to unauthorized recipients. By accepting this publication, a recipient hereof agrees to be bound by the foregoing limitations.

© Erste Group Bank AG 2019. All rights reserved.

Published by:

Erste Group Bank AG
Group Research
1100 Vienna, Austria, Am Belvedere 1
Head Office: Wien
Commercial Register No: FN 33209m
Commercial Court of Vienna

Erste Group Homepage: www.erstegroup.com