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Why should the portfolios of mandatory, private pension funds be captive? (The foreign investment question)

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Abstract

A model of portfolio optimization, which takes account of the difference between the private and social cost of foreign investment, is used to analyze the relationship between capital shortages and the international diversification of mandatory, private pension funds in developing and transition countries. The socially optimal rate of foreign portfolio investment may be positive, even when access to international capital markets is limited. I propose replacing investment limits with a tax on foreign investments, equal to the difference between their social and private cost. The use of international pension swap is seen to be formally equivalent to the imposition of such a tax.
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1. Introduction

Do balance of payments constraints justify the ceilings on foreign investment which regulatory authorities impose on mandatory, private pension funds in many developing and transition countries?

When returns on securities markets in different countries are less than perfectly correlated, international diversification can expand the risk–return frontier faced by investors everywhere. [1] However, in order to reap the benefits of diversification, investors must be able to move capital freely in and out of their home country. In developing and transition countries, widespread capital shortages may argue against unrestricted capital mobility. Indeed, the governments of many of the developing and transition countries, which have introduced mandatory private pension funds (MPPFs) during the last twenty years, have generally been motivated, in part, by the desire to increase the quantity and quality of domestic saving (The World Bank, 1994; Vittas, 1998, 2000; Impavido and Musalem, 2000). [2] This motivation may explain some of their reticence to allow the resulting domestic funds to export their capital.

Fontaine (1997) discusses the rationale for the foreign investment ceilings imposed by MPPF regulators in Chile. Reisen (1997a,b) looks also at regulatory foreign investment ceilings in OECD countries. Davis (2002) argues that foreign investment ceilings limit portfolio optimization, and simulates averages and standard deviations of real returns in ten OECD countries, 1970–1995, for different hypothetical degrees of international diversification. He discusses the resulting improvement in the risk-return frontier. This paper presents a simplified, formal model of portfolio optimization, which takes account of potential capital shortages.

The paper focuses on the distinction between the private and social cost of foreign portfolio investment. The private cost, to the beneficiaries of a domestic fund, of investing a given sum outside of their home country is simply the opportunity cost of not investing that sum at home. The cost to society is the cost of replacing the exported capital on international markets. If the country is fully integrated into international capital markets, which are, in turn, completely competitive, international lenders will provide credit to domestic firms at the same rate as domestic savers, and private and social costs will be equal. But, if capital markets are segmented, international lenders will charge more to domestic firms than domestic lenders, if they perceive the risk of domestic investment to be higher than domestic lenders do. In such a situation, the social cost of foreign investment will exceed the private cost. I will refer to that situation as one in which access to international capital markets is restricted.

In the model presented below, I explicitly derive the optimal degree of foreign diversification when access to international capital markets is restricted, and com-

[1] Lewis (1999), Reisen (2000) and Davis (2002).

[2] The Financial Sector Development Department of the World Bank has conducted numerous studies of the effects on previously under-developed capital markets of the introduction of MPPFs. See also Impavido et al. (2002) and Impavido et al. (2003).

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