

■ HIGHLIGHTS

Events

CERP 10TH ANNIVERSARY CONFERENCE ADDRESSES FINANCIAL CRISIS

The recent financial crisis calls into question the very grounds of pension reforms in Europe, in particular the risk diversification rationale for adding a private, funded pillar to the public one. Inadequate financial market performance and limited financial literacy among households fuel the temptation of “going back to the State”. But how far is a verdict of “failure” of the pension market justified?



The CeRP 10th Anniversary Conference, with the title “**Saving for Old Age in a Financial Turmoil: New Challenges for Households, Providers and Policy-makers**”, aims at addressing various issues

within this broad picture, on both a theoretical and a policy level.

The conference will take place on 24 -25 September 2009. **Mario Draghi**, Governor of the Bank of Italy, will held the second **Onorato Castellino Lecture** on September 24.

A call for papers has been recently launched, inviting submissions on issues related to: retirement savings; risks and guarantees; pension funds performance and asset allocation; private pension provision and agency problems; labour markets and pension designs; saving and housing wealth; financial literacy.

<http://cerp.unito.it/events>

New book edited by Annamaria Lusardi **OVERCOMING THE SAVING SLUMP**

The great majority of working Americans are unprepared to face the difficult task of planning for retirement. In fact, the personal savings rate has been holding steady at zero for several years, down from 8 percent in the mid-1980s.

Overcoming the Saving Slump - released by the University of Chicago Press in January 2009 - explores the many challenges facing workers in the transition from a traditional defined benefit pension system to one that requires more individual responsibility, analyzing the considerable impediments to saving and evaluating financial literacy programs devised by employers and the government.

<http://www.dartmouth.edu/~alusardi/book.html>



■ RESEARCH OUTPUT

ADEQUACY OF SAVING FOR OLD AGE IN EUROPE by Elsa Fornero, Annamaria Lusardi, Chiara Monticone

This paper provides an overview of the state of the

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art on the adequacy of saving for old age in European countries. Given the most relevant conceptual issues and policy questions, the paper discusses the major progress made by the economic literature in understanding the extent and characteristics of the problem, as well as the remaining gaps in knowledge.

The paper concludes with an examination of the current state and future needs in terms of research infrastructures and data sources.

The paper has been realized for the Forward Look Programme “Ageing, Health and Pensions in Europe”, funded by the European Science Foundation. The work has been presented by Elsa Fornero at the final conference of the FL in the Hague on April 22.

<http://www.netspar.nl/events/2009/forward/>

TIME AND RISK DIVERSIFICATION IN REAL ESTATE INVESTMENTS: ASSESSING THE EX POST ECONOMIC VALUE by Carolina Fuggazza, Massimo Guidolin and Giovanna Nicodano; CeRP WP 82/09

Welfare gains to long-horizon investors may derive from time diversification that exploits non-zero intertemporal return correlations associated with predictable returns. Real estate may thus become more desirable if its returns are negatively serially correlated. While it could be important for long horizon investors, time diversification has been mostly investigated in asset menus without real estate and focusing on in-sample experiments.

This paper evaluates ex post, the out-of-sample gains from diversification when equity REITs belong to the investment opportunity set. We find that diversification into REITs increases both the Sharpe ratio and the certainty equivalent of wealth for all investment horizons and for both classical and Bayesian (who account for parameter uncertainty) investors. The increases in Sharpe ratios are often statistically significant. However the out-of-sample average Sharpe ratio and realized expected utility of long-horizon portfolios are frequently lower than that of a one-period portfolio, which casts doubt on the value of time diversification.

DEBT LITERACY, FINANCIAL EXPERIENCES, AND OVERINDEBTEDNESS by Annamaria Lusardi and Peter Tufano; CeRP WP N. 83/09

The authors analyze a national sample of Americans with respect to their debt literacy, financial experien-

ces, and their judgments about the extent of their indebtedness. Debt literacy is measured by questions testing knowledge of fundamental concepts related to debt and by self-assessed financial knowledge. Financial experiences are the participants' reported experiences with traditional borrowing, alternative borrowing, and investing activities. Overindebtedness is a self-reported measure.

Overall, the authors find that debt literacy is low: only about one-third of the population seems to comprehend interest compounding or the workings of credit cards. Even after controlling for demographics, they find a strong relationship between debt literacy and both financial experiences and debt loads. Specifically, individuals with lower levels of debt literacy tend to transact in high-cost manners, incurring higher fees and using high-cost borrowing. In applying these results to credit cards, the authors estimate that as much as one-third of the charges and fees paid by less knowledgeable individuals can be attributed to ignorance. The less knowledgeable also report that their debt loads are excessive or that they are unable to judge their debt position.

MICROSIMULATION OF PENSION REFORMS: BEHAVIOURAL VERSUS NONBEHAVIOURAL APPROACH di Margherita Borella e Flavia Coda Moscarola; WP CeRP N. 86/09

The authors analyse the impact of various pension regimes, as shaped by recent Italian reforms, on retirement age, adequacy issues, and redistribution. This work adds to the literature on microsimulation by accounting for individuals' reactions to financial incentives when deciding to retire.

The authors find that shifting from a generous defined benefit (DB) system to an actuarially fair notional defined contribution (NDC) system induces individuals, particularly men, to postpone retirement. Voluntary postponement of retirement and, above all, participation in the second pillar would grant a comprehensive replacement rate (first plus second pillars) comparable to that obtained with the first pillar alone in the pre-reform DB regime.

CAN PENSION FUNDS HEDGE WAGE RISK? by Carolina Fugazza, Maela Giofré, Giovanna Nicodano; *Rotman International Journal of Pension Management*, Vol. (2)1, 2009

Human capital is the present value of future wages, so it can be a large component of the total wealth of active workers. This raises the question of whether labour income risk can be hedged by how the retirement savings of workers are invested. The answer is that it cannot if correlations between labour income and financial return fluctuations are zero, or close to it. Previous research suggests this is generally the case at the total economy level, when domestic investments are used.

This article presents the results of a study addressing the above question at the industry level, using a menu

of foreign investment indexes. Specifically, the authors examine the situations of American and Canadian workers in seven different industries whose pension funds can invest in the equity markets of 10 countries, including their own. They find largely positive and negative correlations between wage and return fluctuations, which point to opportunities to hedge labour income risk at the individual industry level through the investment of industry pension funds.

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News in brief

ONORATO CASTELLINO FELLOWSHIP AWARDED TO MATHIS WAGNER

Mathis Wagner, PhD candidate at the University of Chicago, will be the first Onorato Castellino Fellow. Mathis has been awarded an Assistant Professorship at CeRP, starting from September 2009. His fields of research are labor economics and public economics.

The Onorato Castellino Junior Chair was established by CeRP to honor the memory of Onorato Castellino, one of the founders of the centre and the first President of the Collegio Carlo Alberto.

GIOVANNI MASTROBUONI WINS CARLO GIANNINI PRIZE

Giovanni Mastrobuoni's paper "The Incapacitation Effect of Incarceration: Evidence from Several Italian Collective Pardons" (with Alessandro Barbarino) has been awarded the Carlo Giannini prize for the best conference paper written by a young scientist in Econometrics and Empirical Economics.

The paper has been presented on January 31 at the Third Italian Congress of Econometrics and Empirical Economics (ICEEE), in Ancona.

FOUR CERP PAPERS ACCEPTED FOR PRESENTATION AT THE MEA CONFERENCE

The following papers by CeRP researchers have been accepted for presentation at the Mannheim Research Institute for the Economics of Aging conference "Economic and Psychological Aspects of Households' Saving Behaviour: Old-age Provision, Financial Literacy and the Financial Crisis", to be held in Deidesheim on 29-30 June 2009:

"Homeownership Decisions: The Role of Credit Markets" by S. Trucchi

"Adequacy of Saving for Old Age in Europe" by E. Fornero, A. Lusardi, C. Monticone

"The Effect of House Prices on Household Saving: The Case of Italy" by R. Calcagno, E. Fornero, M.C. Rossi

"How Much does Wealth Matter for Financial Literacy Acquisition?" by C. Monticone

■ WORK IN PROGRESS

HOUSE PRICES AND PRECAUTIONARY SAVING by Riccardo Calcagno and Mariacristina Rossi

This paper focuses on how households allocate their resources inter-temporally through savings and intra-temporally through portfolio decisions, by considering investment in real estate as the only risky asset available in the economy. The purpose is to capture the idea that housing market risk is not diversifiable.

Housing has a unique characteristic, representing both a consumption good and an investment asset: it is a consumption good as it provides housing services, which we consider as an unavoidable commodity households have to consume during their entire life-cycle. Moreover, housing services can be bought either through the renting market or by investing in the real estate asset. Since the price of housing and rents are correlated, both renters and owners face some risk specific to the housing market. Households optimally choose to take a long position in such risk in order to hedge their need for future housing services. Contrarily to other financial assets, an increase in future housing price and rent volatility may increase savings, due to precautionary reasons. The authors estimate the impact of real estate risk on the consumption of Italian households from the SHIW data set. The empirical evidence confirms the theoretical predictions of the model.

HOW MUCH DOES WEALTH MATTER FOR FINANCIAL LITERACY ACQUISITION? by Chiara Monticone

The acknowledgment of a widespread lack of financial literacy casts serious doubts on the ability of individuals to take financial decisions. Given how important this kind of knowledge is for households, it is worth investigating why its degree remains so low. Some studies suggested that the acquisition of financial knowledge may be induced - among the others - by the necessity to manage household wealth.

This paper investigates the determinants of financial literacy, testing the role of household wealth in providing a motivation for learning. For this purpose, the author uses the 2006 wave of the Italian Survey of Households Income and Wealth, which contains specific measures of financial knowledge and allows to estimate the effect of household financial wealth correcting for endogeneity. The findings provide evidence of a statistically significant positive effect of wealth on the degree of financial knowledge, even though this effect turns out to be small.

HOMEOWNERSHIP DECISION: THE ROLE OF CREDIT MARKETS by Serena Trucchi

This work focuses on housing tenure choices of Italian households and the extent they can be explained by financial market imperfections. When borrowing and lending, rates differ from each other and from the implicit rate of interest paid by real assets; the structure of those rates influences the decision to buy a house. The empirical analysis is based on the Bank of Italy's

Survey of Household Income and Wealth (SHIW) and exploits regional heterogeneity in financial markets to assess their effect on households' behavior. Empirical results find strong evidence that the interest rate spread interacts with the time path of resources and alters the desired age profile of housing tenure by discouraging or postponing the dwelling purchase by households with steeper resources time path.

■ RECENT EVENTS

PRIN workshop: "Prodotti pensionistici: analisi economica, finanziaria ed attuariale dei benefici nell'ottica della domanda e dell'offerta; evoluzione del mercato" 27-28 February 2009

Workshop in capital markets: **Luis Viceira** (Harvard Business School) "Inflation Bets or Deflation Hedges? The Changing Risks of Nominal Bonds" 31 March 2009



Lunch seminar "Longevity Risk: Pricing, Hedging and Capital Market Solutions" by **Jorge Miguel Bravo** (University of Evora); 01 April 2009

Workshop in capital markets: **Joao Cocco** (London Business School) "Longevity Risk and Retirement Savings" 07 April 2009

Workshop in capital markets: **Riccardo Calcagno** (VU University, Amsterdam e CeRP) "Corporate Governance of Hostile Takeovers" 08 April 2009

Seminar: "Effects of Predictable Tax Liability Variation on Household Labor Income" by **Peter Katuscak** (CERGE-EI, Prague) 23 April 2009

Seminar "Technology Diffusion and Productivity Growth in Health Care" by **Jonathan Skinner** (Dartmouth College) 27 April 2009 (organized with Collegio Carlo Alberto)

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RECENT PRESENTATIONS AT INTERNATIONAL CONFERENCES

M. Belloni, F. Coda Moscarola, R. Calcagno, C. Fugazza, G. Mastrobuoni at the *Third Italian Congress of Econometrics and Empirical Economics* (ICEEE), Ancona, 30-31 January 2009.

C. Morana at the *17th Annual Symposium of the Society for Non Linear Dynamics and Econometrics*, Federal Reserve Bank of Atlanta, 16-17 April 2009

T. Dubovyyk and C. Fugazza at the *Royal Economic Society 2009 Conference*, University of Surrey, 21-22 April 2009

E. Fornero at the *final conference of the Forward Look Programme "Ageing, Health and Pensions in Europe"*, Netherlands Organisation for Scientific Research, The Hague, 22 April 2009

M. Giorfé at the *XIV Spring Meeting of Young Economists*, Istanbul, 23-25 April 2009

focus**FINANCIAL CRISIS AND PENSION REFORMS**

The recent financial crisis has called into question the very grounds of pension reforms in Europe, in particular the «risk diversification» rationale for creating a privately funded pillar, based on financial returns, alongside the public one, established on an intra-generational pact. At the same time, the crisis has highlighted that most individuals lack knowledge of the basic financial principles, which makes it very difficult for them to take sensible and forward looking saving and investment decisions.

A verdict of «failure» of the pension market and of the mixed system would be, however, both untimely and misleading. Conditions do exist for financial markets to become a significant, profitable and sustainable complement to the public system. For this purpose, trust and reliability features in supplementary pensions should be strengthened, and individuals (workers/families) should be enabled, also through programs of financial education, to take adequate and informed (if not optimal) decisions on the accumulation of retirement saving. Improvements are also desirable in asset management techniques.

On the public side, it is important that the NDC method introduced in 1995 is preserved and strengthened, as it is the only formula that can guarantee sustainability of the system and equity of treatment.

While the crisis is a cause of serious distress, it can also be a source of new opportunities, not to be missed. This would indeed happen if a pure and simple return to the past social security model should prevail.

These paragraphs are drawn from “Crisi finanziaria e riforme previdenziali: quale ripensamento critico?” by E. Fornero, Rivista di Politica Economica, XXV (1), 2009.

Recent Publications**ARTICLES IN SCIENTIFIC JOURNALS**

“Crisi finanziaria e riforme previdenziali: quale ripensamento critico?” by E. Fornero, *Politica Economica*, XXV, n. 1, April 2009.

“Le pensioni dei lavoratori parasubordinati: prospettive dopo un decennio di gestione separata”, by M. Borella and G. Segre, *Politica Economica*, XXV, n. 1, April 2009.

“The Importance of Financial Incentives on Retirement Choices: New Evidence for Italy” by M. Belloni and R. Alessie, *Labour Economics*, doi:10.1016/j.labeco.2009.01.008

“Can Pension Funds Hedge Wage Risks?” by C.

Fugazza, M. Giofré, G. Nicodano; *Rotman International Journal of Pension Management*, Vol. 2(1), Spring 2009.

“International Macroeconomic Dynamics: A Factor Vector Autoregressive Approach” by F. Bagliano, C. Morana, *Economic Modelling*, 26, 2009, 432-444.

On the Macroeconomic Causes of Exchange Rate Volatility, by C. Morana, *International Journal of Forecasting*, 25, 2009, 328-350.

“Time and Risk Diversification in Real Estate Investments: Assessing the Ex Post Economic Value” by C. Fugazza, M. Guidolin, G. Nicodano; forthcoming in *Real Estate Economics*.

“The Effect of House Prices on Household Consumption in Italy” by R. Calcagno, E. Fornero, M.C. Rossi, forthcoming in *The Journal of Real Estate Finance and Economics*.

Life-cycle Portfolio Choice: the Role of Heterogeneous Under-diversification, by C. Campanale, forthcoming in *Journal of Economic Dynamics and Control*.

LATEST CERP WORKING PAPERS

N° 81/09 Permanent and Transitory Dynamics in House Prices and Consumption: Cross-Country Evidence by F. Bagliano, C. Morana

N° 82/09 Time and Risk Diversification in Real Estate Investments: Assessing the Ex Post Economic Value by C. Fugazza, M. Guidolin, G. Nicodano

N° 83/09 Debt Literacy, Financial Experiences, and Overindebtedness by A. Lusardi, P. Tufano

N° 84/09 Il sistema previdenziale italiano dallo shock petrolifero del 1973 al Trattato di Maastricht del 1993 by L. Spataro

N° 85/09 The Life-Cycle Income Analysis Model (LIAM): A Study of a Flexible Dynamic Microsimulation Modelling Computing Framework by C. O'Donoghue, J. Lennon, S. Hynes

N° 86/09 Microsimulation of Pension Reforms: Behavioural versus Nonbehavioural Approach by M. Borella, F. Coda Moscarola

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OTHER PUBLICATIONS

“Pensioni: la flessibilità in uscita si realizza con la riforma dei salari” by E. Fornero, G. Mastrobuoni, F. Taddei, forthcoming, *ItalianiEuropei*

“Adequacy of pension systems in Europe: an analysis based on comprehensive replacement rates” by M. Borella and E. Fornero, ENEPRI research report n. 68, April 2009

“White Knights and the Corporate governance of Hostile Takeovers” by R. Calcagno and S. Falconieri, Tinbergen Discussion Paper 2008-118/2

“I giovani pensino alla pensione, gli anziani curino il patrimonio” by E. Fornero, *AREL Europa Lavoro Economia*, October 2008