Insurance and economic development: Growth, stabilization and distribution

Briefing Note

Insurance is a largely invisible yet ubiquitous part of our economies. Our health, movements, purchases, homes, and even lives are usually covered by insurance. Without insurance, the unpredictability of the future would be too great and it would be difficult to take risks and innovate. In other words, insurance typically allows people to break the psychological and financial barriers which normally prevent them from engaging in potentially riskier activities thus forgoing greater reward and innovation. Insurance has contributed to macroeconomic development through economic growth, stabilization, distribution, and innovation.

ECONOMIC GROWTH
Insurance can be described as an enabler for people and companies to take risks and as a way to allow individuals’ minds and assets to be productively and confidently invested in the economy. Higher economic development usually leads to larger risk-taking, and greater financial inclusion and sophistication supporting insurance development. Insurance provision helps to improve the overall efficiency of the financial sector, notably by facilitating the provision of credit to the private sector.

Low levels of economic development are usually associated with low insurance penetration, with informal and traditional self-insurance schemes operating instead. At levels of around $3,000 to $5,000 GDP per capita, insurance penetration rates rise faster than GDP until a maturation of the markets sets in to form a kind of “plateau”. One study (Lee et al. 2013) suggests that for OECD countries, a 1% increase in life insurance premia raises real GDP by 0.06% per year. On a dataset of 77 advanced and emerging economies from 1994 to 2005 Han et al. (2010) find that a 1% increase in total insurance penetration led to a 4.8% increase in economic growth per year.

STABILIZATION
Insurance has a key function of economic stabilizer in times of individual shocks, smoothing the consumption of individuals facing idiosyncratic or aggregated shocks such as natural disasters or financial crises. Some examples of such stabilizers are variable annuities and unemployment insurance.

Insurance is also a source of stable funding for both the financial markets and the economy as it fosters lending and investment with a long-term perspective. This has to do with insurance companies being far more “future-oriented” than other companies, such as banks, for example.
DISTRIBUTION
As is often said, insurance is about connecting “the misfortunes of the few to the fortunes of the many” which naturally creates a form of distribution. Insurance creates an invisible net of solidarity between economic agents, interconnecting them in time and place around shared preferences and priorities. Insurance organizes the concept of solidarity through its fundamental pooling principles --aggregating and mutualizing risks by pricing them depending on their statistical occurrence for the larger pool and not for the individual.

Intergenerational sharing of financial risk by life insurers has an impact on intergenerational welfare that has been deemed equivalent to an increase in asset returns by as much as a full 1% every year (Gollier 2008). This social benefit is obtained by an anti-cyclical retention of the return of the invested assets, as well as the guarantees provided by the insurer over time.

INNOVATION
Insurance entertains a paradoxical relationship with innovation. On the one hand, insurance fosters innovation by protecting innovators from external shocks and protecting wealth, while, on the other hand, it can limit innovation by adapting its coverage to new types of risks or adapting its own functioning to technological changes. Some examples of this are cyber risks, or, autonomous vehicles --which could call for the reinvention of insurance itself.

FOCUS ON MICROINSURANCE
There has been evidence that the development of microinsurance induces economic benefits at both the micro and macroeconomic levels. By providing external financial protection to poor households, microinsurance can enable the beginning of specialization, as households do not need to resort to substitute and ineffective coping mechanisms. Insurance can also increase people’s productivity by inducing healthier habits, as in the case of health insurance. One example of innovation in microinsurance is with parametric agricultural insurance. Parametric (or index) insurance contracts outline specific predefined conditions that will lead to compensation of customers (level of rain, sun, temperature... which are public parameters easy to track automatically by satellite for instance), to be used to estimate damages not directly observable or difficult or expensive to assess (fields in remote areas...).

The role of modern insurance is multi-layered. By managing risks, insurance allows individuals and companies to take risks and innovate. Insurance also reduces the level of interest rates by lowering default probabilities and investing with long-term horizons. Finally, insurance modifies the level and allocation of individual and aggregate savings, leading to a more optimal allocation of capital. By doing so, it has an impact on the economic cycle, the nature of economic development, and on the distribution of income and shocks across economic agents.