Demography and Public Debt: The Crisis Beyond

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All around the world today—from Tea Party activists in the United States to Euro-zone financial markets to central Bankers in Beijing—there are signs of palpable and growing apprehension about the immense fiscal deficits and mounting public debt burdens the developed countries have assumed during the current global financial crisis. Yet even greater pressures on Western budgets and debt levels lie immediately beyond the current crisis. These will be driven by the inexorable demographic forces that are transforming the OECD countries into a "gray zone". Demographic projections today depict a radically different Western world 20 years hence: one with stagnating populations, shrinking workforces, steadily increasing pension-age populations, and ballooning implicit social spending commitments.

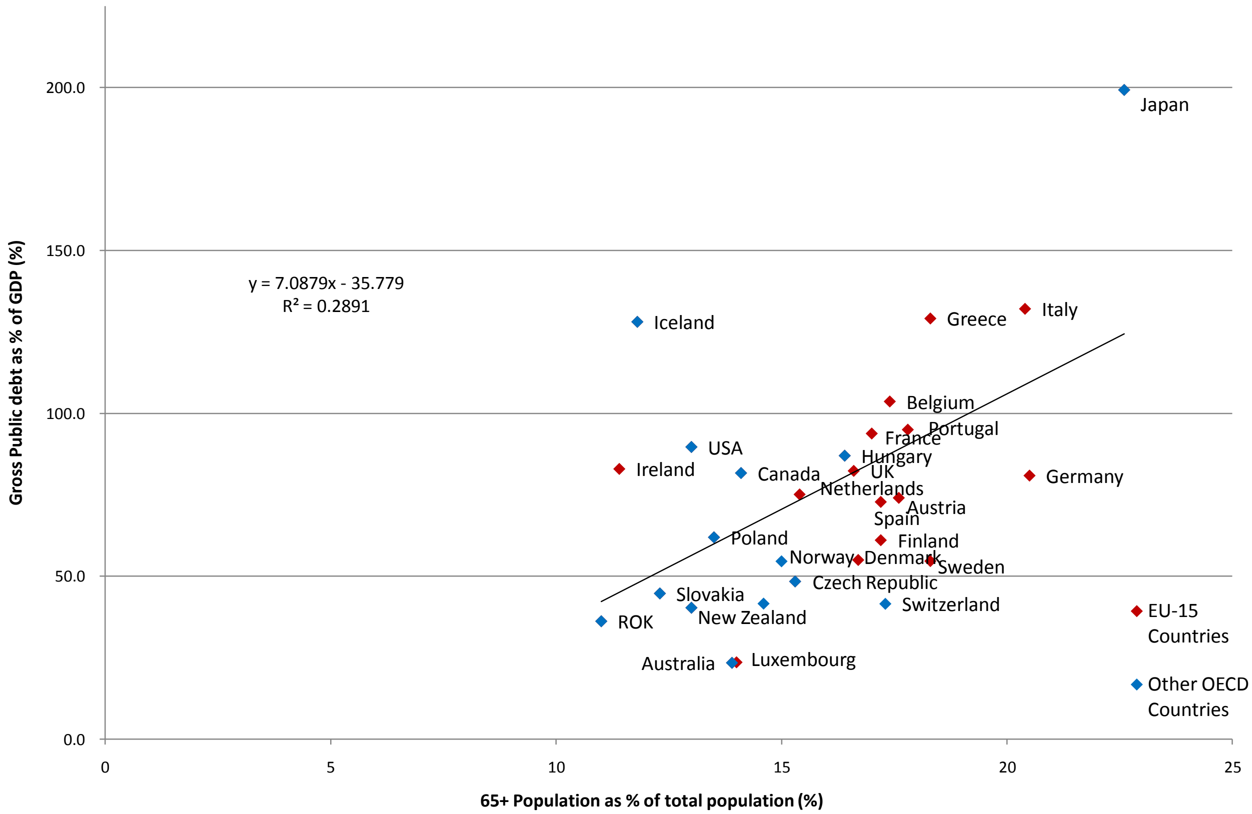
These trends portend ominous change in Western economic prospects: both major increases in public debt burdens, and slower economic growth. Yet curiously, despite the relative predictability of these impending demographic trends, neither policy-makers, business leaders nor financial markets seem as yet to have taken the demographic factor into account their assessments of the longer-term outlook for the world's leading economies (much less in considering the measures that must be taken if prosperity and financial stability are to be secured over the coming generation).

Just 20 years ago, there was no evident relationship at all between the "age profile" and the public debt burden of affluent OECD countries. But this earlier world was also a more youthful one. Over the past two decades, median age in the world's more developed countries has jumped by over 5 years, and the numbers of senior citizens (who tend to be heavy claimants of public benefits) have risen much faster than total population in every Western society. Today, as we see in Figure 1, there is a clear relationship within the OECD between a country's level of public debt and its proportion of population aged 65 or older.

The relationship, to be sure, is not tight and mechanistic: many other factors besides the health care, long-term care, and public pension outlays for senior citizens affect the run-up of public debt in affluent Western societies these days. Even so: we can see that in general, every percentage point increase in a country's 65+ share of total population is associated with about a 7 percentage point increase in the ratio of gross public debt to GDP. Between 1990 and 2010, according to OECD estimates, the ratio of gross public debt to GDP rose by about 40 points for the leading Western economies. Over that same period, according to the United Nations

Population Division (UNPD), the 65+ group's share of total population for these countries rose by over 3 points. By such crude arithmetic, population aging corresponds with something like half of the increase in public debt burden in affluent Western societies over the past two decades

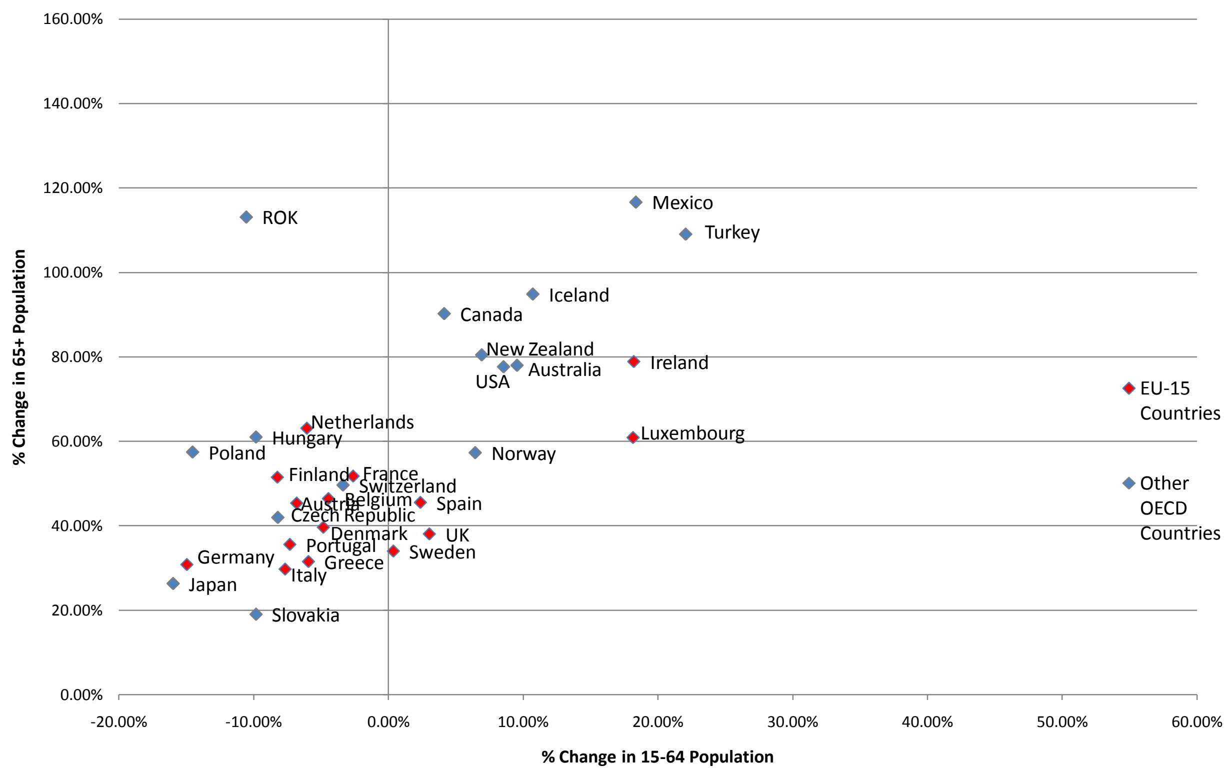
Figure 1: Gross Public Debt as % of GDP (2010) vs 65+ Population as % of Total Population (2010), Selected OECD Countries



Sources: United Nations Population Division. *World Population Prospects: The 2008 Revision Population Database*. Accessed electronically at http://esa.un.org/unpp/index.asp; Organisation for Economic Co-operation and Development. *OECD Economic Outlook No. 87 Annex Tables*. Accessed electronically at http://www.oecd.org/dataoecd/5/51/2483816.xls. Note: This graphic is for affluent "Western" OECD members only.

And population aging in the prosperous West is set to accelerate in the years ahead: the fraction of 65+ population in these countries is slated to jump by over 6 percentage points over the next 20 years, roughly twice as big a rise as over the past two decades. In all, the 65+ population in the affluent OECD countries is set to surge by over 50% between now and 2030. But over those same decades most OECD countries face a fall-off in the absolute size of their working-age population (conventionally, if not always accurately, defined by demographers as the 15-64 group). [SEE FIGURE 2] And such projections posit continuing net migration flows into the OECD: if the inflow of new workers should slump - or be restricted by policy - the shrinkage of working-age manpower would be even sharper than Figure 2 suggests.

Figure 2: Change in 15-64 population vs. change in 65+ population, OECD Countries, 2010-2030 (projected, medium variant, in percent)



Source: United Nations Population Division. *World Population Prospects: The 2008 Revision Population Database.* Accessed electronically at http://esa.un.org/unpp/index.asp.

What does demographic change portend for public debt and economic performance in the West? Consider the outlook for the "big three" Western economies: Germany, Japan and the USA, which together account for over half the West's output, and nearly 30% of the world's GDP.

•*Germany*: Germany is already a "shrinking society": its population commenced what looks to be an indefinite decline seven years ago, in 2003. Despite the pending depopulation, Germany's 65+ group is set to grow by about 30% between 2010 and 2030; its 80+ population, by almost 50%. Big increases in pension, health care, and long-term care needs for Germany are thus in the offing. Yet at the same time, Germany's pool of working age manpower (15-64 years of age) - the group responsible for financing these needs – is set to shrink by a projected 15% over those same years (and without continuing in-migration, by much more). Germans have been famously diligent savers over the postwar era, but these looming demographic changes will put big downward pressures on household savings rates and budgetary balances. In 2007 - before the current global crisis - Germany gross public debt amounted to 65% of GDP - well below the OECD's then-average of 73%. But a recent Bank of International Settlements (BIS) study suggests Germany is on track for a massive accumulation of public debt over the coming two decades, absent some major adjustments in fiscal policies and public policy commitments. By that study's "baseline" projections, Germany's ratio of public debt to GDP could exceed 200% by 2030 - with service on this debt approaching 10% of GDP - nearly twice Greece's current debt service burden! In such a world, Germany might be hard pressed to remain the ultimate guarantor of the Euro—and even if it could still manage this feat, economic performance could be seriously jeopardized.

•*Japan*: Japan is the world's most aged society today, and will be even grayer tomorrow. By 2030, 30-plus% of the country could be over 65; no less stunning, nearly 13% of the Japanese could be 80 or older - more than one in eight. Japan's working age population, which has been falling since the mid-1990s, is projected to drop by another 16% between 2010 and 2030. Today Japan's gross public debt is around 200% of GDP: a result of years of heavy deficit spending in the face of economic stagnation and incipient deflation. On current course, by the BIS "baseline" estimates, Japan's public debt would hit 600% of GDP around 2030. Given Japan's low (near zero) interest rate environment for public borrowing, such a massive debt overhang might not lead to a sovereign debt crisis. But this is not the same as saying such debt levels might not be "toxic".

•*United States*: America is the OECD's great "demographic exception": with relatively high birth rates and a robust inflow of immigrants (roughly half of them legal) , the country can expect to see continuing population and manpower growth between now and the year 2030, and will remain most youthful Western society in the decades ahead. But the US has demographic problems of its own - the most salient of which relate to health and health costs. Over the postwar era, America's relative health performance, in relation to other Western societies, has been on a slow but gradual decline. (Astonishingly enough, for example, Eastern Germany—the former territory of the Communist GDR—has overtaken the United States in life expectancy at birth.) US health care costs, for their part, are notoriously high, and presently unfunded liabilities in the American health care system (primarily, guarantees for senior citizens) are on course to skyrocket over the decades ahead. According to one important pre-financial crisis study, the unfunded liabilities of the US health care system were then roughly ten times as large as for the US social security system - and those unfunded liabilities have only risen in recent years (not least with the latest round of US "health reform"). At present, the US ratio of gross public debt to GDP is nearing 100%, and the country is today running annual deficits of around 10% of GDP per year. The Congressional Budget Office (CBO) projects gross public debt at 200% of GDP by 2020, and the BIS study sees it hitting 300% of GDP by 2030. By the BIS estimates, restoring the American public debt burden to pre-crisis levels would require the US to run a budget surplus of 2.4% of GDP for the next 20 years: a long-term fiscal swing today of the same relative magnitude as that urged on Greece under the recent IMF "rescue package".

Looking forward, there is ample reason to be concerned about the interactive impact of demography and debt on the performance of the Western economies in the decades ahead.

Without a fundamental and far-reaching re-thinking of current approaches to work and retirement, pension and health care policies, and government budget discipline, maintaining economic growth and avoiding government “debt traps” may become progressively more difficult as each year gives way to the next. Thanks to the current global economic crisis, concerned citizens and policymakers are by now familiar with the concept of the “financial stress test” used in evaluating the soundness of banks and allied institutions. It is high time for a “demographic stress test” for Western economies: so that Western voters and their elected representatives can assess the scope and scale of the challenges that confront their societies, and deliberate in an informed manner about the most effective and responsible strategies for addressing these.

Financial crises can erupt suddenly—unexpectedly, and without warning. Demographic pressures, by contrast gather slowly and predictably accumulate slowly: but they can transform the economic and social landscape fundamentally and irreversibly over the course of a generation. Long-term demographic forces may have an even more impact on transforming the economic outlook of Western societies than transient financial crises - no matter how painful and dramatic the latter may be when they erupt. We can already know today what the future holds, in broad outline, for population prospects of the Western economies. The question is: are we prepared to understand these prospects - and to act on the basis of what we learn?

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