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Opinion

Time for 'Demographic Stress Tests'; By 2030, Germany's ratio of public debt to GDP could be twice what Greece's is today. Japan, the United States and others face similar challenges.

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Financial crises can erupt suddenly and unexpectedly. Demographic pressures, by contrast, gather slowly and predictably—but over just a generation they can transform the economic and social landscape irreversibly.

Such a transformation is already underway in the developed world. Twenty years from now, Western economies will be characterized by stagnating populations, shrinking work forces, steadily increasing pension-age populations, and ballooning social spending commitments. These demographic changes will mean major increases in public debt burdens and slower economic growth, as savings are diverted from investments and innovation that enhance productivity.

Consider the "big three" Western economies: Germany, Japan and the United States, which together account for over half of the West's output and nearly 30% of the world's GDP.

• In Germany, the working-age population (those aged 15-64) is projected to decline by 15% between now and 2030, and the decline will be much steeper if immigration slows. Meanwhile, Germany's 65-plus population is set to grow by a third, to 27% from 20%. Its 80-plus population will grow by over half, to 8% from about 5%. Big increases in pension obligations, health-care costs and long-term care needs are thus in the offing.

Germans have been famously diligent savers since World War II, but these demographic changes will put big downward pressures on household savings rates and budgetary balances. A recent Bank of International Settlements (BIS) study suggests that, absent major adjustments in fiscal policies and public policy commitments, Germany's ratio of public debt to GDP could exceed 200% by 2030—with annual service on this debt approaching 10% of GDP.

That's nearly twice Greece's current burden of debt service. In such a world, Germany might be hard pressed to remain the ultimate guarantor of the euro—and even if it could, economic performance would be seriously jeopardized.

• In Japan, 30% of the population could be above age 65 by 2030, and nearly 13%—more than one in eight—could be 80 or older. Japan's working-age population, which has been falling since the mid-1990s, is projected to drop by another 16% between 2010 and 2030.

The implication? Today Japan's gross public debt is already around 200% of GDP, the result of years of deficit spending. On the country's current course, estimates the BIS, Japan's public debt would hit 600% of GDP around 2030.

Given Japan's low (near-zero) interest rates for public borrowing, servicing such a massive debt overhang might not lead to a sovereign debt crisis. But such a huge public debt burden could poison the country's economic outlook.

• The U.S., meanwhile, can expect to see continuing population and manpower growth between now and 2030, thanks to relatively high birth rates and a robust inflow of immigrants (roughly half of them legal). America will remain the most youthful Western society, although its 65-plus population will be about 19% of the total, up from 13% today.

Nevertheless, entitlement liabilities—especially the unfunded liabilities in the health-care system—are on course to skyrocket in the decades ahead. The country's recently enacted health reform will make the burden heavier.

At present, the ratio of gross U.S. public debt to GDP is nearing 100%, and the country is running annual deficits of around 10% of GDP. The Congressional Budget Office projects gross public debt to be 200% of GDP by 2020, and the BIS sees it hitting 300% of GDP by 2030. By the BIS estimates, restoring the U.S. public debt burden to 2007 levels would require budget surpluses of 2.4% of GDP for the next 20 years.

Maintaining economic growth in the face of these demographic trends will require rethinking current approaches to work and retirement, pension and health-care policies, and government budget discipline. Thanks to the recent financial crisis, we're now familiar with the concept of the "financial stress test" used to evaluate the soundness of banks and allied institutions. A "**demographic stress test**" for Western economies is now in order, so that voters and their elected representatives can cope with aging populations and declining work forces.

Such an exercise would assess how manpower availability, labor force participation rates, aging and budgetary commitments would, over the next 30 years, affect key measures of national economic well-being like growth and productivity, fiscal balances, and government debt. It would also indicate the extent to which adverse "baseline" costs and consequences could be mitigated or offset by changes in lifestyle, personal behavior and public policy. These could include, for example, later retirement thanks to healthy aging, increased attention to preventive health care, enhanced personal savings, and adjustments to health and pension schemes.

Every Western country will have to determine how to pursue a future that is grayer but healthier and more affluent. The sooner we pay serious attention to the demographic challenge, the likelier we will be to meet it successfully.

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