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GERMANY'S DEMOGRAPHIC CRASH COURSE

Why Europe's powerhouse is headed towards an unsustainable future

by Rebecca Payne

In the aftermath of the financial crisis, Germany has impressed the world as a bastion of economic stability in Europe. Germany's initial recovery from the Great Recession was one of the soundest among Western economies, and after a period of lower growth in 2012 and 2013, the economy has picked up speed again. While most of its European neighbors battle record unemployment, the German labor market has remained resilient throughout the crisis years. Germany's manufacturing sector earned the country third place globally (behind China and the United States) for the dollar value of goods it exported in 2014, and its current account surplus has exceeded China's since 2011. The economic fundamentals are impressive and it would seem that now is a good time for Germany to rest on its laurels.

But just how confident should Germany be? In its 2015 country ratings, INCRA, the Bertelsmann Foundation's alternative sovereign debt rating agency project, argues that even Germany's current success will be insufficient to maintain its generous social policy spending in coming years. As comfortable as things may seem, Chancellor Angela Merkel must find a way to "sell" entitlement reforms to Germans before these programs become unsustainable.

Unsustainable Pension Promises

Two interconnected variables help explain why a need for reforms has appeared on the horizon now, at a time when Germany seems to be at its strongest. First, the Christian Democrat/Social Democrat "Grand Coalition" government, which came to power in 2013, implemented a series of changes which counteracted previous reforms, ultimately making the country's pension promises unsustainable in the long run. One of these changes, the lowering of the retirement age from 65 to 63 for all workers who contributed to the pension system for at least 45 years, effectively allows workers to retire at 61, collect unemployment benefits for two years, and then receive a full pension at 63. Other changes made in 2013 included back payments to mothers of children born before 1992, to retroactively bring their family benefits up to contemporary levels, and improvements to disability pensions.

With Germany's booming economy, these changes could seem egalitarian, even justified, as everyone benefits from the country's prosperity. Unfortunately, this is only true if German population demographics remain stable, and predictions indicate that they will not. This is the second variable which has brought a need for reform to the fore. Germany is an aging country, and simultaneously, thanks to advances in modern medicine, also a country where the elderly are enjoying longer and longer lifespans. This means that while the retirement age has recently been lowered, average life expectancy continues to increase - a combination which demands ever greater sums in retirement pension payouts from a finite pool of workers' contributions. Moreover, stagnant birth rates suggest that the burden of supporting the many elderly will fall upon a smaller generation of young Germans.

Generational Accounting Deficit

From a social security perspective alone, Germany's "generational accounting" will soon face a serious deficit. New funding for mothers and a lower retirement age have aggravated this issue by adding additional entitlements that are estimated to cost 160 billion euros by 2030. The Grand Coalition seems to have accepted this increase in social spending, and while Germany now surpasses the United States in social expenditure as a percentage of GDP (25.5 percent compared to 18.7 percent, respectively) Germany's contributions remain lower than those of France, which add up to 31 percent of GDP. However, the US population is currently growing at a rate of 1 percent per year, whereas Germany's population growth has stalled almost entirely. As a result, the United States has more time before its aging population and social security payouts will become a danger to its economy. By contrast, INCRA's team of experts estimates that combined impacts of Germany's shrinking workforce and its increased and prolonged entitlement payouts will begin to impact the country as early as 2018. Unless it can undergo serious reforms in the very near future, Germany is setting itself up for financial unsustainability.

This assessment begs the question: why has Germany done virtually nothing thus far to head off this crisis? In light of the country's recent success, such steps may seem unnecessary. Reforms designed to reduce social benefits would be wildly unpopular, and they are sure to seem particularly mean-spirited now, at the peak of German prosperity. This may explain why none have yet been proposed, even though they are urgently needed if the future crisis is to be averted. Germany may be Europe's economic powerhouse, but it is time for those who oversee entitlements to take a cue from the reforms that were implemented in the country's energy sector, and shift their focus towards *sustainability*.

To learn more about INCRA, or to read its full 2015 report on Germany, visit http://www.bfna.org/page/incra-the-first-international-non-profit-credit-rating-agency-for-sovereign-risk

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