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# The Coming Private Pension Plan Crisis

BY ROGER M. KUBARYCH

*The unavoidable consequences of dollar manipulations and widening U.S. trade deficits.*

The United States has a current-account deficit of close to 6 percent of GDP. Many forecasters expect this to swell to 8 percent of GDP during the next few years.

There are several reasons why the United States has such a mammoth deficit. But it really boils down to three factors: oil, growth differentials, and the dollar.

First, higher oil imports accounted for 30 percent of last year's $95 billion increase in imports and 36 percent of this year's annualized $172 billion increase in imports. Nothing else comes close in explaining the deterioration of the trade position lately.

Second, relative growth rates of demand in the United States versus the rest of the world have diverged. Demand for goods and services has risen much faster in the United States than in other important countries.

Third, market forces that would ordinarily have brought about a decline in the value of the dollar against foreign currencies—and compelled foreign exporters to raise the prices of the products in U.S. markets—have been thwarted. That is because of the actions of governments and central banks in several regions of the world, particularly in Asia. They have conducted persistent, large-scale foreign exchange market intervention to keep their currencies from appreciating against the dollar. Even when they weren't intervening directly in the markets, many of those

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same governments have encouraged or arm-twisted a number of domestic financial institutions that are ostensibly in the private sector, but often defer to official policy views, to buy dollar assets, too.

These actions have been performed with the sole purpose of preserving the profitability of exports to the United States. The U.S. government has done little or nothing about it up until now—or even acknowledged the market-distorting behavior as a problem. It is particularly ironic because this has been an administration that prided itself on never submitting to international constraints on the ability of the United States to pursue an independent national security policy. But in the area of international finance, it has totally submitted to foreign powers, who have achieved a virtual veto power over the U.S. trade position in the world.

Note that the European governments and central banks have not been intervening. So the euro has been allowed to go up against the dollar—by a cumulative 56 percent from the low point of $0.82 in early 2002 to just under $1.28 as of the end of October, 2004. Correspondingly, import prices of European products have gone up by 12 percent during that time.

In sharp contrast, import prices of Japanese products have stayed virtually unchanged while prices of products from other Asian countries have actually fallen by 3 percent during that two-year period. Hence there is no market incentive for U.S. customers to cut back on their purchases, and the U.S. trade deficit goes up. By the way, the 56 percent cumulative appreciation of the euro against the dollar gives some order of magnitude of what would have happened to Asian currencies had the interference in the marketplace not occurred.

A strong dollar—judged from the perspective of trade—and a large trade deficit are neither good nor bad for the United States, but simply redistributional. Companies in some industries and their workers are better off than they would otherwise be with a lower value of the dollar and a smaller trade deficit. But companies in other industries and their workers are made worse off.

The best example of an industry that benefits from a strong dollar and a trade deficit is the home-building industry. A high dollar, especially an artificially high dollar propped up by huge foreign official purchases of U.S. securities, keeps U.S. interest rates lower than they otherwise would be. That is because deficient U.S. savings are being supplemented by foreign savings. The low interest rates of the past few years gave a big boost to interest-rate sensitive sectors of the U.S. economy. And probably the most interest-rate sensitive sector is the housing market, especially home-building.

A few numbers might be useful here. In 2001, U.S. GDP was $10.1 trillion, while the trade deficit was about $360 billion, or a ratio of 3.6 percent of GDP. That year, the total value of American homes amounted to $12.5 trillion. By the middle of 2004, GDP was an annualized $11.6 trillion, the trade deficit was running at about $600 billion annually, or 5.6 percent of GDP. Meanwhile, the total value of American homes had soared to $15.7 trillion, as measured by the Federal Reserve. So the ratio of housing prices relative to the overall GDP has climbed to 135 percent from 124 percent. Naturally, a lot of the bidding up of the value of the U.S. housing stock was the product of easy access to large amounts of relatively cheap mortgage financing. So the net addition to housing net worth was a lot less—to $8.6 trillion from $7.1 trillion. But that still added about $1.5 trillion to the spendable resources of Americans, which of course many were able to tap into—through mortgage refinancing or home equity loans—to beef up their consumption of an array of goods, including especially imported consumer durables. So the payoff to those Asian governments and central banks that intervened to avert a significant appreciation of

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**U.S. corporate profits, selected sectors**
**Level, with inventory valuation adjustment, seasonally adjusted annual rates**

| | 2001 | 2002 | 2003 | 2004 q1 | 2004 q2 |
|---|---|---|---|---|---|
| Domestic nonfinancial corporations | 357.2 | 418.4 | 516.4 | 604.6 | 640.8 |
| of which manufacturing | 52.6 | 50.7 | 67.3 | 81.5 | 94.8 |
| of which durable goods | -25.4 | -8.3 | -3.5 | 2.8 | 14.9 |
| of which motor vehicles, bodies and trailers, and parts | -9.2 | -6.0 | -6.2 | -0.5 | -1.2 |

Source: BEA

their currencies was magnified. Market manipulation paid in two ways, or at least it has so far.

The losers in this game of economic musical chairs were U.S. manufacturers and their workers. Manufacturing employment is down over two million since 2001. And U.S. manufacturers have struggled to make profits, especially those facing the stiffest foreign competition, namely those most vulnerable to imports from Asia.

Heading the list is the industry that the U.S. statisticians inelegantly call "motor vehicles, bodies and trailers, and parts." The table shows what their operating earnings, as measured by the U.S. Department of Commerce Bureau of Economic Analysis, have done since 2001.

This industry keeps losing money from operations, even though in real terms it has been contributing positively to the generation of real GDP. That is because it has had to use an array of financing and other incentives to lower effective prices to consumers. And that is a direct result of the foreign currency disadvantage it suffers from.

Admittedly, depreciation of the dollar will not solve all the problems of the industry—far from it. But a substantially weaker dollar, by squeezing the profitability of Asian suppliers, would compel them to raise prices in the United States. That would give U.S. manufacturers a little more pricing power. Thus, they might be able to eke out somewhat greater profitability for a while, allowing them to buy time for other necessary, though surely painful, adjustments in the business. And one of the most painful adjustments of all would be to reach an agreement with labor unions to somehow pare down the huge so-called "legacy costs" that the industry is stuck with because of mismanagement of the highest order by earlier generations of short-sighted managers. The most important of these are the promises past managements made to cover the pensions and health care insurance of unionized current and prospective retirees. Those promises were made on the flawed assumption that U.S. industry would always be dominant and that the costs could readily be passed through to consumers. That kind of dominance hasn't existed for a long time and won't exist in the future. So the promises cannot be met in their entirety without some major changes.

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What might happen if the combination of a weaker dollar against Asian currencies plus negotiated give-backs by the unions doesn't work? There are many plausible scenarios, but here is one that is on the radical side but is not entirely farfetched.

Imagine you are the CEO of a firm in the "motor vehicles, bodies and trailers, and parts" industry, and you are reaching the limits of your ability to sustain ongoing operating losses. However, you have a second line of business that is quite profitable: a finance company. In fact, under some assumptions, that business, if it were a stand-alone company, might have a market capitalization close to the current market cap of the entire automaking and finance enterprise combined. You have looked at your cost structure and have decided that the legacy costs are unbearable. What can you do?

To begin with, you watch what is happening to companies in other troubled industries, notably the U.S. airlines industry. You notice that United Airlines has stopped funding its pension fund, that US Airways is also in Chapter 11 and has announced a suspension of contributions, and that Delta is threatening to go into bankruptcy. You recall that all along your company has been paying insurance premiums to a relatively little-known government agency called the Pension Benefits Guarantee Corporation or PBGC.

What is the PBGC? According to its Web site, the PBGC is a "federal agency created by the Employee Retirement Income Security Act of 1974 (ERISA) to protect pension benefits in private-sector traditional pension plans known as defined benefit plans." Its current head, Bradley D. Belt, calculates it now protects the retirement incomes of about 44 million American workers in about 31,000 private defined benefit pension plans. One can think of the agency as a governmental safety net for the half of the private pension system made up of defined benefit pension plans. Those are plans in which companies pledge to pay their retired employees monthly benefits based on such guidelines as salary and length of service. In a defined benefit plan, a company funds accounts that are invested in equities, bonds, real estate and other assets. The earnings are used to pay the promised pensions to retired workers. But the funds belong to the company, not to the employees themselves. Government rules dictate how big these funds should be in order to be sufficient to pay for the pledged pension benefits.

But companies that fall into bankruptcy frequently have underfunded accounts that are insufficient to pay full benefits. So the PBGC must step in. Already one million workers of companies that have gone into bankruptcy have terminated defined benefit pension plans (the largest is Bethlehem Steel), with the result that retirees have had to go to the PBGC to receive a pension, though often only a partial one. Where does the PBGC get the money to pay these people? Through premiums charged to all of the companies that have defined benefit plans, investment income, and pension assets of failed companies. It does not get taxpayer funding—not now anyway.

Now you are fully briefed that if you took the company into bankruptcy, you would probably get out of paying pension benefits to retirees (assuming Congress doesn't change the law and new rules are not adopted to stop you).

But you are still a profitable company because of the finance subsidiary. How could you orchestrate such a "strategic bankruptcy" in a way that would be legal and that your shareholders would approve? By spinning off the finance company and selling it to a strong player in the market (like a GE Capital, UBS, or HSBC). You sell the unit for a lot of cash, declare a special dividend to shareholders with the proceeds—possibly as much as the full market value of the combined company today—and watch the stock market value of the stripped down auto-making enterprise go way down, perhaps all the way to zero.

What would happen next is pretty obvious: Banks and other lenders would pull their credit lines, a liquidity crisis would ensue, and the new, and much weaker company would lurch toward bankruptcy. You would then convene the union representatives and say: the car company is yours or else we'll put it in bankruptcy.

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To the people running the PBGC such a scenario is an unmitigated nightmare. Already 75 percent of defined benefit pension plans have been terminated, to 31,000 plans today from a peak of 112,000 in the mid-1980s. No new defined benefit plan of significant size has been established in years. To the contrary, many companies are trying to terminate plans or otherwise "freezing" them. Instead, nowadays companies offer defined contribution plans only—notably the familiar 401(k) accounts. Soon the incentives will be for all companies to try to get rid of defined benefit plans. And if a major corporation, whether in the auto industry or in another industry with similar characteristics—larger numbers of retirees than current employees, to begin with—were to go bankrupt, the PBGC would quickly face a tremendous financial crunch of its own. Mr. Belt speaks in terms of the thrift crisis of the late 1980s. Unfunded liabilities of defined benefit plans are estimated at about $350 billion, or about 20 percent of their liabilities. That is a terrific hole.

So to those who take a cavalier attitude to the consequences of a prolonged period of widening trade deficits and secular decline in manufacturing, all I can say is read up on the PBGC and dust off the books about the Resolution Trust Corporation, because a big government bail-out is definitely on the horizon—and will be major headache for the next president. ◆