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ECONOMIC VIEWPOINT

Detroit's Big Three Are Heading for a Pileup

The Big Three American car companies began talks with the United Auto Workers in July to renew their four-year labor contracts, and they intend to conclude new arrangements by mid-September. Although critical issues such as job security, pensions, and health-care benefits are at stake, the final settlement is likely to be a relatively modest compromise. These negotiations, however, could be a prelude to a far deeper and politically contentious restructuring of the industry. Before this decade is over, the U.S. auto business may go through some of the agonizing downsizing and even bankruptcies seen lately in steel and airlines.

Ford ([F](#)) Motor Co. lost more than \$6 billion in 2001 and 2002. Chrysler ([DCX](#)) Corp. hemorrhaged \$1.1 billion in the past quarter alone. In fact, the strongest element of the companies' income is not profits from car sales but earnings from their financing divisions. General Motors Corp. ([GM](#)), for example, earned more than three times as much from selling mortgages in the past quarter as from cars.

Since the mid-1980s, moreover, foreign auto makers have increased their U.S. market share from 24% to 40%. Now, Detroit faces ruthless competition on the lucrative turf of pickup trucks, minivans, and sport-utility vehicles. Making matters worse, the global auto market suffers from 30% overcapacity -- amounting to as much as 20 million vehicles a year. That's more than all auto sales in North America. The crunch will get worse: In the coming two years, Nissan Motors Corp. ([NSANY](#)) is planning to increase production by 1 million vehicles.

Perhaps the most intractable problem is that the Big Three bear enormous unfunded pension obligations and health-care costs for hundreds of thousands of retirees, while their own employee base is shrinking. Of Ford's annual \$2.8 billion health bill, 70% goes to retirees. GM has 2.5 retirees for every active worker. Japanese carmakers have avoided such burdens by generally employing younger, nonunionized workers. Little wonder that Moody's Investors Service ([MCO](#)) gives Toyota ([TM](#)) Motor Corp. a credit rating of Aaa while classifying Ford and GM as Baa -- the low end of investment grade.

To be sure, Ford and Chrysler have survived near-death experiences before. This time, one way out would be for Detroit to outdo its foreign competitors massively in productivity and quality. But surveys by J.D. Power & Associates and Harbour & Associates Inc. show that, although the gaps between U.S. and Japanese producers have narrowed, they are still significant. Alternatively, some American makers could get a dramatic lift from introducing a slew of blockbuster models, as Ford once did with the Taurus. But this kind of boost is likely to be temporary. Fact is, Detroit's condition will probably continue to worsen, while that of Japanese rivals gets stronger.

When the day of reckoning comes, two options will emerge: bankruptcy and bailout. Some in Washington will want natural market forces to handle the adjustment to an auto industry that is dramatically downsized and predominantly Japanese-owned. They would accept a bankruptcy or two, allowing the severing of contractual obligations to retirees, as well as major production outsourcing to China and other places where costs are much lower.

But other Washington players will argue for substantial government assistance conditioned on radical corporate restructuring. The Big Three and the unions would have to agree to close many more plants and to expand their investment in more competitive technologies. Health-care benefits for current workers and obligations to retirees would be gradually cut back, but far less drastically than in the case of bankruptcy. Considerable foreign outsourcing will be allowed, but within parameters. In return, Washington would provide certain tax breaks and loan guarantees and it would assume some pension and health-care obligations.

Of course, it would be better if the auto companies, together with their unions, radically restructured themselves voluntarily, but there is scant precedent for that in the annals of American industry. So, of the two remaining choices, I would reluctantly favor a variant of the bailout option. It's not because the management and shareholders of the Big Three have any claim on the public purse, because they surely do not. After all, they failed to respond adequately to the challenge from Japan throughout the 1990s, and they squandered huge profits toward the end of the decade. But why should workers and retirees pay so dearly for these flawed strategies? To be sure, past and present employees should make concessions, but they also deserve help from the companies -- which can provide it only if they survive -- and from Uncle Sam.

The global marketplace demands players that are hypercompetitive. With or without Washington's help, the restructuring that lies ahead for Detroit could be deep and painful. Barring a miracle, however, that seems inevitable.

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