Bush's Social Security Plan Assumes Much From Stocks

To conclude that Social Security is careening toward a crisis in 2042, President Bush is relying on projections that an aging society will drag down economic growth. Yet his proposal to establish personal accounts is counting on strong investment gains in financial markets that would be coping with the same demographic head wind.

That seeming contradiction has become fodder for a heated debate among economists, who divide sharply between those who believe the stock market cannot meet the president's expectations and those who say investor demand from a faster-growing developing world will keep stock prices rising.

"If economic growth is slow enough that we've got a problem with Social Security, then we are also going to have problems with the stock market. It's as simple as that," said Douglas Fore, director of investment analytics for TIAA-CREF Investment Management Group. A spokeswoman said the company has not taken a position on the Social Security debate.

In the next two decades, as elderly populations swell throughout the developed world, retirees will begin withdrawing their savings, selling their financial holdings to raise cash and potentially glutting the world with stocks and bonds. Richard Jackson, director of the Center for Strategic and International Studies' global aging initiative, called it "the great depreciation scenario." Germany's Mannheim Research Institute for the Economics of Aging dubs it the "asset meltdown hypothesis."

That would not be an auspicious environment for young investors opening personal accounts to replace a portion of their traditional Social Security benefits.

"If there isn't an alternative source of demand for those assets, you're going to have a tremendous slowing of growth," said Jeremy J. Siegel, a University of Pennsylvania finance professor who just completed a book on the subject. "The only way to save the financial markets is very rapid growth in the developing world."

Compounding the problem of oversupply, economic growth -- predicted by the Social Security Administration to slow from a historical annual rate of 3.5 percent to a sluggish 1.9 percent -- would hit corporate profits and lower stock prices further, the theory goes.

That would cause stock prices to drop, because they are priced as a multiple of a company's earnings. (…)

For workers choosing between private accounts and a traditional, defined Social Security benefit, the question would be important. Under Bush's proposal, for every dollar deposited in a personal account, a worker's traditional benefit -- delivered in a monthly Social Security check -- would be diminished by a dollar, plus the interest rate the money would have earned in Treasury bonds. (…)

White House officials think the decision is easy. Social Security's chief actuary assumes that an account invested half in stocks and half in corporate and Treasury bonds would yield a 4.6 percent return above inflation, enough for a comfortable profit over the traditional benefit. An index of stocks alone would return 6.5 percent over inflation, based on historical performances.

But some economists are not so sure. Richard Berner, senior U.S. economist at Morgan Stanley and an opponent of diverting Social Security taxes into private accounts, said strong stock market returns of the past 20 years were an anomaly driven by a confluence of low inflation and low interest rates that is not likely to repeat. "The administration's assumptions, especially for a balanced portfolio, sound pretty high," he said.

In a recent paper, Prudential Equity Group strategist Edward Keon wrote that long-term economic growth of around 2 percent would probably produce equity returns of, at most, 3.5 percent after inflation.

Growth in China, India and other parts Asia will help, Siegel said, because the growing middle class in those countries will want to invest in the West, creating demand for the stocks and bonds that retirees will sell. But if the economic laggards in Africa, the Middle East and Latin America don't speed up fast, the pool of capital from the developing world will not be large enough to make up for the West's decline. He gives future workers an 84 percent chance of beating the White House's 3 percent threshold. That might seem like good odds, he said, but, "if you're going to miss it, that's going to hurt a lot more than if you exceed it."

Others say the hurdle will be impossible to clear. Given the assumed slowdown in the economy, stocks could only get to a 6.5 percent return if they are rising from a post-

crash, depressed level or if their prices were inflated to Internet bubble valuations, according to calculations of University of California at Berkeley economist J. Bradford DeLong and Dean Baker of the liberal Center for Economic and Policy Research.

White House economists say such calculations are absurd because they ignore global economic growth and investment in countries unaffected by the demographic slowdown. The Mannheim Research Institute recently concluded that "the asset meltdown" is a bit overstated. Demographic trends, it said, will hit asset prices, but not disastrously.

But counting on the developing world to save Western financial markets is a risk, economists say. And it paints a bleak picture for the U.S. economy. If corporate profits grow two-tenths of 1 percent more rapidly due to investments in developing countries, in 75 years, 30 percent of U.S. profits would come from the Third World, Baker said.

Besides, he said, when the president talks of limiting personal account investment options to safe stock and bond funds, he is probably not thinking about an emerging-market mutual fund, the returns on which have been extremely volatile.

"I don't think that's where [workers] think their Social Security saving is going to go," Baker said.

By Jonathan Weisman and Ben White

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