the weekly Standard

Be Afraid . . .

There could be nasty economic surprises during the next four years. **BY DAVID M. SMICK**

REPUBLICANS, giddy and gloating, are understandably proud of the outcome of the election. Democrats from Boston to San Francisco are on a 24-hour suicide watch. Before the GOP euphoria gets out of hand, though, consider that the next four years could be challenging in ways unimagined.

I'm not thinking mainly of the president's domestic agenda, court vacancies, or Iraq, difficult as those tasks may be. No, the far greater challenge may come in mastering the global economic Rubik's Cube of a world dramatically more financially integrated than even when the president's father was in office. No surprise event, sudden imbalance, or price shock occurs these days without ramifications on our shores. Worse, a lot of the old, reliable solutions may no longer suffice. Even the experts are confounded.

Begin with the price of oil. Some optimists suggest a return to the high $20 per barrel level is possible; others make a plausible case for a permanent jump to $60. Philip Verleger, an expert at the Institute for International Economics, goes further: "The situation . . . today bears a remarkable similarity to the one observed in the late 1960s. . . . In theory, crude prices might rise to $160 per barrel if history followed the 1973 script precisely."

While even $60 oil ain't beanbag from a U.S. standpoint, it would be devastating for China, possibly collapsing its banking system. Why is that important to Americans? The U.S. budget deficit is large, but interest rates have stayed low here because the countries with which we run large trade deficits tend to reinvest their surplus dollars in U.S. Treasuries. Economist David Hale argues that the funding that helps keep U.S. interest rates low comes from commodity-producing countries that have benefited from the impact of China's economic boom on their export prices. Put another way, the future of the U.S. dollar will depend on the longevity of the Chinese boom.

Again, some experts see China booming for as far as the eye can see. Yet a growing number are beginning to warn of trouble ahead, starting with the failure of Chinese consumption in recent years to underpin overall growth. Is a Chinese bubble about to burst? One Western analyst writes that the latest cottage industry in China is getting the money of elites out of the country, often in suitcases. What do they know that we don't?

No surprise event, sudden imbalance, or price shock occurs these days without ramifications on our shores.

Despite the large U.S. budget and trade deficits, why are interest rates still so low, against all mainstream economic thinking? More specifically, why did the long-term bond market rally each time the Fed began raising short-term rates in the past six months, something that hasn't happened since the 1960s? The Fed offers positive spin—that the market is simply convinced of the central bank's inflation-fighting credibility. IMF experts suggest that because of the aging U.S. population, pension funds are merely engaged in a long-term shift of their portfolios from equities to bonds.

A more troubling hypothesis comes from Japan, where some analysts argue that the U.S. experience since the information technology bubble burst in 2001 bears a remarkable resemblance to Japan's frustrating economic decline and stagnation in the 1990s. U.S. interest rates remain low and monetary policy relatively ineffective, they say, because corporate demand for debt has come to a standstill. Analysts at Nomura Research call this the "corporate debt rejection syndrome." In light of America's cautious corporate sector, which is now in surplus, they think the federal deficit and public borrowing are a godsend. Such thinking of course runs counter to the global consensus view, which is why it is so troubling.

Not worried yet? Consider the scenario offered by analysts such as Roger Kubarych of a coming U.S. private pension crisis which could wreck the auto industry. Or try this on for size: Remember the scare of a decade ago over the dangers of financial derivatives? Measured at the end of the first quarter of 2004, derivatives held by U.S. commercial banks rose to $76.5 trillion—a 21.2 percent jump in one year alone!

Then there's what Michael Ledeen describes as "the old reliable: human stupidity." One foolhardy move by an important government or a megacorporation or global hackers suddenly successful in gumming up the financial system, and George W. Bush could really have his hands full. Fiddling with the Rubik's Cube, the effects could quickly spread and be impossible to undo.

This is why Republicans need to balance their postelection gloating and glee with a dash of humility. It's a dangerous world out there. Bad things happen, and it's in the interest of a lot of people around the world to see George Bush fall flat on his face.♦

David M. Smick is the founder of Johnson Smick International and editor and publisher of International Economy *magazine.*