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ECONOMIC VIEWPOINT
By Jeffrey E. Garten

Why Wall Street May Soon Deliver a Nasty Shock

With the global economy in a funk, Western nations squabbling, and the U.S. budget and trade gaps growing, look out

In the aftermath of the Iraq war, Wall Street and Washington could be on a collision course. I can't predict when a confrontation will occur, what it will look like, or what will set it off, but two dangerous trends are intersecting: weakening economic fundamentals and deteriorating relationships among key governments.

I was thinking about this potential clash when I recently came across a half-completed manuscript of mine, written in 1992, describing how sour markets and nasty politics can interact. My paper started with a story that may have resonance today. The scene was the morning of Sunday, Oct. 18, 1987. James A. Baker, then Treasury Secretary, was on TV's *Meet The Press*. He was asked about the recent drop of the dollar against the Deutschemark, a currency movement caused by the runup of German interest rates. Baker replied bluntly. "We will not sit back and watch Germany jack up its rates and squeeze world growth," he said. He emphasized "squeeze" by tightening his fist and raising it close to his jaw.

Wall Street already knew that global economic conditions were fragile, but now it had more bad news: a clear signal that economic cooperation between Washington and Bonn had ruptured. When U.S. stock exchanges opened the next day, the markets crashed. In the following weeks, the Reagan Administration became obsessed with smoothing out its foreign relations and addressing its budget and trade deficits. But it was too late.

I'm certainly not saying that today's economic conditions are the same as they were in 1987, nor that we are necessarily on the eve of a dramatic stock market tumble. Still, there is an important parallel in the connection between economic problems and political tensions, particularly when both are off course and financial vulnerabilities are growing.

Consider the sorry state of today's world economy. In recent weeks, the International Monetary Fund, the World Bank, Morgan Stanley, and other institutions have all lowered their forecasts for global growth. They have pointed to the declining volume of both global trade and to the shrinking financial cushion for big banks and insurance companies abroad. Business confidence has plummeted everywhere. CEOs are averse to taking even educated risks.

The U.S. is the only motor for the world economy, but a precarious one. Growth is anemic. Many U.S. stocks are still overvalued by historical standards. Most important, as in 1987, Uncle Sam is running sky-high fiscal and trade deficits, causing it to rely heavily on foreign inflows of some $2 billion per day -- and making the dollar unusually vulnerable to a destabilizing sell-off.

Meanwhile, Japan and Germany are flirting with both recession and deflation, with no politically realistic way out for the foreseeable future. More money is flowing out of emerging markets than into them, a bad omen for their future growth.

It is easy to see why Wall Street should want governments to work together to meet these challenges. But the transatlantic fights of 1987 were nothing compared with today's serious divisions in NATO and the U.N. They pale relative to the current deep animosity between President Bush and his counterparts in France, Germany, and even Canada and Mexico.

The breakdown in cooperation is spreading. The Doha Round of trade negotiations could easily collapse. The European Union is close to imposing $4 billion worth of trade sanctions on the U.S. for failure to remove tax subsidies to its exporters. The key industrial nations are arguing bitterly over who should control the rebuilding of Iraq.

The big question is why Wall Street hasn't reacted more violently to this dysfunctional global environment. Perhaps traders and investors are overly optimistic that modest gains in corporate profits will pull the world economy out of its funk. Maybe they think tax cuts will work their promised economic magic. Maybe they naively believe that disputes among allies will quickly evaporate.

But it's more likely that Wall Street's seeming indifference won't last. Some precipitating event -- it's impossible to say what -- could cause the financial markets to again send shock waves through the American and global economies. The Standard & Poor's 500-stock index could be driven much lower, chilling new corporate investments. The dollar could tank as foreign investors lose confidence in U.S. policies. This could force the Fed to raise interest rates to keep attracting foreign investors. Or it could push up the value of the euro and the yen against the greenback, choking off critical European and Japanese exports.

What is certain is that in the face of problematic economic and foreign policies, Wall Street has been giving the Bush Administration a relatively free ride. In similar situations in the past, the markets have delivered a much harsher verdict. Look for that to happen again -- sooner rather than later.

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