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Four really, really bad scenarios

By [EAMON JAVERS](#) | 12/17/08 4:39 AM EST

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Intelligence adviser James Rickards outlines four financial scenarios that threaten national security.
Photo: AP

What's the worst that could happen?

That's a question that James Rickards spends a lot of time pondering these days, as he sifts through the national security implications of the financial crisis facing the United States.

Rickards will lay out his worst case scenarios in a lecture sponsored by the Navy and the Office of the Secretary of Defense for Policy tonight. And his forecasts aren't for the faint of heart.

Rickards calls it the "A to Z" problem: What are the threats that could make the U.S. economy look less like America and more like Zimbabwe? He sees them everywhere – in the Chinese ownership of vast amounts of American debt, in Russia's increased centralization of its economy, in Al Qaeda's long-established fascination with damaging the U.S. economy.

In many ways, Rickards is the ultimate bear. He's not just thinking about whether the stock market will decline, but whether or not the stock market will survive.

All that puts Rickards decidedly outside mainstream economic and political thinking in America. But he does have an influential audience: the United States intelligence and defense communities.

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Rickards is a regular adviser on financial issues to the director of national intelligence's office, and he lends his financial advice to the national security community.

His lecture comes as part of an annual "Rethinking Seminar" produced by the Johns Hopkins University Applied Physics Laboratory. Rickards argues that government is not doing nearly enough to prepare for the worst. "Here's the policy problem for the United States," he said in an interview. "We have experts in defense and intelligence, and huge depth in capital markets

experience at the Fed and at Treasury. But they're separated by the Potomac River. And they're not talking to each other."

Rickards came by his economic experience the hard way. He was the general counsel at Long Term Capital Management, the hedge fund that collapsed in spectacular fashion in the late 1990s and nearly took the global economy along with it. That near-economic death experience gave him a healthy appreciation for risk. Today, he's the senior managing director for research at Omnis, an applied research firm.

Four of the scenarios keep him up at night:

The Bait Effect

Terrorists, and al Qaeda in particular, are fascinated with the idea of destroying the U.S. economy. Rickards worries that the economic meltdown in the United States could serve as bait of sorts for a terrorist attack, as plotters calculate that a strike now could have a "force multiplier" effect because of the already skittish U.S. stock market.

The China Syndrome

The Chinese own more than \$500 billion worth of U.S. Treasury bonds, and billions more in the debt of other U.S. entities such as those held by Freddie Mac and Fannie Mae. And a general sense of mutually assured financial destruction keeps them from wielding that debt like a weapon: if the Chinese dumped U.S. debt on the global market, their own holdings of U.S. debt would decline in value, the U.S. economy would be damaged, ultimately harming the Chinese economy by reducing American ability to buy more Chinese goods.

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They'd have to be crazy to try it. But Rickards points out that governments don't always do the rational thing. And in the meantime, their holdings give the Chinese incredible power over American decision making.

"It gives the Chinese de facto veto power over certain U.S. interest rate and exchange rate decisions," Rickards explained. "For example, there's a limit to how much dollar depreciation the Chinese would tolerate."

That potentially closes off one American economic strategy: allowing the dollar to decline in value in order to help boost U.S. exporters. And China's leverage is only growing as each federal bailout adds to the U.S. deficit.

The Existential Crash

A pessimist by nature, Rickards believes that many economic forecasters are wrong, and the recession will get far worse than predicted.

He sees an epic disaster scenario in which the U.S. gross domestic product declines by a staggering 35 percent over the next six to seven years. Crippling deflation could take hold. Unemployment, he says, could approach 15 percent.

That's a calamitous rate, but it would not be an all-time high: unemployment hit 25 percent during the Great Depression.

"The national security community needs to be conversant with this," Rickards said. "In defense, intelligence, and national security, you earn your money by preparing for things that may be remote, but pose an existential threat if they come to pass."

In this scenario, the possibilities for global unrest increase dramatically as a staggering United States retreats from foreign aid and global diplomacy and the list of dangerous failed states grows sharply.

The Alternate-Dollar Nightmare

"The Number One vulnerability is the dollar itself," Rickards concluded. "We're printing them and shoving them out the door, and the Fed is basically out of bullets. So why hasn't the dollar collapsed? The short answer is, global investors don't have any other choice." That is, there simply aren't enough Euro- or Yen-backed securities for investors to shift their money out of dollars and into some other currency.

But what if some kind of global coalition – say a trillion-dollar sovereign wealth fund allied with several countries around the world – banded together to create a gold-backed alternative to the dollar?

Rickards says investors – many of whom already resent that they have no alternative to the dollar – would sell American currency in huge numbers to take advantage of the new opportunity. "If that happens, that's the end of the dollar," Rickards said. "You'd have high unemployment, deflation, and interest rates would go up. It would take what already looks like a strong recession and make it a Great Depression or worse."

Still, even Rickards sees a silver lining to all this. He looks around the world to the problems facing other countries such as Russia, China, Iran, and those in the Middle East.

"There are vulnerabilities for the United States, but also opportunities," he said. "I'd rather be the United States than any of these other countries."

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