American consumers and Chinese producers have led a global boom. China is creating genuine wealth, but America's binge is based partly on an illusion, says Pam Woodall, our economics editor

OVER the past year the world economy has grown by almost 5%, its fastest pace in two decades. Growth has been powered by two high-octane fuels: America's exceptionally loose monetary policy, which has encouraged consumers to keep spending; and an unprecedented investment boom in China. America and China together accounted for almost half of global growth over the past year. If American consumers and Chinese producers were to retreat at the same time, global growth could slump.

Until the Federal Reserve started to lift interest rates in June, money had been cheaper than ever before, and not just in America: average short-term interest rates in the world's big economies were at their lowest in recorded history. Average real interest rates are still at their lowest since the high-inflation 1970s. By slashing rates to 1% after the stockmarket bubble burst, the Federal Reserve saved America from a deeper recession and the risk of deflation.

But inflation is now rising, so monetary policy needs to be tightened. How will the American economy—indeed, the world economy—fare if interest rates return to more normal levels of perhaps 4-5%? Super-low rates have encouraged consumer behaviour that will look a lot less sensible as interest rates rise. And to make things trickier, crude-oil prices have surged to new heights at the very time that the Fed has started to raise rates. Dearer money and dearer oil have already caused consumers to cut back.

China's breakneck pace of growth also looks unsustainable. In the
year to the second quarter its GDP grew by almost 10%. Real fixed investment was increasing at an annual rate of 35% earlier this year; bank lending has been rising too fast, fuelling a property bubble; and inflation has moved above 5%. If China suffers a hard landing, the rest of the world will feel the bump: in the past three years, the country has contributed one-third of the world's growth in real output, measured at purchasing-power parity (see chart 1).

Only a few years ago, the term “the world economy” was used as shorthand for the economies of the developed world; China would at best rate a brief mention. But now it is too big to ignore (see chart 2, below). It was largely thanks to China's robust growth that the world as a whole escaped recession after America's stockmarket bubble burst in 2000-01. But its recent boom is also responsible for much of the surge in global energy demand that has pushed up oil prices. China's massive purchases of American Treasury bonds explain why the dollar has not fallen further or bond yields risen more sharply—even though America's huge current-account deficit continues to widen. Last but not least, many people blame the sickly state of America's jobs market on imports from China and on outsourcing.

China is home to one in five of the world's people, and has long been the most populous country on earth, but economically it has started to matter only recently. China's GDP already accounts for 13% of world output (at purchasing-power parity), second only to America's. By the end of this year China will probably be the world's third-biggest exporter (after America and Germany). It is also the largest recipient of foreign direct investment as multinationals have moved operations to China to take advantage of its low labour costs and huge domestic market. It is the new workshop of the world, producing two-thirds of all photocopierners, microwave ovens, DVD players and shoes, over half of all digital cameras and around two-fifths of personal computers.

But China is not only a big new producer, it is also a big new market. Its imports grew by 40% last year, and over the past three years it has accounted for one-third of the total increase in world import volumes. China has become a locomotive for the rest of East Asia, accounting for half the total export growth of the other East Asian economies last year. Indeed, exports to China have played a big part in Japan's recent economic recovery. China's demand for commodities has also rocketed, driving up world prices.

If China sneezes

Over the past year, China's policymakers have been trying to cool the economy, and there are signs that they are succeeding. Both investment and bank lending have already slowed quite sharply. But will the economy land gently or with a crash, as it did after the 1993-94 boom? A crash would dent growth in the rest of the world just when the Fed is raising interest rates.

Yet China's boom is itself partly the product of the Fed's super-lax monetary policy. With its currency pegged to the dollar, China has been forced to import America's easy monetary conditions. Its higher interest rates have attracted large inflows of capital that have inflated domestic liquidity, encouraging excessive investment and bank lending in some sectors which could lead to a bust. Fortunately the economy is not as overheated as it was in the early 1990s, when investment, credit and inflation were all growing much faster; and this time the authorities have acted sooner. But even if China can engineer a soft landing (which is generally defined as growth slowing to around 7%), growth in investment and
imports of capital equipment and raw materials would slow much more severely, causing some global discomfort.

Some commentators liken China's boom to America's dotcom bubble in the late 1990s; but although investors have clearly got carried away, much of the exuberance about China is rational. The country's recent ups and downs are reminiscent of America's booms and busts during the period of industrialisation in the late 19th century. These did not prevent America becoming the world's economic giant, creating fast-growing markets for European goods. If China continues with its reforms, it will enjoy faster growth than America ever achieved. Within a decade it will probably be the world's largest exporter and importer, and one day it may overtake America as the world's largest economy.

That strikes fear in the heart of many businessmen and workers in rich countries. In America's presidential-election campaign, China has been widely blamed for America's "jobless recovery"; yet faster growth in China should mean faster rather than slower growth elsewhere too. China has a unique combination of a huge population and an economy that is unusually open to the rest of the world, as measured by trade or foreign direct investment. China's catch-up in income and its integration into the world economy could be the single biggest driver of global growth over coming decades. Indeed, China's boost to global growth could exceed the much-trumpeted gains from the IT revolution.

China's road to prosperity is not without risks. Its economy may well stumble during the next year or so. But its future prospects remain excellent, built on genuine wealth creation as currently underemployed labour is put to productive use. In contrast, American consumers have been living in never-never land, financing their spending by borrowing against illusory gains in wealth.

**Not as rich as you think**

Economies can get truly richer only through increased productivity growth, either from technological advances or from more efficient production thanks to international trade. Thus China's integration into the world economy genuinely creates wealth. The same cannot be said of all the "wealth" produced by stockmarket or housing bubbles.

In recent years, many people around the world have found it easier to make money from rising asset prices than from working. Roger Bootle, the managing director of Capital Economics, a London consultancy, calls this "money for nothing". The surge in share prices in the late 1990s boosted the shareholdings of American households by $7 trillion over four years, equivalent to almost two years' income from employment—without requiring any effort. The value of those shares has since fallen, but the drop has been more than offset by soaring house prices. Over the past four years the value of homes in America has increased by more than $5 trillion, making many Americans feel richer and less inclined to save. But much of this new wealth is an illusion.

The first mistake, at the end of the 1990s, was to believe that shares were actually worth their quoted price. The second mistake, today, is to view higher house prices as increased wealth. A rise in share prices can, in theory, reflect expected future gains in profits. The stockmarket boom did reflect some genuine wealth creation in the shape of productivity gains, however exaggerated they may have been. But rising house prices do not represent an increase in wealth for a country as a whole. They merely redistribute wealth to home-owners from non-home-owners who may hope to buy in the future. Nevertheless the illusion of new-found wealth has caused households as a whole to save less and spend
Historically low interest rates have fuelled housing bubbles in America and many other countries around the globe. At some stage prices will fall, obliging consumers to save much more and spend less. The unwinding of America's vast economic imbalances could depress growth there for many years, whereas China's slowdown looks likely to be fairly brief.

Oddly enough, China may be partly to blame for this wealth illusion in rich economies, because central bankers have been slow to grasp the consequences of China's rapid integration into the world economy. By producing goods more cheaply and so helping to hold down inflation and interest rates in rich economies, China may have indirectly encouraged excessive credit creation and asset-price bubbles there. Inflation has remained low, but excess liquidity now flows into the prices of houses and shares rather than the prices of goods and services. And to keep its exchange rate pegged to the dollar, China has been buying vast amounts of American Treasury bonds, which has helped to depress bond yields and mortgage rates, fuelling America's property boom.

This survey will explore the many ways in which China's rapid economic development is affecting the rest of the world, from jobs and growth to oil prices and inflation. The integration of China's 1.3 billion people will be as momentous for the world economy as the Black Death was for 14th-century Europe, but to the opposite effect. The Black Death killed one-third of Europe's population, wages rose and the return on capital and land fell. By contrast, China's integration will bring down the wages of low-skilled workers and the prices of most consumer goods, and raise the global return on capital.

Some central banks, slow to grasp the effect of these structural changes on inflation and monetary policy, have been running overly loose policies that have fuelled unsustainable booms in America and some other economies. In the short term, therefore, China could make growth more volatile, but in the long term it will be a powerful engine of global growth. The Black Death is thought to have originated in China and spread to Europe through trade. This time China will export vitality to the world economy instead.

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