

## The markets and the world economy/ Bears in the woods

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### Despite the rattled markets, the world economy is still relatively strong. Just don't bet your house on it

IF YOU meet a bear in the woods, try not to panic or scream; on no account should you turn your back and run. As markets around the world have turned grizzly over the past two weeks, some investors seem to have forgotten the old hikers' maxim. After three years of big gains, many stockmarkets have tumbled by 10% or more in less than ten days. The loudest growls have echoed around emerging markets and commodities. Europe has surrendered most of this year's gains. Americans have so far escaped lightly, but they would be unwise to take comfort. Their housing market, the recent rock of their economy, is where a much grizzlier creature lies in wait.

Most investors tend to look first at equity markets—and they have certainly had a good run virtually everywhere. Yet a repeat of the slump after the bursting of the dotcom bubble in 2001-02 remains highly unlikely. In 2000 shares were wildly overvalued. Today price/earnings ratios in most stockmarkets are near, if not below, their long-term averages. This suggests that the slide in shares could be short-lived.

So what has caused this burst of volatility? One popular explanation conjures up fears of rising inflation and hence higher interest rates (see [article](#)). Yet this sits oddly with the fall in bond yields and the gold price over the past week: if inflation were the culprit, you would expect both to have risen. The real puzzle is not why volatility has suddenly increased, but why it had been so low in the past year or so. The answer seems to be an abundance of cheap money, which lured investors into complacency. Now they are starting to demand higher returns on riskier assets. Emerging-market equities and metals, not (generally safer) bonds, suffered the biggest mauling in the past week. It could be a healthy correction.

### A formidable machine

Indeed, the recent jitters need not harm the world economy, which even bears admit has performed stunningly. World GDP has grown at an annualised rate of more than 4% for 11 consecutive quarters (see our [economic and financial indicators](#)). This is the strongest upturn for more than 30 years. Yet global inflation remains historically low. Strong growth with mild inflation is all the more amazing given the tripling of oil prices since 2003. Past oil-price shocks have caused stagflation.

The world has so far shrugged off higher oil prices with the help of two powerful economic forces. The first is the opening up and integration into the world economy of China, India and other emerging economies. This has given the biggest boost to global supply since the industrial revolution. Their cheap labour has cut the cost of goods. The threat that jobs in rich economies could move offshore has helped hold down wages. Although demand from emerging economies has fuelled the surge in oil and commodity prices, the newcomers' overall effect has been to curb inflation in the rich world.

That, in turn, has magnified the second stimulus. Since the bursting of the dotcom bubble, central banks have pumped out cheap money. In 2003 average short-term interest rates in the G7 economies fell to their lowest in recorded history. Because inflation remained low, the central banks have been slow to mop up the excess liquidity. Cheap money has encouraged households, especially American ones, to borrow and spend lavishly. It is not just house prices that have surged ahead; cheap money has encouraged investors across the world to take bigger risks, creating several smaller bubbles. Together the huge boost to supply (from emerging economies) and the huge boost to demand (from easy money) have offset the burden of higher oil prices, creating the once-impossible combination of robust growth and modest inflation.

### Don't panic

The era of cheap money is nearing an end. For the first time in 15 years, the three big central banks are now all tightening monetary policy. The European Central Bank has already followed the Federal Reserve's lead in raising interest rates; the Bank of Japan has stopped printing lots of money and will start lifting rates soon. Only now are the markets realising that interest rates may rise by more than they had expected. In the long term, rates should be roughly equal to nominal GDP growth, but in America and elsewhere they are still well below it. Optimists argue that America's economy is coping well with rising interest rates, but it hasn't really sniffed tight money yet. Without easy credit, dear oil will cause more pain.

Until recently, financial markets appeared to be betting that the Goldilocks economy—neither too hot, nor too cold—was safe from the bears. The rattled markets are a reminder that sooner or later growth will slow or inflation will rise. Inflation is not about to spiral upwards but with

diminishing spare capacity, it could edge up. America has an extra risk because Wall Street suspects that Ben Bernanke, the Fed's new chairman, may be a soft touch on inflation. If that suspicion persists, he will need to raise interest rates by more than otherwise—or investors will do the tightening for him by pushing up bond yields. That would make other assets look expensive.

It is in the American housing market that the bear may growl loudest. By borrowing against the surging prices of their homes, American consumers have been able to keep on spending. The housing market is already coming off the boil (see [article](#)). If prices merely flatten, the economy could slow sharply as consumer spending and construction are squeezed. If house

prices fall as a result of higher bond yields, the American economy could even dip into recession. Less spending and more saving is just what America needs to reduce its current-account deficit, but for American households used to years of plenty it will hurt.

For the world, it is best that America slows today. Later, imbalances will loom even larger. A few years ago, Japan and the euro-area economies were flat on their backs. Now they are growing "above trend", so the world depends less on America than it once did. The boost to the world economy from China and India will last into the future, even allowing for mishaps. Wise investors should resist the urge to flee, reduce their holdings of risky assets and stare down the bear.

**1,090 words**