The U.S. is healthy enough to withstand Black Monday, but it and the rest of the world must learn to watch out for China's well-being.

When the Dow Jones industrial average fell almost 1,100 points soon after the opening bell on Aug. 24, the world suddenly seemed like a very small place. A tidal wave of stock selling that began in Shanghai had rolled all the way into lower Manhattan as China's problem became, undeniably, America's. Wall Street panicked. General Electric, JPMorgan Chase, and Home Depot lost a fifth of their value in minutes. For the first half-hour, the Chicago Board Options Exchange couldn't even calculate its Volatility Index, also known as the fear gauge. Markets from Asia to Europe preceded the U.S. downward. "There's no rational choice anymore, no rational reaction," Michael Wolschneck, a senior equities manager for Lampe Asset Management in Düsseldorf, Germany, told Bloomberg.

U.S. markets partially rebounded that day and the following ones as investors realized that the U.S. economy isn't on the precipice of a recession. But that doesn't take away from the importance of what was quickly dubbed Black Monday. China, which makes the world's steel, electronics, and bobblehead dolls, has now demonstrated it can make a pretty serious market crisis, too.

China accounted for almost 40 percent of global growth last year. Its appetite for raw materials has undergirded economies from Australia to Brazil to South Africa, and its production capabilities have lowered prices of industrial machines and consumer goods everywhere money changes hands.

But it's also kind of a mess.
Fueled by real estate and shadow banking, China's debt quadrupled from 2007 to 2014, according to a McKinsey analysis. Its economic growth is slowing, pollution is awful, and a hawkish foreign policy is alienating neighbors. Investors were willing to ignore all that because of their faith in the technocratic excellence of China's economic managers, but that faith has been destroyed by this year's bungling of the stock and foreign exchange markets.

"The main aims of China's leader Xi Jinping are political and geopolitical, while his economic goals are contradictory," Arthur Kroeber, founding partner and head of research at GaveKal Dragonomics, a Beijing research firm, wrote to clients on Aug. 25.

The way this meltdown occurred—first slowly and locally, then rapidly and globally—says a lot about the nature of the world economy and markets today. Many investors don't trust stock valuations, which they think have been inflated by easy money from the central banks. The tripling of U.S. stock prices since their 2009 bottom had a lot of them ready to sell at the first sign of trouble. "We believe that this has been the most doubted, second-guessed, and frankly hated stock market rally in history," Brian Belski, chief investment strategist at BMO Capital Markets, wrote to clients the day of the tumble. When trouble emerged in the form of China, trend-following trading strategies kicked in, amplifying the plunge. Potential bargain hunters stood aside. "Prudence dictates waiting for a technical sign that the momentum has exhausted itself," advised Marc Chandler, head of currency strategy at Brown Brothers Harriman.

In a genuinely globalized economy, excesses and imbalances in one corner of the world inevitably affect other countries. (The last example: the U.S. subprime mortgage bubble.) China is home to some of the biggest excesses, with vast overinvestment in everything from chemicals to apartments. In many ways, President Xi and Premier Li Keqiang were doing the right thing—trying to push the economy away from its addiction to exports, manufacturing, and construction and toward producing goods and services for consumers at home. They also vowed to give the free market a "decisive" role in setting prices and interest rates. But they couldn't reconcile that with the Communist impulse to control the commanding heights of the economy and tamp down the natural volatility of capitalism.

The government's first mistake was to encourage ordinary Chinese to invest in the casino-like Chinese stock market, thus pinning its prestige on the market's rise. The Shanghai Composite index rose 152 percent this year through June 12. When the speculative frenzy finally cooled, Premier Li and Vice Premier Ma Kai led the effort to stop prices from falling, banning sales by major shareholders, stopping initial public offerings, and using government funds to buy stocks. It worked for a while, but eventually the markets succumbed to investors' fearfulness.

The government didn't do anything to manage the value of its currency, the yuan. In a bid for global financial leadership, Xi has said he wants the redback to be a reserve currency on par with the dollar, euro, yen, and pound. A market-based exchange rate is a necessary step in that direction. But when China devalued the yuan on Aug. 11 and said it would rely more on supply and demand to determine its rate, traders fairly or not suspected that Xi and his team actually wanted a cheaper yuan to boost Chinese exports—which had fallen 8.3 percent in July from a year earlier. Traders pushed the currency down so much, China was forced to reverse course and buy up yuans by cracking open its hoard of foreign currencies.

Global investors reacted to China's clumsiness first with amusement, then with fear. New York's Black Monday came on the heels of an 8 percent same-day drop in Shanghai, which occurred when Chinese investors sold after authorities didn't do as much as they'd hoped they would to prop up the market. "This is a real disaster, and it seems nothing can stop it," said Chen Gang, Shanghai-based chief investment officer at HSBC Aman Asset Management. A day later the government did come to the rescue, cutting the one-year lending rate by a quarter of a percentage point and freezing up bank funds by lowering the fraction of deposits that banks are required to hold in reserves. Chinese issues kept falling through Aug. 26, though, bringing their weekly decline to 23 percent.

The whole drama may have weakened Xi, who has been on course to become China's strongest leader since Mao. On Aug. 20, state media carried an article saying the leadership's push for reforms—such as fighting corruption and shrinking state-owned enterprises—had come up against "imimaginably" fierce resistance.

The overdue decline in the fairly small, underdeveloped Chinese stock market caused such a ruckus because it woke larger fears. It "crystallized something the market ought to have been aware of, which is that there is a very, very major slowdown occurring in China," says Adair Lord Turner, chairman of the Institute for New Economic Thinking and past chairman of the U.K. Financial Services Authority. "Every single major global recession in the last 50 years has started in the United States," Ruchir Sharma, head of emerging markets for Morgan Stanley Investment Management, said on Bloomberg Television in July. "The next global recession will be made in China."

Perhaps so. Still, the wall-on-fire reaction of Aug. 24 was a bit much. Markets behaved as they usually do, which is to overreact to new developments for a long time—and then abruptly overreact. "It feels like a severe episode of market hypochondria," Erik Nielsen, chief economist for UniCredit in London, wrote to clients. "Every bit of news is seen as disaster-in-progress."

How much we should worry about China has a lot to do with the definition of "we." Most at risk are countries such as Turkey and South Africa that have heavy debt denominated in foreign currencies like the dollar, persistent inflation, and economies prone to trade deficits. When investors lose confidence in emerging markets, countries like these are always the first to suffer. Although less connected to China, Europe is at some risk, because its economy is barely growing, making it vulnerable to even a smallish shock. Asian nations such as South Korea and Singapore that sell a lot to China have obvious exposure, but they've amassed huge foreign reserves that protect them against speculation. They can cut interest rates to stimulate growth and counteract the drag from China without concern that investors will trash their currencies.

With its huge domestic market, America is always more insulated than other nations from the ups and downs of global trade. Exports to China amount to only 1 percent of its gross domestic product. And crude oil at about $40 a barrel—thanks in part to weakening Chinese demand—will lower the price of gasoline, giving U.S. consumers more money to pay down debt and eventually increase spending on other things.

It helps that the U.S. economy was on a slow but steady growth path to begin with, adding more than 200,000 jobs a month on average. New-home sales rose better than 5 percent in July, the most this year. Equipment orders in July exceeded expectations. Auto sales have rebounded to their highest level since before the financial crisis. Consumer and corporate balance sheets are in excellent condition.

The scenario that gets veteran investors nervous is a repeat of the Asian Contagion of 1997 and '98. Then as now,}

The turmoil has parallels with the 1997 Asian meltdown, including expectations of a Fed rate hike
the Federal Reserve was poised to raise interest rates, oil prices were falling, and investors were losing confidence in certain emerging markets that had gone on a debt-fueled investment binge. Deflation loomed, and money was flowing out of emerging markets at an alarming pace. Fed Chairman Alan Greenspan worried about how long the U.S. could remain an "oasis of prosperity."

The U.S. played a role in causing the Asian Contagion, because investors withdrew money from emerging markets and put it in the U.S. to take advantage of anticipated interest rate increases. Likewise today, the Fed is preparing to raise short-term interest rates off the floor of near-zero, where they've been napping since the end of 2008. Higher rates in the U.S. will suck in money from around the world. That, in turn, could further drive up borrowing costs in vulnerable countries such as Brazil, which the money is leaving. It's the fear of this outcome that has investors suddenly obsessing over declines in obscure currencies like the Vietnamese dong and the Kazakhstani tenge.

The difference between now and then is that a lot of developing nations and global markets have braced themselves against the risks of a currency crisis, making a full-scale Asian Contagion unlikely, Morgan Stanley economists Manoj Prachand and Patrik Drozdzik in London told clients on Aug. 24: "In a nutshell, no one can or should rule out a crisis, but we believe that the risk has fallen from a few years ago."

The U.S. has even less reason to worry about contagion from Asia, since it wasn't harmed by the original episode, says David Rosenberg, chief economist and strategist at Gluskin Sheff, a Toronto-based wealth manager. Over the period of the last crisis, he says, the Fed cut rates instead of raising them, stock prices rose, unemployment fell, and economic growth averaged more than 4 percent a year.

Still, the August selloff is bound to get the attention of Fed Chair Janet Yellen and her colleagues when the Federal Open Market Committee meets on Sept. 16 and 17 to decide whether to raise rates. Because of the latest turmoil, markets are betting the Fed will wait until at least December. That's probably right: The Fed has cited "international developments" as a factor to watch in each meeting since January, says Lindsey Piegza, chief economist of Stifel Nicolaus, a Chicago-based investment firm. For the Fed, the biggest concern is that in a turbulent world, the dollar will become even more of a haven, driving up the exchange rate and making U.S. goods and services less competitive in global markets. Although the dollar has sagged recently against the euro and yen, it rose 13 percent this year through July, according to the Fed's index of a broad set of trading partners' currencies adjusted for inflation.

Financial markets depend on good information. When it's lacking, investors flail. They assume the best when they're bullish and the worst when fear gets the best of them. That helps explain the eruption over China, a nation that remains opaque despite having the world's second-biggest economy. Facts as basic as its GDP are hard to pin down: Officially it grew at 7 percent in the first and second quarters—suspiciously, precisely the rate Li predicted for 2015. Some outsiders put growth at closer to 5 percent based on data such as electricity consumption and rail cargo. The official unemployment rate is even less plausible. Despite all the changes China's gone through, it hasn't left a narrow range of 4 percent to 4.3 percent since late 2002.

Financial markets don't mesh well with command-and-control economics, either. Traders react instantly to new information, constantly updating prices on the latest intel. Viewed up close, the process of adjustment can look choppy to China's leaders. They try to keep a lid on volatility the opposite way—by fixing prices and rates—but all they manage to do is bottle it for a time. "The first mark of a fragile state is a concentrated decision-making system," wrote Nassim Nicholas Taleb and Gregory Treverton in the January-February issue of Foreign Affairs.

China still has a lot of strengths, including plenty more room to cut interest rates if needed and a war chest of about $3.6 trillion in foreign exchange. (Although it's spending dollars fast to support the yuan.) What it lacks for the first time in awhile are trusting investors. Some are angry enough to have taken matters into their own hands. On Aug. 22 a group of investors seized the head of the Fanya Metal Exchange, threw him into a car, and drove him to a Shanghai police station, alleging that Fanya had stopped making payments on its heavily advertised financial products.

These are strange times. Barack Obama has spent his entire presidency with short-term interest rates of essentially zero percent. The transition back to normal, when it happens, might be wrenching at home and abroad. For the U.S., the nightmare scenario is less financial than political: no one wants a China whose leaders try to cover up economic woes by stirring patriotic fervor with confrontations in, say, the South China Sea or East China Sea. (One Putin is enough, thanks.) An embarrassed leadership could be even harder to deal with than a belligerent one. Bashing China is a popular American sport, especially on the campaign trail, but gloating over the made-in-China meltdown is an antiquated response. When China sneezes, the world just might catch a cold.