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World economy: Confidence takes welcome turn

By Chris Giles

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Full speed ahead? The global economy faces more uncertainty before it matches the performance of China's bullet trains

Glimmers of hope have begun to light up the world economy. This autumn, for the first time in three years, advanced economies are leading the charge as the emerging world stabilises after a torrid summer.

Cautious optimism has yet to translate into a boost to sluggish world economic growth, but so long as the sparks are not just a flash in the pan, 2014 appears set to be a better year.

The improvement in the outlook comes with a health warning, however. So much has changed in the global economic environment since the spring that the current snapshot can only give tentative indications of a sustained recovery.

In April, the International Monetary Fund talked of a "three-speed recovery" with emerging economies set fair and growing rapidly, the US and Japan doing reasonably, and Europe still mired in crisis. Last week, IMF managing director Christine Lagarde had to reverse those views in a speech acknowledging that "in many of the advanced economies, however, we are finally seeing signs of hope", while "momentum is slowing" in countries such as China, India and Brazil.

These sobering problems in the characterisation of the world economy reflect the fact that there is no longer a simple sound bite to describe who is up and who is down. The increasingly complicated picture is one in which individual economies are distinct in their performance at the same time as they are mutually dependent.

Five years on from the collapse of 2008, "the journey is not yet complete", Ms Lagarde said. "But the fog of crisis is lifting and we can see that its aftermath leaves us with multiple new transitions."

The strength in the world economy centres on the large advanced economies that have put the worst behind them. Professor Eswar Prasad at the Brookings Institution, says: "The US economy continues to push forward at a modest pace and the UK is experiencing surprisingly good growth, while the core eurozone economies and Japan are also turning in positive growth."

The unexpected growth upswing in the second and third quarters raises questions over the cause of the brighter mood and the sustainability of the recovery.

Confidence has turned everywhere, with business and consumer surveys showing higher orders and increased production. The US motor industry has been revving faster on the back of improved household finances and a stronger housing market, but rapid recovery has been held back by this year's sharp tightening of fiscal policy.

This creates a "chicken and egg" problem, according to Bill Dudley, the president of the New York Federal Reserve. Households are unwilling to borrow and spend, while real incomes are unlikely to grow quickly.

In Europe, the bigger difficulty is in understanding why there has been an upswing at all. The eurozone surprisingly emerged from six quarters of contraction in the second quarter of the year, while UK growth powered ahead to 0.7 per cent in the same period despite no let up in its relentless deficit reduction programme. Such is the turnround in Britain's economic sentiment that the widely watched PMI indices have moved into boom-time territory.

According to Goldman Sachs, the indicators are consistent with annualised growth of 5.5 per cent in the third quarter. Improved confidence is the only clear answer, but that raises the question of why households and companies are suddenly looking on the bright side.

In Japan, the march of Abenomics continues with the country growing at its fastest pace in years. The outlook has improved so much that Shinzo Abe, the prime minister, has decided to bite the bullet and raise sales taxes to 8 per cent from 5 per cent in 2014 in a bid to reduce the budget deficit.

Beyond the large and richer economies, the early autumn has witnessed some stabilisation of the other big global players. China's growth rate dipped from 7.8 per cent in 2012 to an annual rate of 7.5 per cent in the second quarter of 2013, its worst performance since 1990 when China was subject to sanctions in the aftermath of the Tiananmen massacre. Although financial and economic reform is urgently required in the world's second-largest economy, the deterioration in growth appears to have been checked and some stability has returned.

The same modestly optimistic story does not apply to the eurozone's periphery or to other emerging economies. While a sense of imminent doom has passed and the eurozone periphery is stemming its losses and improving its trade balances, fiscal positions remain weak and unemployment is too high for comfort. Vulnerability to economic or political shocks remains. Mario Draghi, president of the European Central Bank, said recently that the recovery was "weak, fragile and uneven and from low levels".

The improvement in Europe's current account has a downside. Its increased surpluses over the past few years have been matched by deteriorations elsewhere, mostly in emerging economies. This has created new vulnerabilities that were exposed over the summer. Capital flight from countries such as Brazil to India, after the US Federal Reserve hinted that it was considering scaling back its monetary loosening, led to rapid currency depreciation, inflation and a greater burden of foreign currency debt.

Growth slowed, leaving the dilemma of whether to loosen monetary policy with associated currency risks, or to tighten it and hit growth further. HSBC chief economist Stephen King said the developments were "not so much a disaster, but a short-term constraint" on growth.

In a multi-speed world where the grounds for optimism are as diverse as the causes for concern, simple policy recommendations are tough to make. Everyone understands the validity of the IMF's spring warnings of the difficulties and dangers of removing extreme monetary stimulus in the US, Europe and Japan, but this knowledge has few practical applications.

In September, the Fed declined to begin a "taper" of its asset purchase programme, citing a still too weak recovery. There are no imminent signs of monetary tightening in other advanced economies. After the summer's turmoil, Ms Lagarde says the US has a special responsibility to normalise its monetary stimulus "very carefully" and should do so after dialogue with other countries.

Fiscal policy is just as fraught. The US is standing again on the edge of a fiscal precipice. The government shutdown in early October has a limited effect on the US and global economy but if it were to be followed by a failure to raise the government debt ceiling, the threat of a US default would be a real one.

In Europe, the improved outlook and a slightly looser fiscal stance should reduce some immediate tensions over fiscal policy but will not help create a durable fiscal pact for the single currency area.

The key task for countries is to seek ways to improve productivity to boost the longer-term outlook. As the Organisation for Economic Co-operation and Development regularly states, painstaking and persistent structural reform over many years is the proven way to boost the longer-term performance of economies. If the world moves out of the emergency ward in the months ahead, the need for growth-enhancing reform will become all the more important.

Economists' views

Kenneth Rogoff, professor of economics, Harvard University

"The developed world is moving towards recovery, and the overall risks to growth are balanced. We have entered a period where political uncertainty weighs more heavily on growth than at any time since the 1970s."

"Despite these uncertainties, things should get gradually better."

Michael Spence, 2001 Nobel Prize for Economics

"The US is in a steady but slow recovery led by private sector adjustment and extensive deleveraging. But growth is below potential and the non-tradeable sector is short of aggregate demand."

"Europe is not in recovery. It remains in a fragile situation. Japan may be beginning a recovery, but it is too soon to tell."

Edward Prescott, 2004 Nobel Prize for Economics

"Much of the developed world is sinking deeper into depression relative to its pre-2008 trend, with the US and southern European countries doing the worst. Moreover, many developing countries, in Asia in particular, are doing well."

"Growth of 2 per cent in gross domestic product per working age population is healthy."

Edmund Phelps, 2006 Nobel Prize for Economics

"Even structuralists like me can agree that nearly every nation in the global economy needs a strong rise in business investment if we are to regain prosperity."

"We cannot regain high prosperity until we manage to refresh our economies with innovative visions and ventures."

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