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Economists upbeat amid jitters

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Europe's sovereign debt crisis sent shock waves across the world as it proved that the recovery from the great recession was neither steady nor guaranteed.

European shares yesterday closed at their lowest level in nearly nine months, the Dow Jones Industrial Average was pushed below 10,000 and Asia stocks fell to multi-month lows. May has been a difficult month, with the FTSE-All World index diving back to levels seen last autumn.

But through this tense period, most economists have remained confident in the world economic recovery. Greece, Spain, Portugal, Ireland and Italy are simply not big enough to derail the global economy.

Jim O'Neill of Goldman Sachs says the policy crisis in the eurozone is unlikely to be a source of global financial market contagion. "Nearly 70 per cent of the eurozone economy is made up of three countries - France, Germany and Italy - and unless the sovereign debt crisis derails their economies, it is tough to see how the eurozone could weaken sufficiently."

Julian Callow of Barclays Capital agrees: "The real economy still has substantial momentum and pent-up demand at the global level, provided that the current derisking in the financial markets does not become extended and feed back into a fall in business and consumer confidence."

That has not happened to any great extent, a result more encouraging than in the aftermath of the bankruptcy of Lehman Brothers. And forecasts for the global economy, although uneven, are still rising.

"Globally we continue to make more upgrades than downgrades to our 2010-11 growth forecasts," says Michael Saunders of Citigroup, "but these upgrades are concentrated in Asia and emerging markets."

The Organisation for Economic Co-operation and Development is releasing its twice-yearly Economic Outlook today and its leading indicators have continued to rise since its October forecast. The picture of a rapidly growing but nervous global economy also emerges from the new Brookings-Financial Times index, designed to track the global economic recovery. Based on a composite of real economy indicators, financial indicators and indicators of business and consumer confidence, the index takes the pulse of the world economy, each Group of 20 country and various world economy sectors.

It shows the recession petered out in mid-2009, with many indicators registering high rates of growth. But within that robust global recovery the picture remains highly uneven: emerging markets are showing much greater vibrancy than advanced economies; production and trade have rebounded strongly, while employment has lagged behind; and until recently financial markets had raced far ahead of the real economy.

Eswar Prasad, senior fellow of the Brookings Institution and professor at Cornell University, says: "We should not discount the fundamental resilience of market economies and there are certainly signs of a continued recovery among the G20 economies, especially the major emerging markets." In the most recent data, "a theme that emerges is that emerging markets are barrelling their way to a strong performance despite the problems that have beset advanced economies", he adds.

But that, he says, does not mean the global economy is out of the woods. Far from it. "The world economy may have dodged a bullet aimed at its heart, but there are still many stray bullets in the air."

The European sovereign debt crisis has shown the global recovery might have been rapid, but it is potentially fragile.

This month private sector investors lost confidence in the ability of peripheral European governments to pay back their debt and money flew back to the relative safety of US and German government bonds; and the spectre of a second banking crisis rocked European bank funding markets, which are again showing signs of stress.

Ethan Harris of Bank of America Merrill Lynch warns: "The biggest risk to Europe is that recessions in the periphery work their way into the core and a recession coming this early in the recovery could tip the region into deflation."

Business confidence in Europe's flash May purchasing managers' indices was weaker than in April, showing some of the gains have dissipated since markets lost confidence in Greece. The rapid fiscal consolidation sweeping Europe is likely to damp the recovery, putting more downward pressure on the euro. In turn, "the weakening of the euro is shifting more deflation pressure on to the US", says Mr Harris.

The big question is whether the growth in emerging markets can become self-sustaining so the world depends less on advanced economies to maintain recovery. The answer is "not quite yet", says Prof Prasad, even though emerging markets are much less dependent than they were on the advanced world.

"Continued weakness in the advanced economies could mean we are in for a long and hard slog towards a durable global economic recovery," he says.

But a rapid yet fragile global recovery is a big improvement on the sense of doom that surrounded the outlook a year ago. The European sovereign debt crisis cannot be dismissed as an irrelevance to the recovery, but it appears so far to be a nasty financial aftershock rather than a new economic earthquake.

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