It may not feel like a recovery yet, but there are reasons to be optimistic

Gerard Lyons
Personal view

THE world economy is two years into a recovery. Yet it does not feel like a recovery everywhere. This is because it is a divided and disconnected world in which there are many policy dilemmas.

Divided, as growth prospects in Asia are better than in the West. In Europe, the core is in better shape than the periphery and in the US and UK, big firms are stronger than small ones.

Disconnected, as events across the Middle East and North Africa have demonstrated, with youth unemployment the biggest global problem. The policy dilemma in the West is to avoid a double-dip recession, despite high headline inflation, while in the East it is to curb inflation without hurting growth too much.

This recovery has been led by policy easing in the West, and by strong growth across the emerging world, particularly Asia. Now the world economy is slowing, as the policy stimulus in the West wears off, and as Asia slows temporarily in response to policy tightening.

Recent problems in Europe will reinforce this trend. The US is also slowing, although it may receive a bounce later this year as tax incentives boost investment. For now, the US is no longer the world's growth engine. That mantle has passed to China.

With the West struggling to reduce debt, Asia matters more than ever. Last year, emerging economies, led by China, drove two-thirds of global growth. This year, Asia has enjoyed strong growth but has also seen inflation because of food and energy prices. Thus policy has been tightened. Asian central banks need to avoid the lethal combination of cheap money, leverage and one-way expectations.

Latest signs are that China's economy has started to slow. The speed with which China's recent tightening has fed through into the economy is remarkable.

Although domestic demand is solid, manufacturing is easing and there is an anticipation of a slowdown in export orders.

Price pressures remain high, owing to a drought in central China. At the moment, this looks like a soft landing. If it proved to be a hard landing, China has ample financial resources to pump the economy back to strong growth. The message is that the business cycle exists in China, and do not be surprised if there are setbacks.

> "The world is in its third cycle of strong growth lasting a generation"

China's announcement in March of its new "Five-Year Plan" was probably the most important global economic event this year. It aims to move China up the "value curve" and included a focus on boosting consumption, addressing social welfare and aiming for energy security and a growth in green energy.

The other big announcement this year is India's desire to move its economy from being 16pc to 25pc in manufacturing over the next decade.

Another development was the correction in commodity markets. But high food prices may become the norm, given strong future demand. Oil prices, too, seem to have a firm floor, because of demand, and a soft ceiling.

What does this mean for the UK? First, we must recognise the uncertain and challenging near-term outlook. The global recovery is still fragile. The UK could fall back into recession if there was a policy mistake, an external shock, or a loss of confidence. We need to be mindful of our ability to cope with the fall-out from shocks, such as that likely to hit the eurozone. It points to the Bank of England keeping interest rates low enough, for long enough, for the economy to cope.

Second, we must expect market volatility, as low global interest rates mean markets are not pricing fully for risk. Third, we need to recognise the significant shifts under way in the world economy.

The world is in its third super-cycle of strong growth lasting a generation or more. The first, from 1870 to 1913, saw the emergence of the US as a superpower. The second, from 1945 to 1972, saw a boom in consumer markets and Japan emergence as a major economy.

Now, this super-cycle is being led by the growth of China and India. It is characterised by the growth of a huge middle class and by a surge in international trade. Open economies such as the UK need not fear this.

The outlook for the UK depends on the interaction between the fundamentals, policy and confidence. The fundamentals suggest a weak recovery. Policy points to a necessary fiscal tightening and low interest rates. Confidence is hardest to predict, and yet often the most important.

Caution needs to be weighed against longer-term optimism as China and the world are likely to see stronger future growth.

The more we can position the UK to benefit from this the more confident we can be.

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