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Reasons to be cheerful about global economics

How different things now look from the dog days of summer, with the stock market funk now over

Falling commodity prices have hurt the global economy Photo: © 2015 Bloomberg Finance LP.

By Roger Bootle

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In economic affairs, you have to be prepared for the unexpected. To consensus opinion, most of the major economic developments of the past 25 years have come as a bolt from the blue. As it happens, the world economy currently looks as though it could be close to an inflexion point and many economists are worried about a renewed global downturn. By contrast, I am wondering whether it is about to perk up a bit.

The world economy has been weak over the past year due to two related factors – the slowdown in China and the weakness of commodity prices, especially oil. The Chinese slowdown undoubtedly reduced the demand for commodities. Meanwhile, the weakness of commodity prices came to be seen by the investment community as a guide to just how soft the Chinese economy had become.

In the dog days of summer, anxiety reached a peak over the Chinese stock market, which dropped by 41pc in 10 weeks. How different things look now. From its low point in late August, the Chinese market has risen by 23pc. And it now stands almost 50pc above where it was a year ago. It always struck me as fanciful that the Chinese stock market could serve as a bellwether of even the Chinese economy, never mind the world's. But now it seems as though the stock market funk is over.

Meanwhile, things at least seem to have stabilised and there are even a few hints of pick-up. Mind you, hardly anyone now believes the official GDP figures. Accordingly, at Capital Economics we have constructed our own proxy measure of economic activity, based on such real indicators as freight volumes, passenger numbers and electricity usage. This measure has the virtue that there is no official target for it and its components cannot easily be manipulated by the authorities. Interestingly, it shows that the softness was most pronounced at the turn of the year and that the economy has stabilised since.

"There is no good reason why the UK recovery should not continue for several years"

If foreseeing the Chinese slowdown was the first key to getting your global economic forecast right this year, understanding the impact of lower oil prices has been the second. I must confess that my timing was wrong. Having been convinced that lower oil prices would stimulate aggregate demand because they would transfer income from those who normally do not spend all of it (the producers) to those who do (consumers), I was rather surprised by the weakness in the world economy earlier this year.

I rationalised this as an asymmetry. Losses of income (to oil producers) were concentrated, whereas the gains (to oil consumers) were spread throughout the whole economy. It would not be unreasonable if the first group initially responded more strongly.

I still think this analysis is right. But there wasn't only a difference in the response in relation to their consumption behaviour, but also with regard to investment. Investment in oil extraction, exploration and substitution dropped substantially. Investment in the US shale industry fell off a cliff, and all over the world, oil majors cancelled investments. This is hardly surprising. Indeed, it was an explicit objective of Saudi oil policy, to maintain their share of the world market.

Offsetting this effect, you might think the corporate sector should surely step up its investment in all those areas now benefiting from lower energy costs. But here comes the old asymmetry again. Invest in what? The gains from lower oil prices are thinly distributed everywhere. Anyway, there is still excess capacity in much of the world. Why step up investment because industrial costs are a bit lower and consumer real incomes have enjoyed a one-off fillip? So, the result, I think, is that, thanks to lower oil prices, the world has suffered from a drag on overall investment.

China's stock markets were in turmoil in August

But at some point this drag will end, simply because the cuts in investment will have been completed. Meanwhile, here and in the US consumers' real incomes are rising. And they will go on rising even when the fall in energy prices drops out of the annual comparison and inflation rises back towards the 2pc target, because earnings will be rising faster. After all, that is the norm in developed economies, and the world is slowly returning to normal.

Of course, the global economy is patchy. Largely due to lower oil prices and the Chinese slowdown, parts of Africa are extremely weak, as are bits of Latin America. The budgets of Russia and the Gulf oil producers have been shot to pieces. But the economies of eastern Europe are now growing strongly. The eurozone is staggering on, and the UK seems quite healthy. After Friday's job figures, the American expansion seems to be on a firmer footing.

Admittedly, some economists are warning that the US recovery is already rather old and is liable to keel over pretty soon. Yet, like some ministers who do not necessarily throw away food once it has passed its sell-by date, they should inspect the details of this recovery rather than just writing it off for ageist reasons.

Economic recoveries do not usually die of old age. They are usually killed off by central banks as they raise interest rates sharply to try to curb inflation. This recovery may be old by past standards but it began from outright depression, unseen in the West since the 1930s. From this start you should not expect a "normal" recovery.

OK, inflation is set to rise and interest rates will go up – probably fairly soon in the US – but both increases will be modest by historical standards. There is no good reason

why the economic recovery – in both the US and the UK – should not continue for several more years.

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