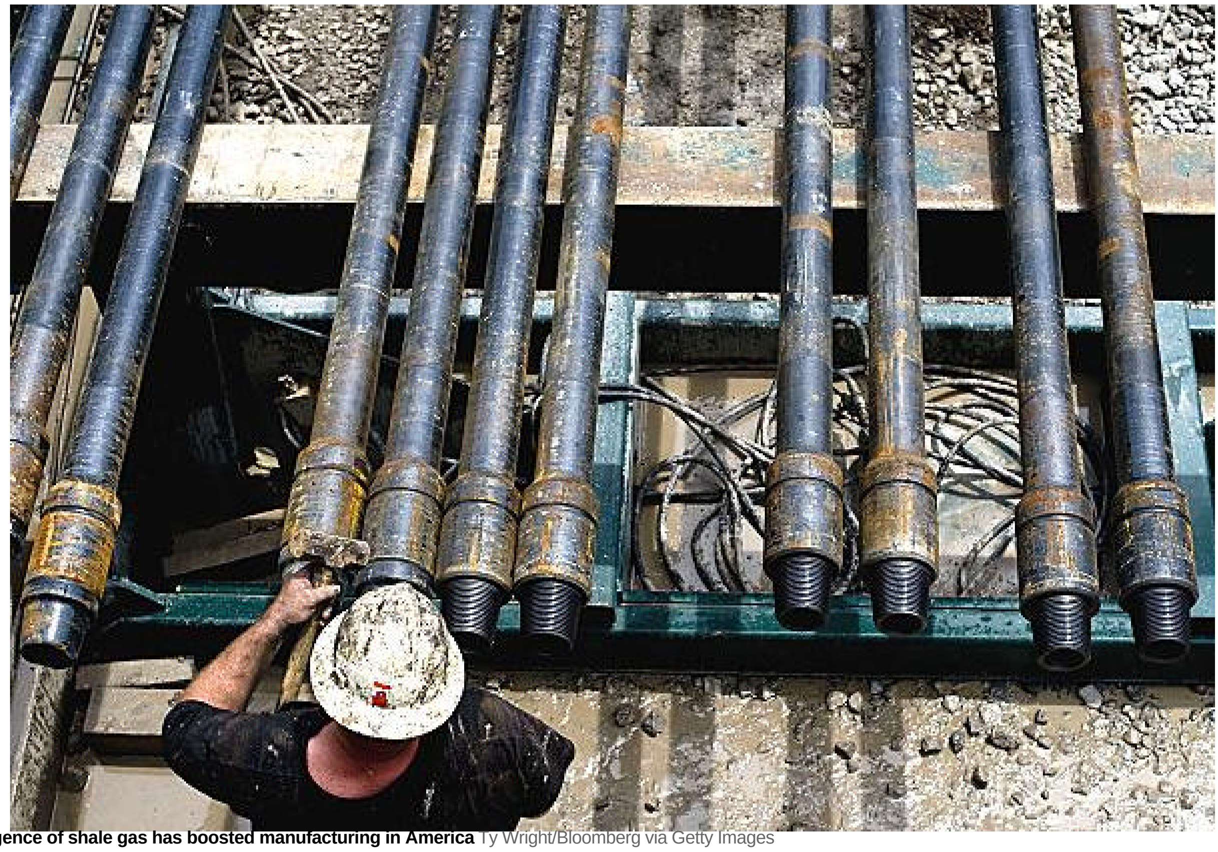
THE TIMES

Time to think positive

Gerard Lyons: Viewpoint



- **The emergence of shale gas has boosted manufacturing in America** Ty Wright/Bloomberg via Getty Images

Published at 12:01AM, January 21 2013

The world economy faces considerable challenges. Despite this, I expect global growth to pick up this year, to its strongest pace since 2010. The mood in the markets is positive. With interest rates set to remain low in the United States and Britain, on the Continent and in Japan, and with bloated central bank balance sheets, there is ample liquidity looking for a home in which to invest. The trouble is, in recent years this positive sentiment has not lasted.

It is easy to construct an all too believable downside scenario, or “perfect storm”, for the world economy. These downside risks, which cannot be ignored, include problems in the eurozone, the combination of fiscal tightening and debt deleveraging hitting demand further in the United States, Britain and continental Europe, and China’s economy running into problems. As if that were not enough, a further risk is geopolitics in Iran triggering higher oil prices.

This week it will be possible to gauge the mood of the moment when the World Economic Forum hosts its annual meeting at Davos. The theme of the event is dynamic resilience, but, as far as I and many other participants are concerned, the state of the world economy will be the main focus.

The biggest disappointment at similar events over the past year has been hearing big companies proclaim that they are in good shape, with healthy balance sheets, but that instead of investing they have continued to cut costs. They should be investing more.

The mood was pessimistic at the annual meeting of the International Monetary Fund in October. Then, the fear was that China would have a hard landing and the US would go over the fiscal cliff. I didn't share that view and the trend of events since helps to explain the present positive market mood.

In many respects, the key issues impacting the world economy have not changed since the crisis began. The big positive is the emergence of China as an economic power — its economy accelerated at the end of last year — and this is spearheading growth across emerging regions. As such, the world economy continues to grow.

The other big impact is too much debt and too little demand in many Western economies. The good news is that signs from housing, jobs and lending suggest that the US economy is improving. Also, manufacturing there is receiving a competitive boost from cheap shale gas and rising wages in China. The headwind, though, is the hit to demand from a tougher fiscal policy. This suggests a steady, not spectacular, recovery, but it is moving in the right direction.

What does this mean for Britain? An improving world economy should help our exports, but we cannot take it for granted and thus must ensure that we boost demand at home. This year will still be tough for the UK. Public sector jobs will be shed. Despite the welcome cut in corporation tax, many small firms are more concerned about rising business rates and do not want to borrow because of restrictive lending terms from banks and sluggish demand.

British policymakers have been perplexed by a combination of factors that have made reading the economy more difficult than usual. These include the continuing growth in private sector jobs. Employment of 29.6 million is an all-time high, yet many graduates are unemployed or underemployed. The transmission of monetary policy is not working properly, as sluggish lending highlights.

The final conundrum for policymakers is that they thought a weak pound would boost exports more. Exports are picking up, but in some markets from low levels, as it takes time, particularly for small and medium-sized firms, to make inroads.

This year policy should focus on getting more demand back into the economy. There is ample spare capacity, which means that monetary and fiscal policy can afford to be looser. This will include ensuring lending pick-ups, delivering on infrastructure and "shovel-ready" projects and reigniting the shrinking construction sector.

People must have more money in their pockets. The increase in allowances this spring will help, but further tax cuts are needed.

Also, the pound must be kept from weakening any further, as it has already caused higher imported food and energy costs, eating into disposable income.

Finally, a more positive message is needed. You can't force people and companies to spend unless they want to. Talk of austerity needs to be replaced by a vision for what will follow, in order to encourage those with the ability to spend and invest to have the confidence to do so.

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