

Disentangling Cyclical from Structural

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More recently, over the past year or so, many commentators have caught on to the reality of this simple math. ■

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It has long been ECRI's view that confusion between longer-term structural shifts and shorter-term cyclical ebbs and flows in economic growth was (and still is) a key driver behind policy errors since the Global Financial Crisis (GFC).

That topic is the focus of a recent ECRI paper, [↗Cyclical Misconceptions Driving Policy Mistakes: Keys to the Productivity Puzzle](#), which has been provided in your meeting materials.

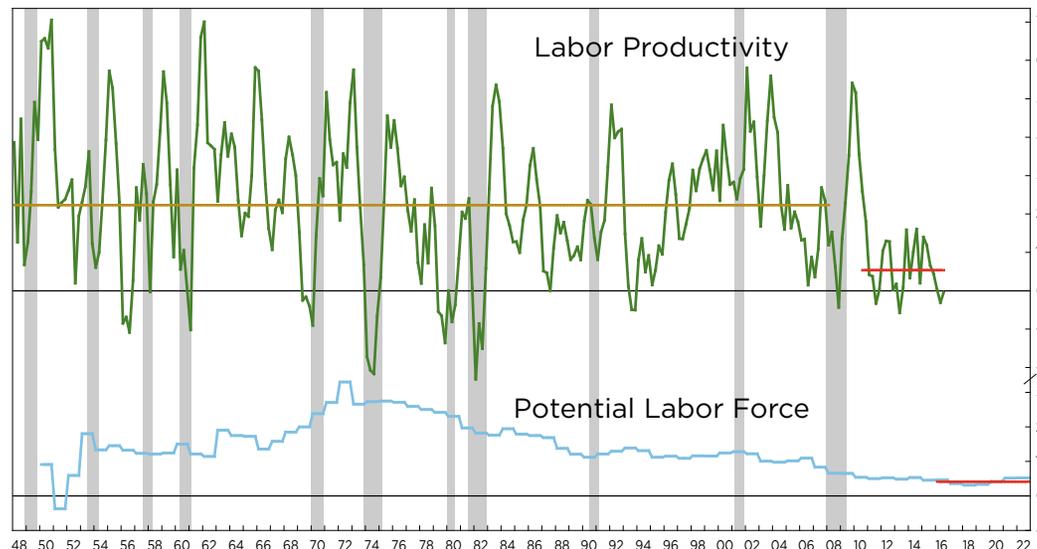
The charts that I'd like to discuss today help illustrate that structural backdrop, and also the cyclical shifts *currently* underway, so that the distinction between structural and cyclical

developments is clear.

In other words, the cyclical vantage point helps reduce the risk that such *cyclical* swings are mistaken as evidence of long-term *structural* changes. This is because, once we strip away the cyclical, what's clearly revealed is the structural backdrop, and we can more easily tell if that's changing.

In 2008 – and this is pre-Lehman – we first identified the long-term decline in trend growth. Subsequently, we explained that decline using the simple math behind potential GDP growth, namely that it's the sum of productivity growth and potential labor force growth.

Growth in Labor Productivity and Potential Labor Force (%)



Shaded areas represent U.S. business cycle recessions.

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So in this first chart, potential labor force growth is shown by the bottom blue line, which the Congressional Budget Office (CBO) projects will average under $\frac{1}{2}\%$ per year for the next six years – shown by the bottom red horizontal line. This is pretty much set in stone, given the demographics.

Productivity growth for the past six years has averaged $\frac{1}{2}\%$ per year – see the top red horizontal line – far below its post-World War II-through-2008 average, which was about $2\frac{1}{4}\%$ per year (top horizontal gold line).

And when you look into the reasons for the downshift in productivity growth following

the Great Recession, the big one is that the contribution of capital intensity – the ratio of capital to hours worked – has gone negative since 2010, which hasn't happened on such a sustained basis for the entire post-World War II period.

Until fairly recently, it was generally believed that productivity growth would rebound to that old average, which not only assumed that productivity growth is mean-reverting, but also that the relevant mean was the post-World War II one. All that is highly questionable.

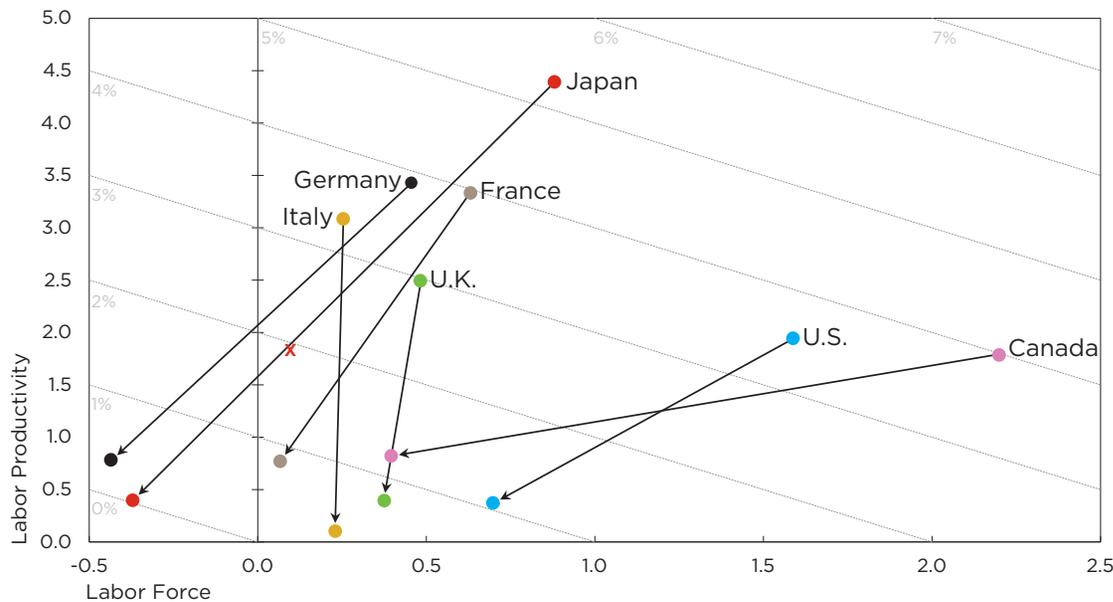
But we at ECRI don't see productivity growth rising materially from the last six years' average over the next several years. It isn't that

productivity growth cannot rise at some point in the future, merely that it is unlikely to do so anytime soon.

So the CBO's potential labor force growth of $\frac{1}{2}\%$ and the latest six-year average of $\frac{1}{2}\%$ for productivity growth add up to just 1% longer-term real GDP growth.

Given that potential labor force growth can't really change in the short- to medium-term, to achieve the "sustained 3-4% GDP growth" promised by incoming Treasury Secretary Mnuchin we'd need six times the last six years' productivity growth – or twice what we saw over the Reagan years. ■

G7 Labor Productivity and Labor Force, Growth Rates (%)



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The basic logic of our simple math is applicable internationally. In fact, using similar data, this next chart shows that this is an international problem affecting every Group of Seven (G7) economy.

The starting coordinate for each country's arrow is the average in the 1957-2007 period for productivity growth (vertical axis) and labor force growth (International Labour Organization data, horizontal axis).

The ending coordinates for these arrows, the arrow heads, are defined by the average productivity growth for the past five years, and potential labor force growth for the next five years.

The slanting gray lines are what one might call "iso-GDP growth" lines. So every point on the slanting gray line near the bottom left corner marked 1% represents different combinations of productivity growth and potential labor force growth that add up to 1% potential GDP growth.

The next one down shows every combination adding to 0% potential GDP growth.

As you can see, everyone is headed in the wrong direction and pretty much everybody is converging to 0-1% trend GDP growth, between those two gray slanted lines, effectively "becoming Japan."

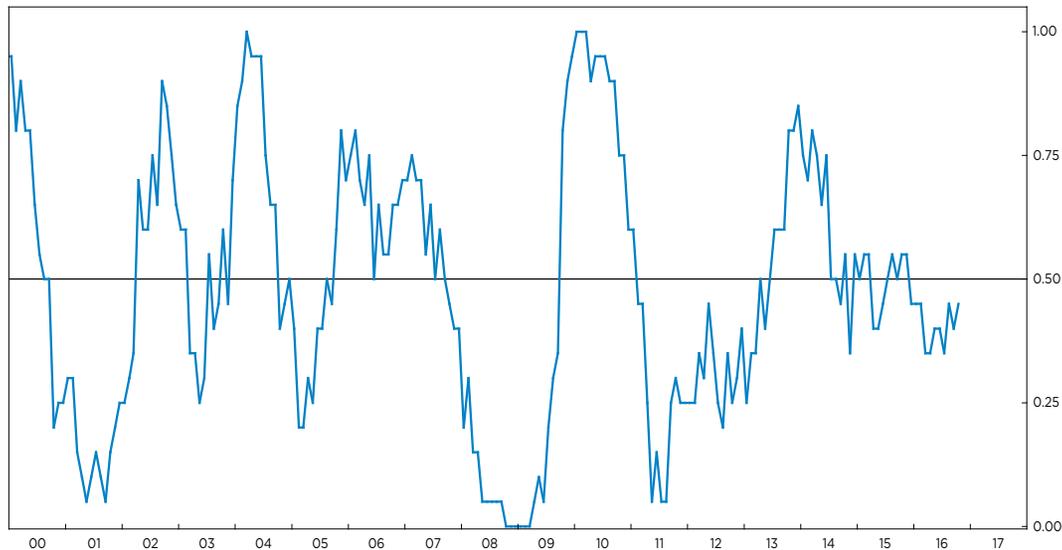
In fact, the red "x" shows Japan's "lost decades" from 1992 (when recession began, following the popping of its asset price bubble) to the eve of the GFC. So it looks like the major economies are heading for even worse (less than 2% trend GDP growth) predicaments.

Germany's demographic problem (next five years' potential labor force growth) is slightly worse than Japan's, perhaps partly explaining Chancellor Merkel's generosity in 2015 towards refugees.

Even the U.S., which has relatively better demographics, is likely to see productivity growth in the same ballpark as the other G7 economies, making for around 1% trend GDP growth.

So that's the structural backdrop describing underlying patterns in economic growth that don't change from year to year. Let's now turn to cyclical issues that do change in the shorter term. ■

20-Country Coincident Index Growth Diffusion Index



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Now let's consider the proportions of the 20 economies regularly monitored by ECRI whose long leading index and coincident index growth rates, respectively, have improved over a 12-month span.

In the summer of 2014, in the face of an increasingly upbeat consensus, ECRI predicted a global slowdown on the basis of these indexes. That global slowdown became evident to the consensus a few months later as the prices of industrial commodities, including crude oil, began to plunge.

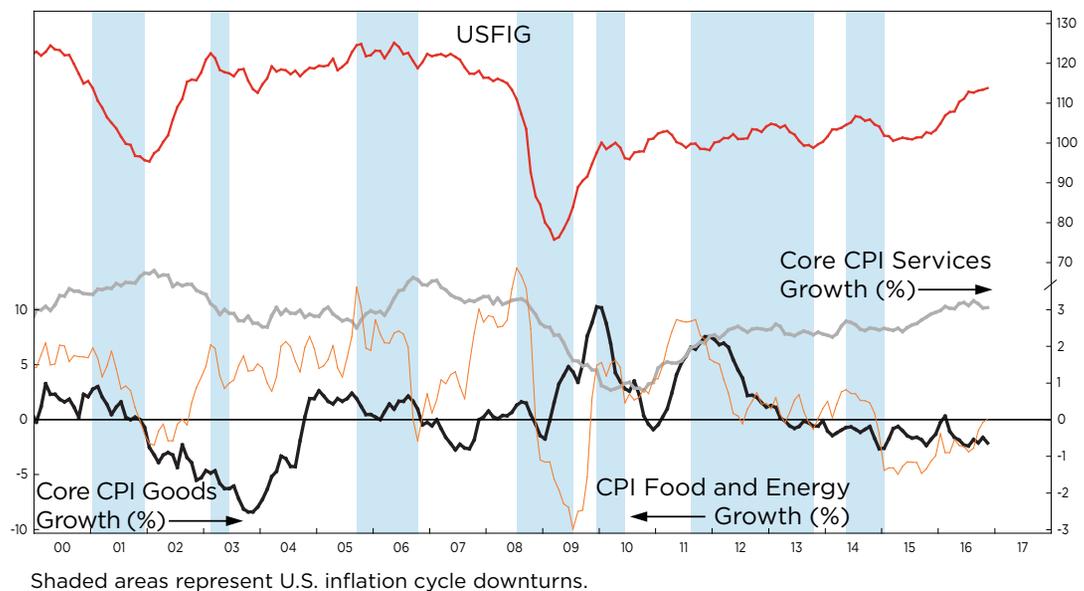
Today, while growth continues to slow in the majority of economies we monitor, the

20-Country Coincident Index Growth Diffusion Index is starting to tick up, rising above its recent multiyear lows (chart).

And the forward-looking 20-Country Long Leading Index Growth Diffusion Index actually started to improve well *before* the U.S. elections (not shown).

Now let's look at the inflation cycle. ■

Indicators of U.S. Inflation



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With ECRI's U.S. Future Inflation Gauge (USFIG) climbing to an 8½-year high, cyclical inflation pressures have not been this strong since 2008 (upper panel). Meanwhile, year-over-year (yoy) CPI inflation has climbed to a 26-month high (not shown). A decomposition of this number is instructive.

In the wake of the upswing in the USFIG, yoy core CPI services inflation has turned up, and is hovering above 3% (lower panel, gray line), boosted by sustained uptrends in shelter and health care inflation.

Holding headline inflation down are yoy core CPI goods growth (black line) and CPI food

and energy growth (orange line), but the latter is already in a cyclical upswing.

In contrast, weighed down by falling prices – especially for vehicles and apparel – yoy growth in the CPI for core goods is languishing near a nine-year low, having stayed in negative territory almost continuously for some 3½ years (black line).

The last time this metric had remained below zero for nearly as long was in the 2001-04 period, under assault from the “globalization tsunami” early this century.

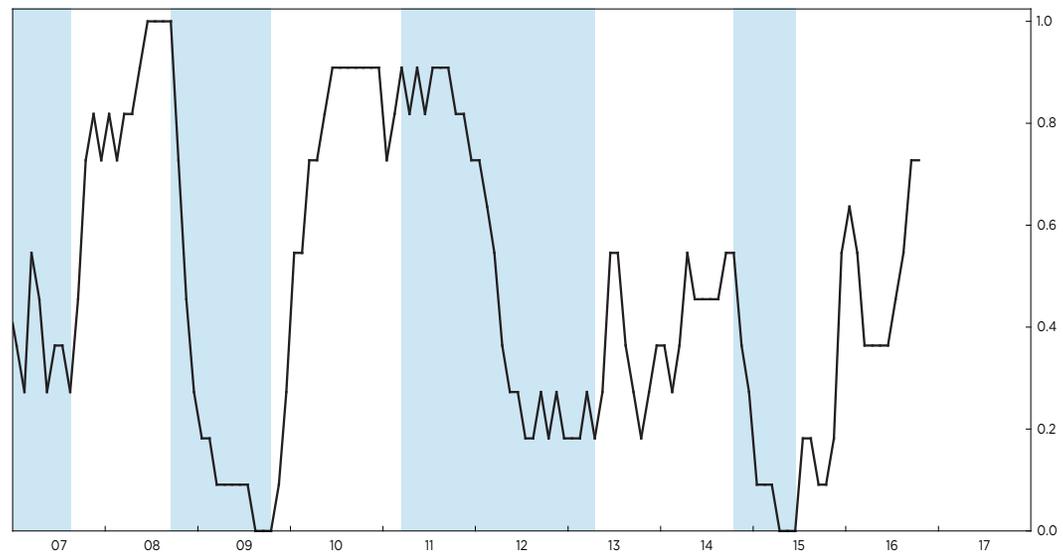
The split could not be starker between sustained structural lowflation and deflation

in tradable goods, and the cyclical upturns in inflation in non-tradable services and food and energy prices.

But they do not offset one another, any more than having one foot in ice water and the other in scalding water feels comfortable, on average.

Since July we've been calling it a “baked-Alaska economy” after the famous dessert invented by Delmonico's in downtown Manhattan – a kind of batter-fried ice cream. Similarly, we have a chilly core of structural deflation and lowflation, and a sizzling crust of rising cyclical inflation pressures. ■

Indicator of Global Inflation



Shaded areas represent cyclical downturns in the 11CFIGDI.

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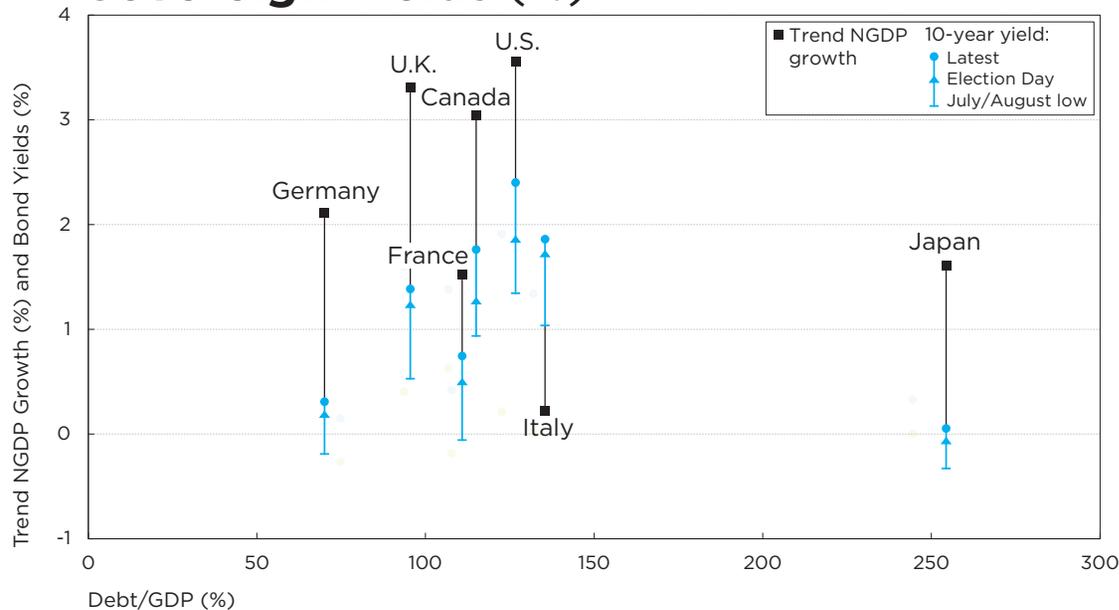
But the cyclical upswing in inflation isn't confined to the U.S. Last summer we also made a "global reflation" call, based on a rise in the 11-Country Future Inflation Gauge Diffusion Index (11CFIGDI) to a five-year high (not shown).

Notably, the global cyclical upturns in our leading indexes of *both* growth and inflation were in place pre-Trump, and those are the key reasons for the rise in international bond yields since last summer.

Of course, post-election, their rise has been reinforced by fiscal policy and deregulation expectations, especially in the U.S.

While all this is fine and good, many are making the leap that the 35-year bond bull market ended last summer. As I said at the beginning, the problem is that they may be conflating the structural and the cyclical. So let's revisit the structural issues raised earlier, with these cyclical developments in mind. ■

Trend NGDP Growth and Sovereign Yields (%)



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This chart brings together the current trend nominal GDP growth, shown by black squares, and 10-year government bond yields, shown in blue at three different moments in time, starting with their summer lows marked off at the bottom; yields on election day, November 8, shown as triangles; and the latest yields shown by the upper blue dots.

The horizontal axis shows the government debt as a percentage of GDP for each economy.

In the G7 economies outside North America, the clear majority of the increases in these bond yields since summer occurred prior to the U.S. elections.

Even in the U.S. and Canada, about half the

moves were pre-election. All this is consistent with the cyclical global reflation call we made last summer, as well as the improving cyclical prospects for global growth, that was already evident in our indicators before the election.

In the U.S., the further rise in bond yields post-election is likely linked in part to policy expectations, and there may be some slight spillover to international economies.

So the rise in bond yields, especially outside of the U.S., has been almost entirely about improved *cyclical* prospects for growth and inflation, and not about any fundamental structural change.

Turning to the black squares showing the latest trend NGDP growth, historically, they've

been roughly tracked by 10-year sovereign yields, which were for instance, about 5% in the U.S. a decade or so ago, about the same as trend NGDP growth at the time.

Today, the U.S. 10-year yield (blue dot) is more than one percentage point lower than trend NGDP growth, with the differential being greater in the U.K., Canada, Germany and Japan, but *negative* 1.7 percentage points for Italy, where, with trend NGDP growth staying so weak, default or higher taxes may be seen as risks, so this is not really a risk-free yield.

Italy aside, the markets are saying that sovereign yields should still be well below NGDP growth, though less so than last summer when the cyclical upturns began. This reflects still-accommodative monetary policy globally, but also that markets probably expect trend NGDP growth to go lower still.

Again, this is very much in line with our structural view based on our simple math showing that real GDP growth in these economies is converging toward the 0-1% range, while the undercurrent of global deflation/lowflation persists. So these charts show that the major change since the lows in yields of last summer is a *cyclical* one, and not so much about any fundamental *structural* change.

Thus, we are skeptical of claims that the global rise in yields is indicative of long-term structural improvement – whether attributed to the success of years of unconventional monetary policy accommodation, or to the anticipated hand-off to effective fiscal policy.

If ECRI is right, then most, if not all the gains since last summer could be reversed when the next cyclical downturns in economic growth and inflation arrive.

Thank you. ■