

“America First” in Perspective

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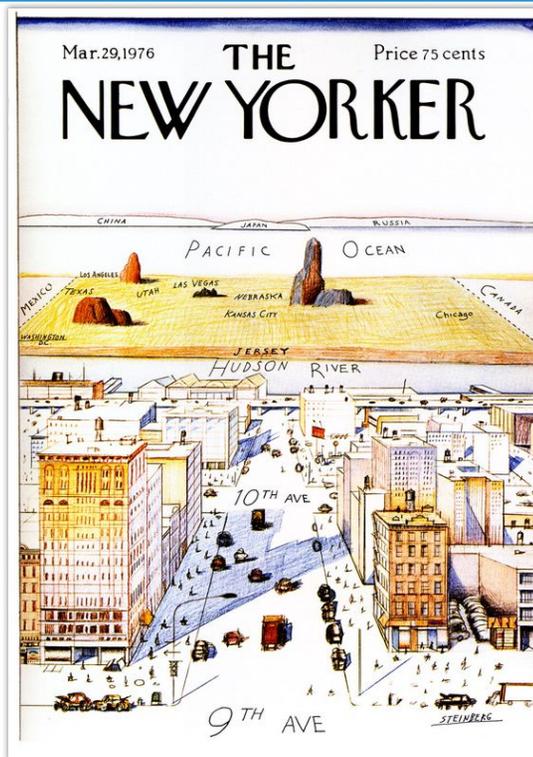
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Good morning. This year’s conference theme is “America First,” and of course, that’s how the Trump administration plans to “Make America Great Again.”

Now, that really means getting the U.S. back to the economic dominance it enjoyed several decades ago, toward the middle of the 20th century.

To put that economic dominance in perspective, it’s instructive to take a long view of history, looking at three different time frames:

- first, the last two millennia and, in particular, the last two centuries
 - second, the 21st century, including the next several years to come
 - and finally, the near-term cyclical outlook for the next couple of quarters
- Perspective is a funny thing ... ■



You may recognize this cartoon of a New Yorker's view of the world.

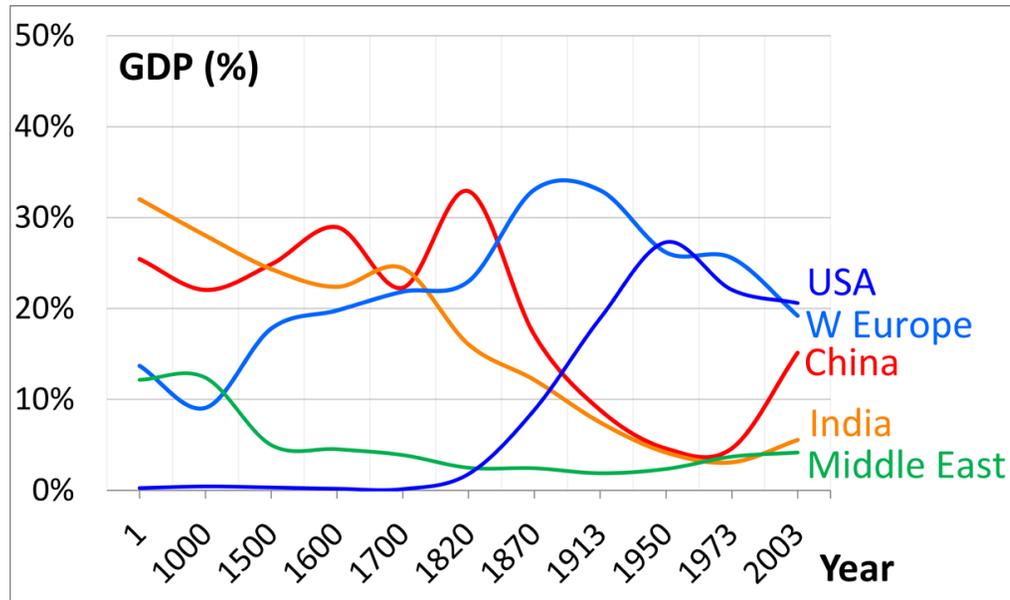
It shows 9th and 10th Avenues in great detail in the foreground; then the Hudson river; a thin strip that's New Jersey; the rest of America and the Pacific Ocean all crunched up; and, barely visible, Asia on the far horizon.

Okay, this reasonably describes many people's subjective reality, but it's also a highly distorted view, wildly exaggerating the importance of the near at the expense of the far.

So it is with our sense of history. Because, again, perspective is a funny thing.

From Angus Maddison's life work, we have economic data going back over two thousand years. Here's how all that data is typically summarized. ■

GDP Share of Major Economies



This is the main chart shown on Angus Maddison's Wikipedia page.

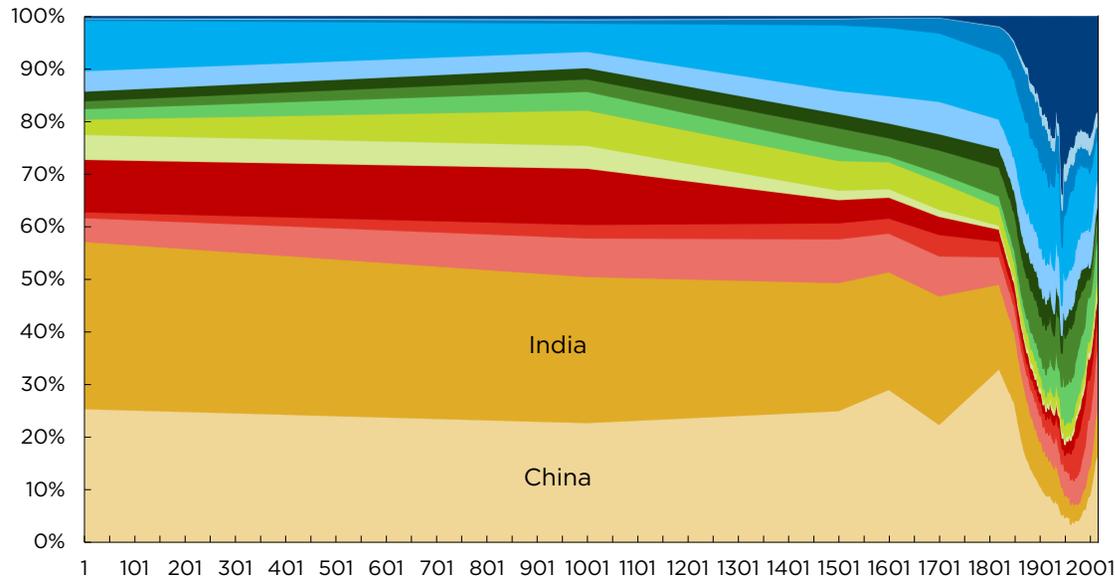
Around the middle of this chart we see the decline of China and India, and the rise of Europe and then the U.S. These trends reverse somewhat toward the end, which is 2003.

But, please notice, like *The New Yorker* cartoon, it wildly overemphasizes the near at the expense of the distant past. A thousand years on the left of the chart occupies the same space as just 30 years on the right.

Instead, having updated the Maddison data through last year, this next chart shifts the historical perspective to properly show the passage of time. ■

Now let's zoom in on these last two centuries of rapid change. ■

Share of World GDP (%), 1-2016 CE



You can see that this chart looks quite different, while it still shows the contributions to world GDP from the major regions since year 1.

But what becomes clear is that, for more than 90% of these two millennia, China and India together dominated the world economy, accounting for about half or more of global GDP in terms of real purchasing power.

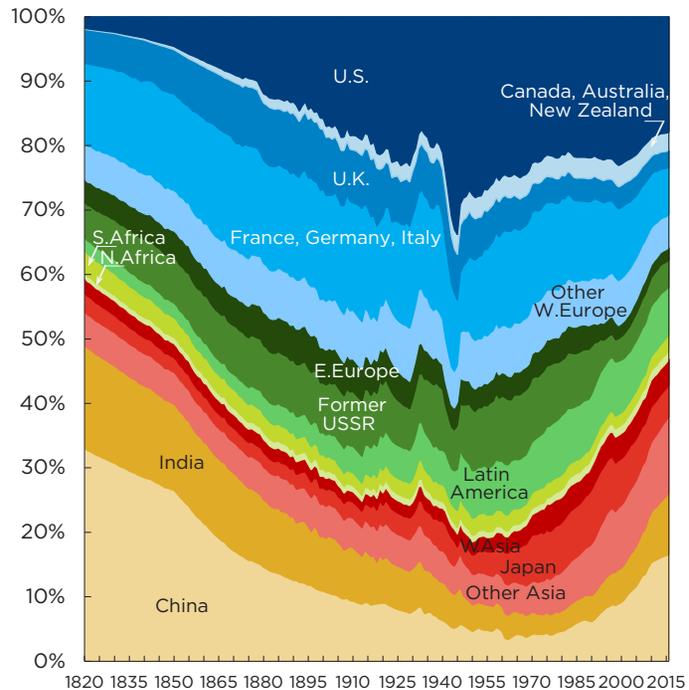
In year 1, India's share was nearly a third of global GDP and China's was over a quarter – both bigger than the Roman Empire. Asia as a whole produced almost three-quarters of global output. A thousand years later those percentages had only declined a little.

Of course, the main point of this chart is that China and India dominated the world economy for the vast majority of this period – until a couple centuries ago.

And then there were *huge* shifts with the rise of the West – shown in blues – which dominated the global economy by the mid-20th century. But, as it's clear to see, that historical “moment” was the exception in the long history of world GDP.

Before I move on, please take a second to appreciate just how breathtakingly fast the rise of the West was, and how equally swift the reversal of fortune has been.

Share of World GDP (%), 1820-2016



Europe's Industrial Revolution, which started in the late 1700s and soon spread to the U.S. – in combination with western colonial exploitation – was responsible for the plunge in India's and China's shares of world GDP between the early 19th and mid-20th centuries.

In a span of just 130 years – from 1820 to 1950 – the GDP share of Asia, excluding the Middle East, plummeted from almost 60% to only 16%.

By the end of World War II, the U.S. reigned supreme, commanding over a third of world GDP, while Western Europe's share fell to well under a quarter – but together, they still accounted for a record 57% of global GDP.

So the mid-20th century saw the GDP share of the West at its zenith, with America dominating the West for decades thereafter. Today, when people say “Make America Great Again,” they're really harking back to this period.

For Asia, excluding the Middle East, the comeback started slowly between 1950 and 1980. The climb then accelerated, with that share surging past 30% by the turn of the century, and standing at 43% today, a 160-year high.

Meanwhile, the combined share of the U.S. and Western Europe has fallen to just one-third, which is a 166-year low. And the U.S. share is now half of its mid-20th century peak.

It's the headlong pace of this decline that is worthy of notice today.

The far right side of the chart shows the early 21st century, when the pace of change really speeded up. Just since the start of this century, Western Europe has lost nearly a third of its global GDP share, while the U.S. has lost more than a fifth. This is similar to the fastest periods of decline for China and India back in the day. It's this swift swing of the pendulum, back from its mid-20th century extreme, that provides necessary historical perspective.

Remember, the two key factors driving the rise of the West relative to others through the mid-20th century were the Industrial Revolution and colonialism. But then we saw the twilight of colonialism, followed in recent decades by a great deal of technological catch-up in China and India, and that isn't over.

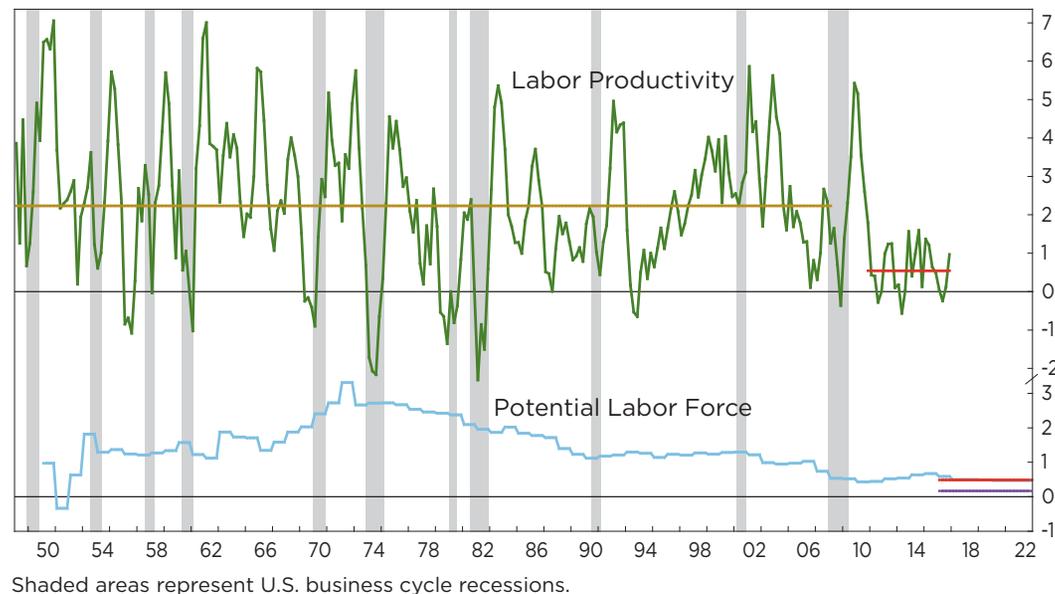
So has the relative decline of the West and the rise of the rest really run its course? If not, it's going to be a tall order for the U.S. to get back to more than a third of world GDP – or even the 22% share averaged over the Reagan years.

In recent years annual World GDP growth ex-U.S. has been running at 3.7%, while U.S. GDP growth has been running just over 2% a year. It follows that, in order for the U.S. to gain back *any* GDP share, it needs to grow at almost twice its 2% pace, on a sustained basis. How likely is that?

Clearly, the decline in America's dominance in the 21st century has been driven partly by the resurgence of China and India, but it's also the fact that U.S. trend growth has really downshifted.

On that point it's instructive to revisit the “simple math” behind potential GDP growth that I've discussed in previous Minsky conferences. ■

Growth in Labor Productivity and Potential Labor Force (%)



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.

This chart begins in the mid-20th century, and shows potential labor force growth as the bottom blue line, which the CBO projects will average under ½% 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 ½% per year – see the top red horizontal line – far below its post-World War II-through-2008 average, which was about 2¼% per year, shown by the top gold horizontal line.

ECRI has been making the point for some time that productivity growth won’t rise 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 ½% and the latest six-year average of ½% for productivity growth add up to just 1% longer-term real GDP growth.

Since potential labor force growth over the next several years is essentially set in stone, in order to achieve the “sustained 3-4% GDP growth” promised by Treasury Secretary Mnuchin we’d need six times the last six years’ productivity growth – or in other words, twice what we saw over the Reagan years.

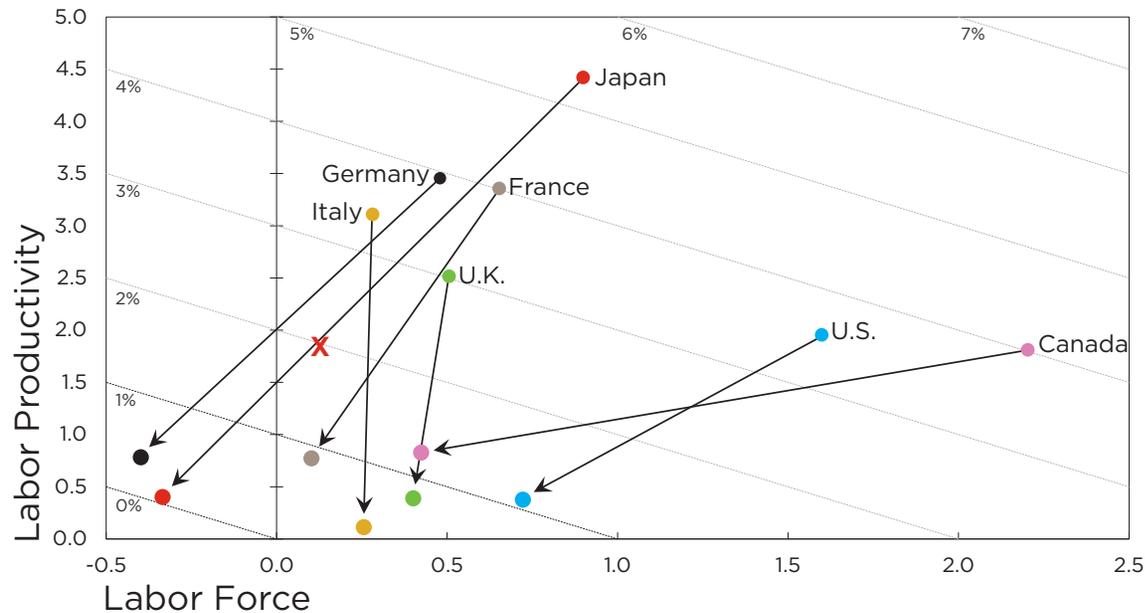
But since immigration is a key element of the Trump policy agenda, even that potential labor force growth is not guaranteed. Undocumented workers aside, legal immigration accounts for the bulk of U.S. labor force growth.

Of the ½% per year potential labor force growth for the coming years, legal immigrants account for two-thirds. If net immigration were to go to zero, potential labor force growth would be cut to less than 0.2% per year (lower panel, horizontal purple line), and the simple math would give us just 0.7% potential GDP growth.

In other words, diminished legal immigration – let alone massive deportation of undocumented immigrants – could significantly reduce potential GDP growth for the coming years.

In 2009, building on our earlier work, we showed that the structural downshift in trend growth went well beyond the U.S., and was also taking place in all the other major developed economies. Once again, this was because of the simple math of demographics and productivity growth. ■

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



Using similar data, this chart shows the simple math for the G7 economies.

The starting coordinate for each country's arrow is the average in the 1957-2007 period for productivity growth and labor force growth. The ending coordinates, near 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 – what one might call “iso-GDP growth” lines – capture the simple math. In other words, the sum of the horizontal and vertical coordinates of every point on the 1% line adds up to 1%. Similarly for the 0% line.

As you can see, everyone is headed in the wrong direction, converging toward 0-1% trend GDP growth – the two slanted gray lines near the lower left-hand corner.

In fact, the red “X” shows Japan’s “lost decades” from 1992, when its post-bubble recession began, to the eve of the financial crisis. The major economies are heading for even worse predicaments.

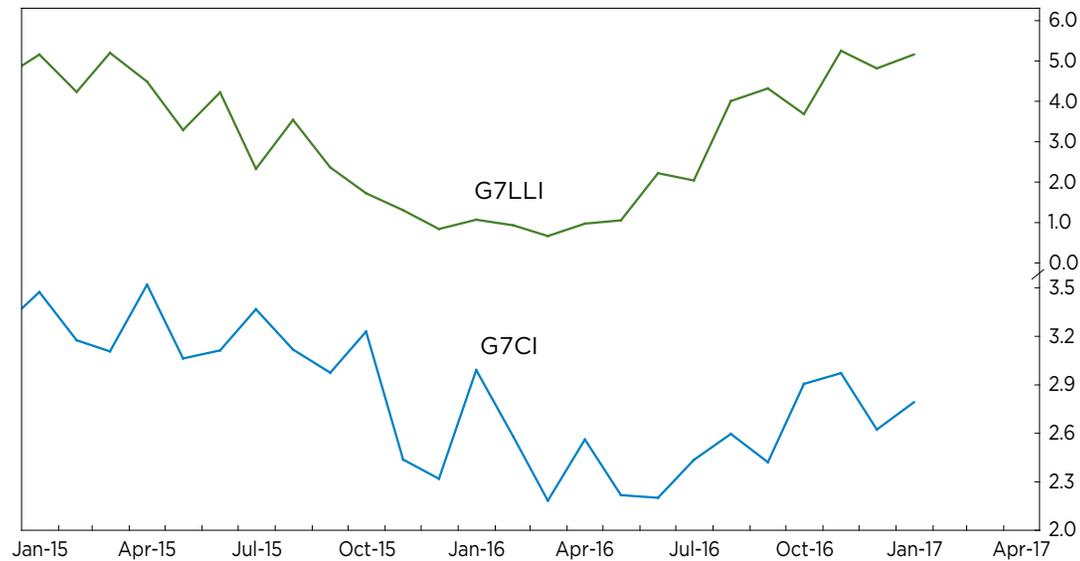
Germany’s demographic problem, meaning the next five years’ potential labor force growth, is slightly worse than Japan’s, perhaps partly explaining Chancellor Merkel’s generosity in 2015 towards refugees, which promises to change

these demographics a bit.

So what I’ve described here are the structural bounds that will define the growth potential of the advanced economies for the next several years – the underlying patterns in economic growth that don’t change from year to year.

Turning to cyclical issues that do change in the shorter term, things look quite different, in fact the most positive they’ve been in years ... ■

G7 Long Leading and Coincident Indexes, Growth Rates (%)



As many of you know, ECRI’s co-founder, the late Geoffrey H. Moore, created the first leading indexes of recession and recovery half a century ago, which is why *The Wall Street Journal* called him the “father of leading indicators.” Since then we’ve developed leading indexes for many other countries, including long leading indexes that look further ahead than typical leading indicators like stock prices or PMIs.

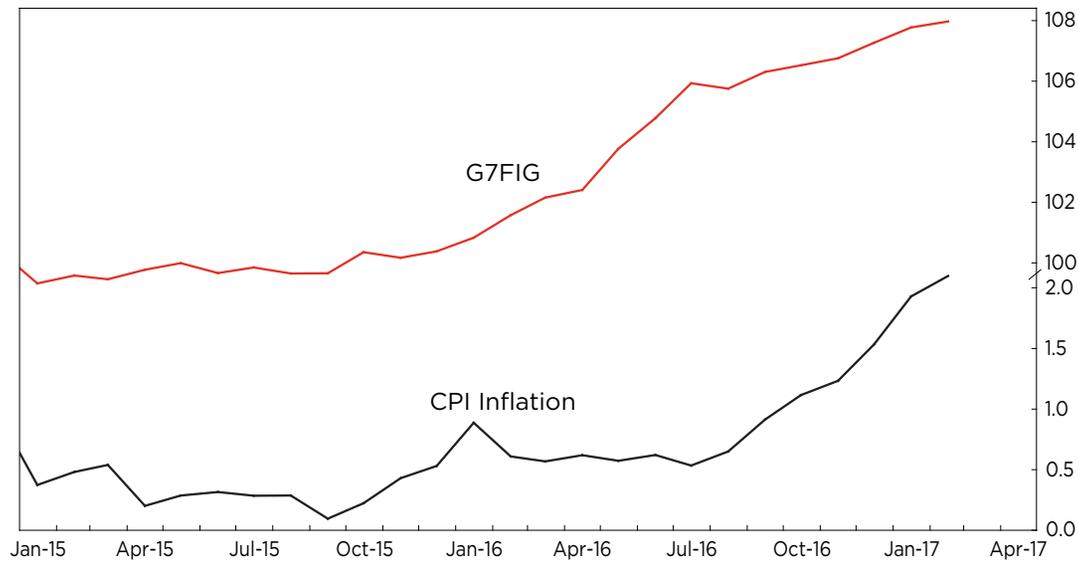
This chart shows the smoothed growth rate of ECRI’s long leading index for the G7 countries combined (G7LLI), that’s the top green line, which leads G7 Coincident Index (G7CI) growth, shown by the bottom blue line. G7LLI growth is

practically back up to this three-year high, and in turn G7CI growth has also turned up.

By the way, our 20-Country Long Leading Index growth (not shown), which includes the major emerging markets, is around its best readings since just after the Global Financial Crisis.

Please note that these growth upturns began well before the U.S. election, as did the inflation cycle upturn. ■

G7 Future Inflation Gauge and CPI Inflation (%)



Since the early 1980s, following the experience of U.S. stagflation, we've monitored leading indexes of inflation that are separate from our leading indexes of economic growth. We call them future inflation gauges, and they measure underlying inflation pressures that anticipate cyclical turns in actual inflation, and typically lead inflation expectations.

ECRI's G7 Future Inflation Gauge (G7FIG) is now at its highest reading since mid-2008, shown by the top red line. Following its upturn, G7 CPI inflation has clearly begun its own cyclical upturn, and is at its highest reading in almost three years, that's the bottom black line. Again,

please note that the G7FIG turned up well before all the global deflation talk began last year.

Let's drill down to the U.S. in particular. ■

U.S. Long Leading Index Growth (%)

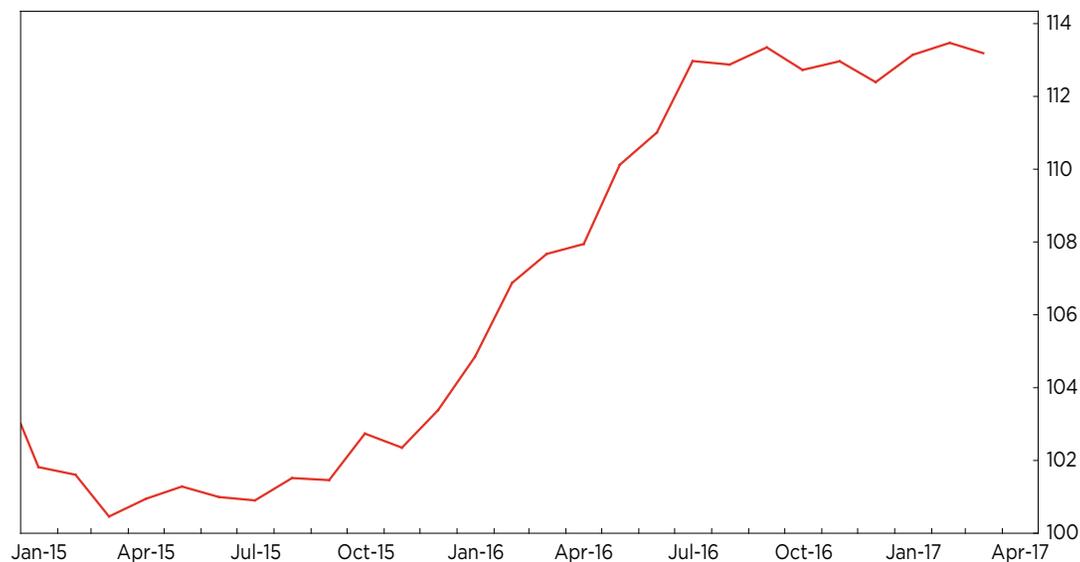


Growth in the U.S. Long Leading Index has been in an uptrend since last year, and remains near a multiyear high. There is a little downtick at the end that we're keeping an eye on.

The upturn in actual U.S. growth began around the middle of last year. Year-over-year GDP growth is now at a one-year high, industrial production growth is at a two-year high, and the jobless rate is at its best reading in almost a decade.

But regarding the concerns about the hard data not being strong enough, indeed something *is* undermining real growth. ■

U.S. Future Inflation Gauge



The U.S. Future Inflation Gauge (USFIG) turned up over a year ago and remains elevated, and actual inflation has since turned up as well. Please note that the USFIG turned up well before inflation expectations, which had plunged in mid-2016.

But what is unusual about this cycle is that the inflation upturn started before the economic growth upturn, so real GDP and real income growth are being undercut more than usual by rising inflation. This is part of the reason that in real – meaning inflation-adjusted – terms, the so-called hard data looks relatively weak.

Nevertheless, both the U.S. economy and the global economy are in simultaneous cyclical upturns in economic growth and inflation, and those cyclical upturns are set to continue for now... ■

Thank you.

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So, from a *near-term, cyclical* point of view, our analysis of the outlook is unambiguously positive, period.

But when we expand our view to consider the *next several years*, because of structural factors, potential GDP growth is seriously constrained, converging to around 1% a year for the U.S.

And the *really long view* over centuries and millennia makes it painfully clear how extraordinary it was for the U.S. to achieve the economic dominance that it enjoyed several decades ago.

In closing, let's enjoy our cyclical good fortune while it lasts, and have the clarity of vision to recognize the longer-term reality of the global economy.

Thank you. ■