

# The Risk of Mistaking Cyclical for Structural

Presented to  
27<sup>th</sup> Annual Hyman P. Minsky Conference

April 2018

Lakshman Achuthan  
Co-Founder & Chief Operations Officer

Good morning – it’s great to be here and to see so many familiar faces.

Given ECRI’s focus on economic cycles, we have a solid read on where we are in the business cycle. And, when we strip out the cyclical, what’s left is largely structural, allowing us to distinguish between economic developments that are cyclical and structural.

Last year I made the point that people often conflate the two, and that, given ECRI’s optimism about cyclical global growth prospects, a lot of conflating was sure to come down the pike. Sure enough, we’ve had a few quarters of synchronized global growth and inflation moving

higher, and the impact of those developments on the mood of policymakers has been palpable.

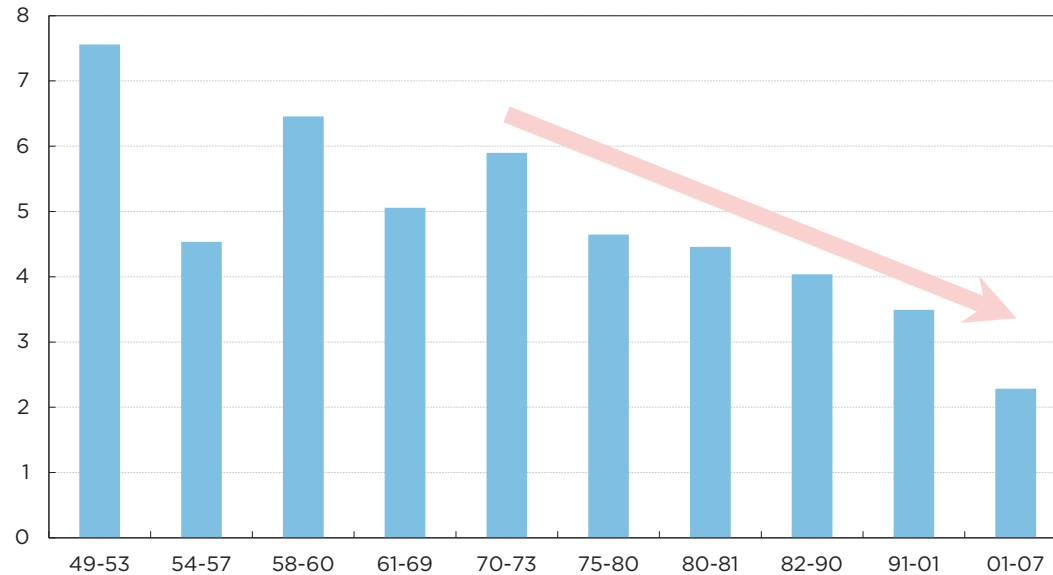
By mid-2017, the world’s central bankers were increasingly convinced that we had turned the corner in a structural sense. Emerging from their group meeting in Sintra, they all sounded more hawkish, or less dovish. This was their “Mission Accomplished” moment and, at least implicitly, suggested that the era of low trend growth and lowflation was over. And their confidence has kept rising.

From the latest Fed minutes we learn that the FOMC was unanimous that the outlook for the economy had strengthened, that inflation

would keep rising, and that fiscal policy would boost the economy even more than previously thought, over the next few years. So again, it sounds like they believe in a structural shift, away from low trend growth and lowflation.

Let’s dig into the evidence, starting with this chart highlighting the structural downshift in growth ECRI identified a decade ago... ■

## Growth Rates in U.S. Expansions (%)



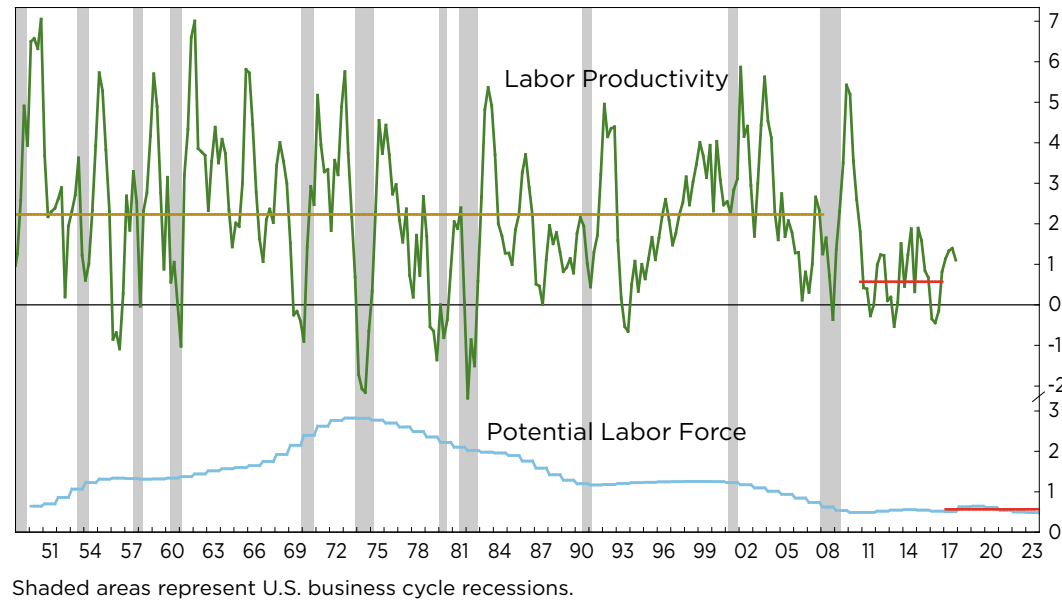
If you think of the economy outside these windows, what's it about? It's about output and jobs, and income and sales, and that's precisely what makes up our U.S. Coincident Index (USCI).

In August of 2008, before the Lehman collapse, we saw this long-term decline in USCI growth during successive expansions going back to at least the 1970s. While that's pretty obvious looking at the chart, apparently nobody had looked at it this way, including us until that time. Clearly, we were fairly late in seeing this long-term decline in trend growth, which had started much earlier.

But we were quite prescient, relative to the consensus view, which started to come on board less than five years ago, following Larry Summers' 2013 speech about secular stagnation that seemed to echo our earlier findings. However, ECRI never bought into that particular diagnosis with all its potential implications. Rather, for a decade, ECRI has been talking about something very specific – this long-term structural decline in trend growth.

Let's revisit the basic building blocks of economic growth, namely, productivity growth and labor force growth. ■

## Growth in Labor Productivity and Labor Force (%)



As a student of the business cycle, again, it's hard to argue that this is a structural breakout in productivity growth.

I understand that plenty of people disagree, so I'll just quote the latest issue of *The Economist* magazine: "Economists understand even less about economic growth than about business cycles."

All right. Let's move on to see that what ails the U.S. ails pretty much everybody... ■

I showed this chart last year, and updated it for you today.

The bottom blue line shows potential labor force growth, which the Congressional Budget Office projects will average around  $\frac{1}{2}\%$  per year for the next six years – shown by the bottom red horizontal line. Labor force growth is pretty much set in stone, given the demographics – unless there's a cut in legal immigration, which accounts for about two-thirds of this number.

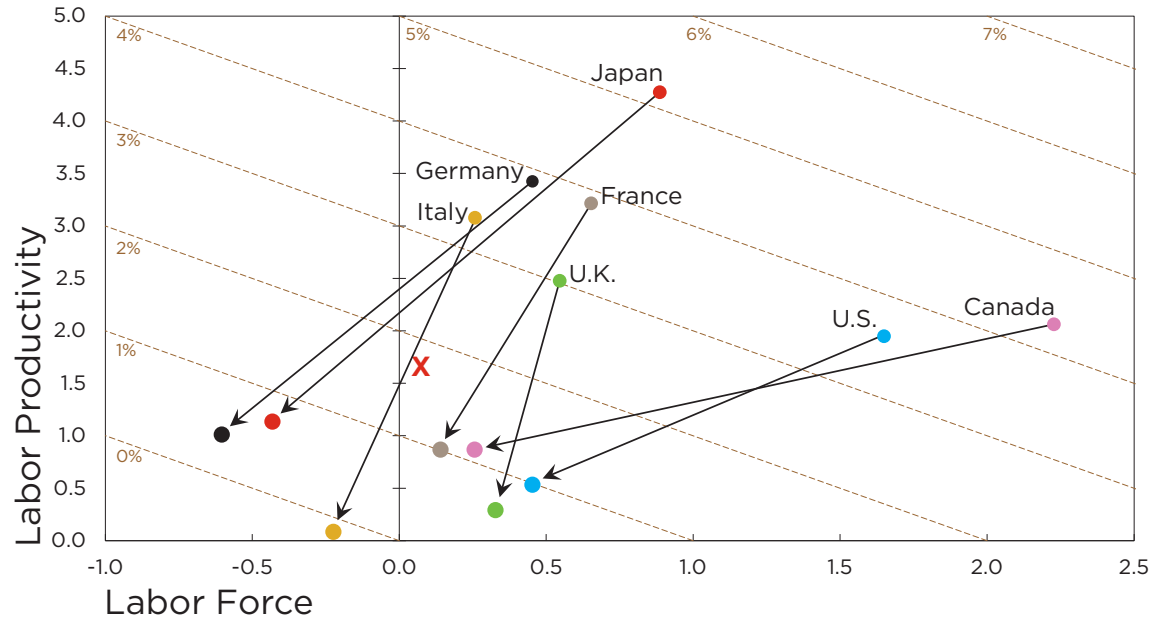
The top green line is productivity growth. The six-year average I had shown last year was about  $\frac{1}{2}\%$  per year – that's the top red horizontal line – far below its post-World War

II-through-2008 average, which was about  $2\frac{1}{4}\%$  per year (horizontal gold line).

With four quarters of new data you can see a bit of a pop in productivity growth, which is already easing off. But to my eye, I'd be hard-pressed to call that pop a structural breakout in productivity growth.

The math is straightforward:  $\frac{1}{2}\%$  labor force growth plus  $\frac{1}{2}\%$  productivity growth add up to just around  $1\%$  longer-term real GDP growth. I understand that this is not what any of us wants to hear. The demographics are what they are, so the pushback is necessarily that productivity growth is, or soon will be, much higher.

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



This chart, using similar data as the previous chart, shows the simple math of adding up productivity growth and labor force growth for the G7 economies.

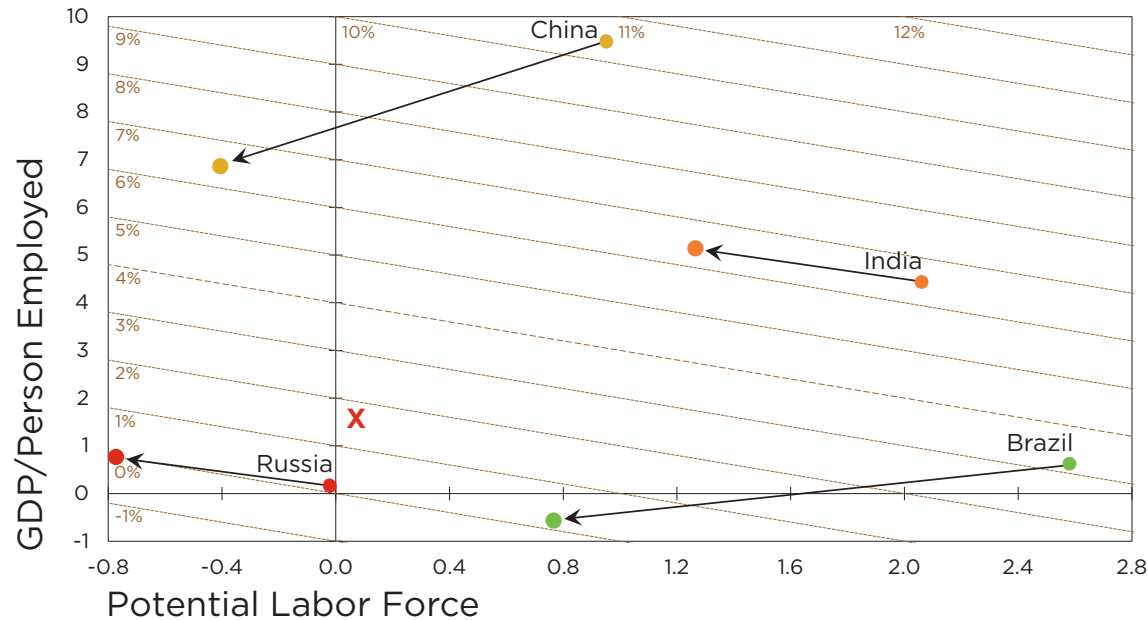
The starting coordinate for each country is the 1957-2007 average for productivity growth and labor force growth. The ending coordinates near the arrow heads mark the average productivity growth for the past six years, and potential labor force growth for the next six years, so you see U.S. potential growth is around 1%. The key here are the slanting brown lines. The horizontal and vertical coordinates add up to 1% for every point on the slanting 1% line.

Similarly for the 0% line.

As you can see, every G7 country is headed in the wrong direction, with potential GDP growth converging toward 0-1% – these two slanted brown lines. And 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.

But what about the big emerging markets? ■

## BRIC Labor Productivity and Labor Force, Growth Rates (%)



Here's the equivalent chart for the BRICs.

The same productivity data is not available, so we substitute GDP per person employed as a proxy. The starting coordinate for each country is the 1991-2007 average.

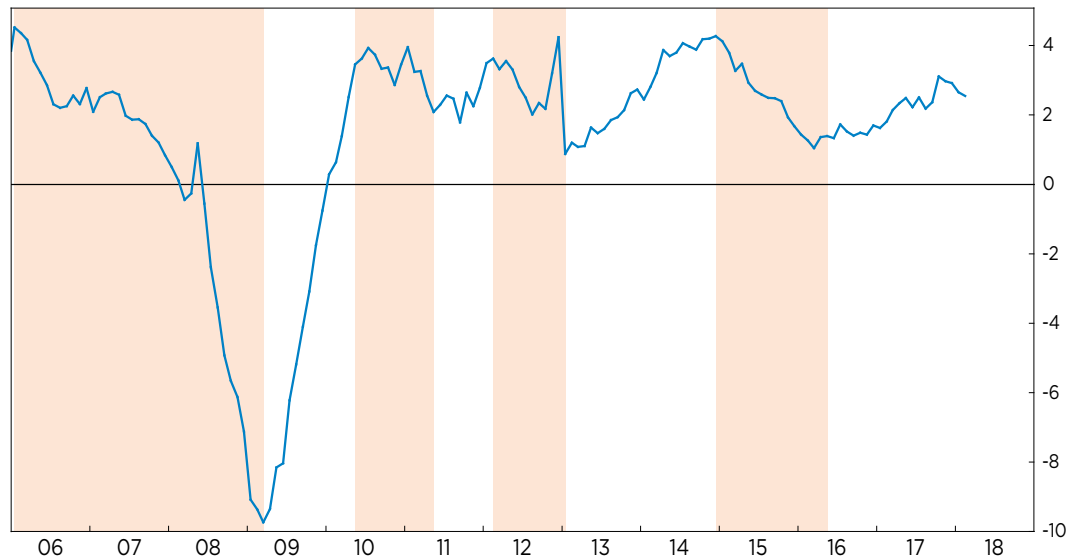
Brazil and Russia's potential GDP growth rates are both heading down to zero. China and India have much better prospects, but even China is losing altitude, from 10½% to 6½% trend GDP growth, as potential labor force growth turns negative, and productivity growth slows. Potential labor force growth for India is also falling, but is still the strongest of the lot, and its productivity

growth is improving, so potential GDP growth is likely to stay around 6½%.

Taking all of this information for the G7 and BRICs together, it's evident that, structurally, the world's growth potential has downshifted. Yet, the prevailing wisdom is that we are seeing a structural upshift away from low trend growth and lowflation, starting with the U.S. This is because people are confusing a cyclical upturn with a structural upshift.

So here's a closer look at U.S. Coincident Index growth... ■

## U.S. Coincident Index, Growth Rate (%)



Shaded areas represent U.S. growth rate cycle downturns.

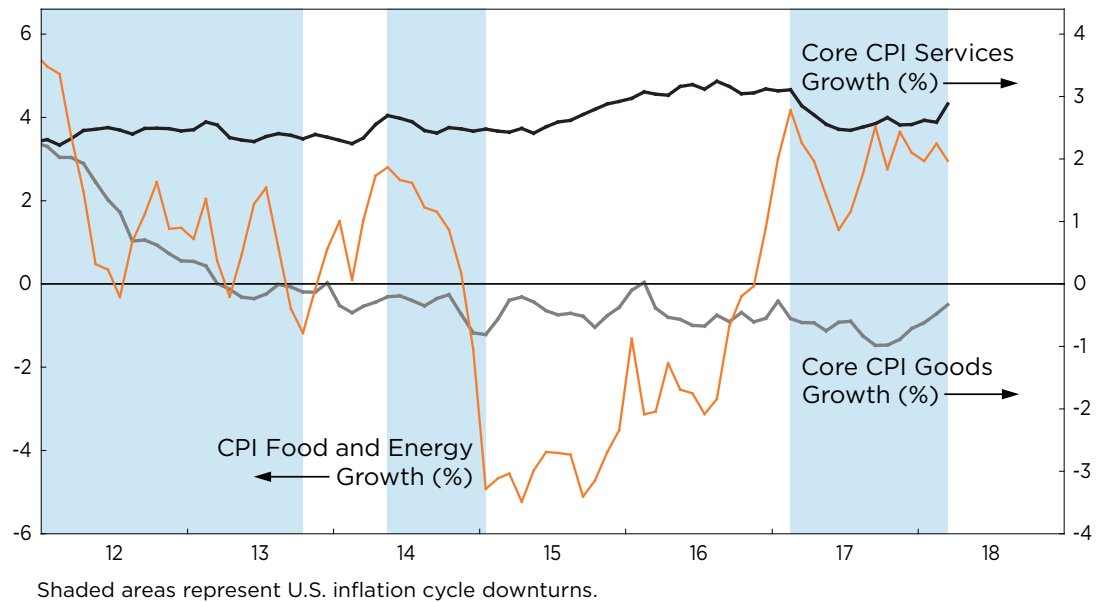
The shaded areas mark off decelerations in economic growth, or growth rate cycle downturns, and the Great Recession is easy to see.

Following the recovery from that recession, please note the three cyclical slowdowns in 2010-11, 2012-13 and 2014-16, following which there was a cyclical upswing from mid-2016 through late 2017. That recovery in growth has eased in the last few months. Put another way, this chart shows the post-recession growth rate cycles, but it's hard to assert that it shows any *structural* upshift taking hold.

Still, after a year or so of a cyclical upswing in growth, as mentioned, many are talking about the end of secular stagnation and a “normalization” of the economy and interest rates. I don't know about you, but to me the lack of evidence of a secular shift back up is clear.

Turning from cycles in U.S. growth, how about inflation? Much has been made of year-over-year (yoy) headline CPI inflation turning up and rising from 1.6% last June to 2.4% in March, within striking distance of 2.8%, which would be the highest in over six years. ■

## Indicators of U.S. Inflation



Looking at the details of this upturn, it was initially driven by the mid-2017 surge in food and energy inflation (orange line).

Core CPI growth troughed late last summer, and I'm showing it split into goods and services so you can really see what's going on. Core services inflation, after increasing only marginally since mid-2017, has ticked up a bit (black line), but even this modest upswing is not very broadbased. In the early fall, core goods CPI growth turned up (gray line), but it's been consistently negative since 2013, despite unprecedented monetary accommodation from the Fed.

If structural lowflation is to end, the persistent core goods deflation must also wind down. In sum, it's hard to argue that all of this amounts to a structural shift upwards.

Now, from ECRI's vantage point monitoring cyclical indicators, we've seen these cycle turns coming. For example... ■

# August 2016

**ECRI**  
International Cyclical Outlook  
ESSENTIALS

## Global Reflation

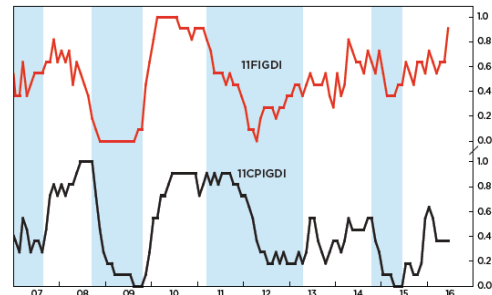
ECRI's International future Inflation gauges show a widespread buildup of cyclical reflationary pressures, despite sustained structural lowflation.

**Global Warning** Underlying inflation pressures are now rising around the world. But most are unaware of this reality which is evident from our large array of international cyclical leading indicators of inflation.

Notably, the future inflation gauges are at their highest readings in over eight years in the US, over five years in the UK, over four years in Germany, and almost four years in Mexico. The French Future Inflation Gauge is nearing a 4½-year high, and the Korean Future Inflation Gauge is at a 1½-year high.

A cyclical upswing in global industrial growth is finally gaining traction, and is likely to continue in

Chart 1: Indicators of Global Inflation



Shaded areas represent cyclical downturns in the 11CPIGDI.

August 2016

International Cyclical Outlook Essentials

Economic Cycle Research Institute Volume

Please recall ECRI's "global reflation" call in the summer of 2016, at a time when market inflation expectations had plunged. That call was based purely on our cyclical indicators of inflation. ■



# December 2016

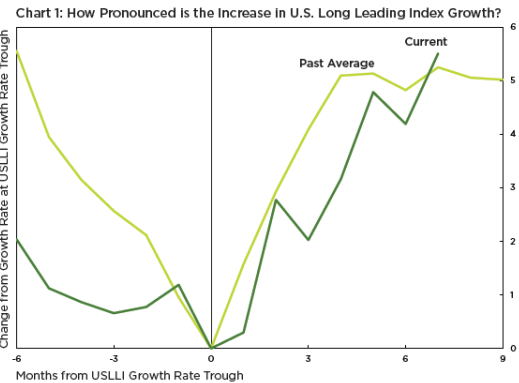
**ECRI**  
U.S. Cyclical Outlook  
ESSENTIALS

## Growth Rate Cycle Upturn at Hand

**U.S. Long Leading Index growth is now in a pronounced, pervasive and persistent upturn.**

**We Have Ignition** Building on the gradual improvement that has been evident in recent months, the latest forward-looking data finally provides clear evidence that a growth rate cycle (GRC) upturn is now at hand. Specifically, the upswing in U.S. Long

Many think the 35-year secular bond



December 2016

U.S. Cyclical Outlook Essentials

Economic Cycle Research Institute | Value

Later in 2016, we made a U.S. growth rate cycle upturn call, this time based on our leading indexes of U.S. economic growth.

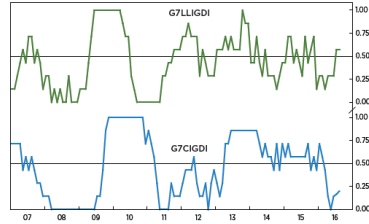
In fact, these U.S. indexes were turning up in sync with our leading indexes of global economic growth, which we highlighted in October... ■

# October 2016, February 2017

**ECRI**  
International Cyclical Outlook  
ESSENTIALS

## Improving Global Growth Outlook

Chart 1: G7 Long Leading and Coincident Index Growth Diffusion Indexes

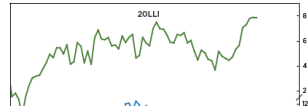


October 2016  
International Cyclical Outlook Essentials  
Economic Cycle Research Institute Volume

## Brightest Global Growth Outlook Since 2010

Most central banks remain highly accommodative, even with growth prospects staying upbeat and inflation nearing their targets in nearly all major advanced economies.

Chart 1: 20-Country Long Leading and Coincident Indexes, Growth Rates (%)



The ongoing cyclical upswings in economic growth and inflation will challenge central bankers sooner than many believe, possibly

February 2017  
International Cyclical Outlook Essentials  
Economic Cycle Research Institute Volume

International Cyclical Outlook Essentials

Economic Cycle Research Institute Volume

So where's the structural shift, and how do we identify one? Our cyclical vantage point allows us to distinguish between those economic developments that are cyclical and, by stripping those out, changes that are structural in nature. Today, we simply don't see such a structural shift that isn't explained by cyclical factors, at least in economic growth and inflation.

But there are other areas where structural changes are more evident. ■

Let's recall a couple of things about October 2016. Of course, this was *before* the presidential election, and that same month the IMF cut its global growth forecasts. This is when ECRI forecast a cyclical upturn in global growth. In particular, we noted that "growth in the majority of our long leading indexes for the G7 has now climbed above year-ago readings."

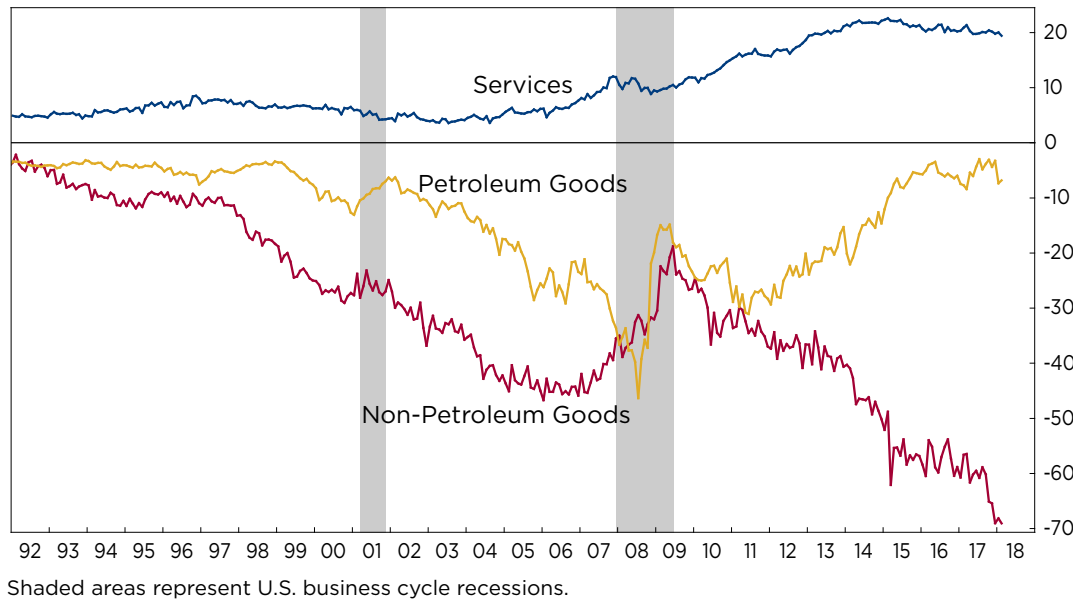
Fast-forward to February 2017, when the popular refrain was that the hard data were not confirming the strength in the soft data. This is when ECRI flagged the "Brightest Global Growth Outlook Since 2010," because growth in

ECRI's 20-Country Long Leading Index was at an 80-month high .

In the months that followed, the consensus caught up, with optimism about global growth belatedly surging. And on cue, having recognized the reality in the rear-view mirror, the IMF has been upgrading its growth forecasts.

But the point remains that the now-famous synchronized global growth upturn is a *cyclical* event that we correctly predicted a year and a half ago based on *cyclical* leading indexes of economic growth, after flagging "global deflation" based on our *cyclical* leading indexes of inflation.

## Trade Balance (Bil. U.S. \$)



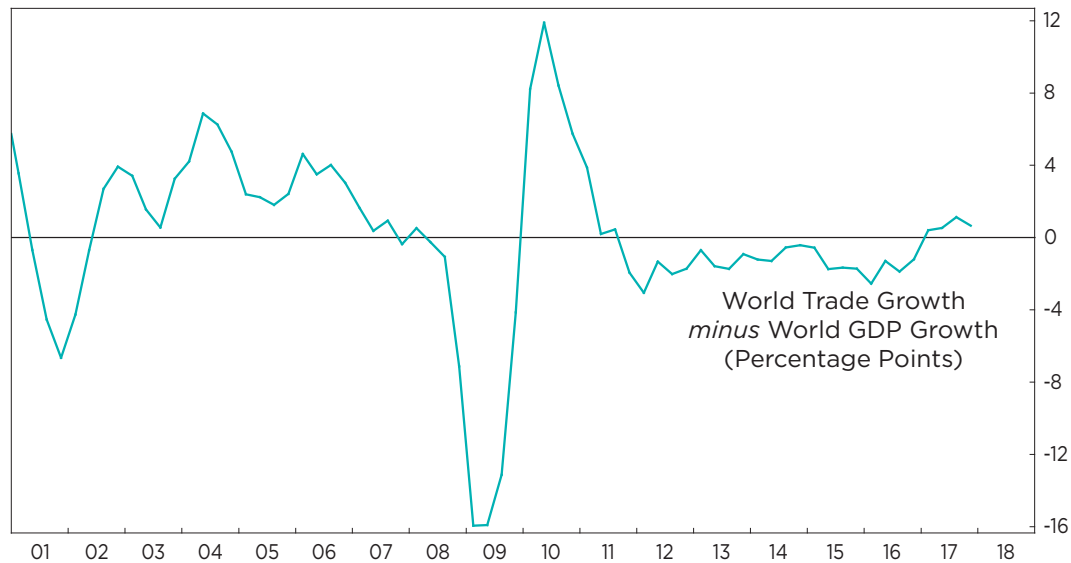
Donald Trump rode to the White House in part on the promise of an economic revival at home, largely by reversing the massive deficits piling up between the U.S. and nearly all its trading partners, China chief among them. Since then this imbalance has increased, and the trends in the three key sectors of U.S. trade are revealing.

The chart shows the U.S. trade surplus in services, along with the trade deficits in both petroleum and non-petroleum goods. Since 2010 the U.S. trade surplus in services has virtually doubled. Meanwhile, the petroleum goods trade deficit has shrunk this decade, to around its lowest level this century.

But this improvement has been swamped by a staggering expansion in the non-petroleum trade deficit to a record high, nearly tripling since 2010 and accelerating in the past year. Indeed, with both China and Mexico, the U.S. non-petroleum goods trade deficit has never been higher over any 12-month period in history. These patterns aren't fully explained by cyclical forces, and in large measure may be structural.

But is this evidence of the continuing advance of globalization? ■

## An Indicator of Globalization



Now, globalization has both *structural* and *cyclical* components.

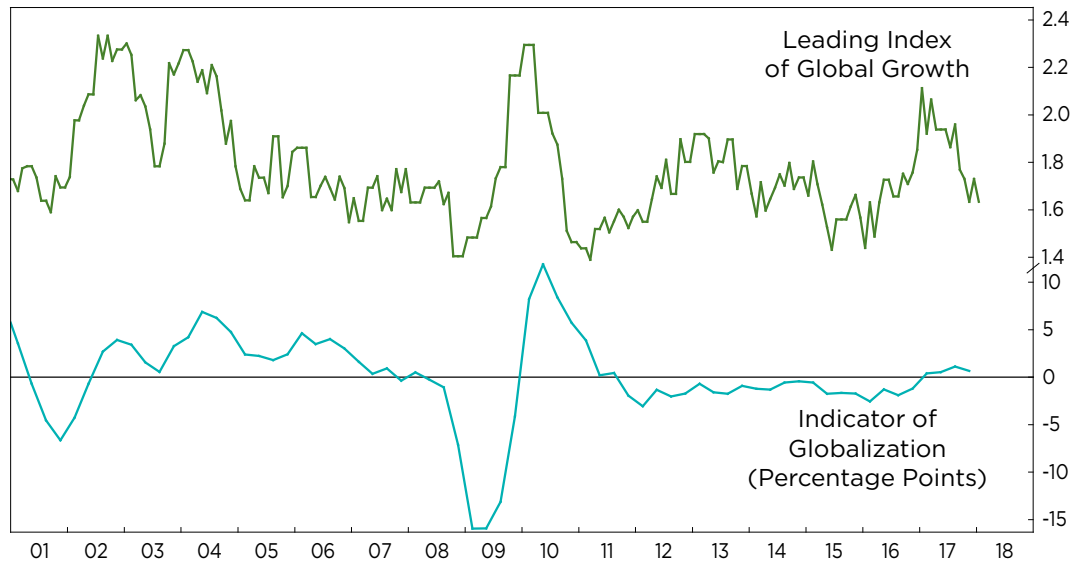
ECRI's measure of globalization is the difference between the growth rates of world trade and GDP, because globalization implies faster growth in trade than in GDP. This measure experiences cyclical swings associated with cycles in global growth because, during an upturn in global growth, international trade tends to grow faster than global GDP, while the opposite is true during a global growth downturn.

Separately, structural globalization becomes evident when this measure is substantially

positive for an extended period. This is what happened when, what we called “the globalization tsunami” over 14 years ago hit the world economy between the beginning of the 21<sup>st</sup> century and the Global Financial Crisis.

Following the financial crisis, however, the structural retreat of globalization becomes evident, with the same metric staying below zero through 2016. While it edged above zero in 2017, it is already turning down, and probably reflects a nascent cyclical downturn as the synchronized global growth upturn comes to a close, as the next slide makes clear... ■

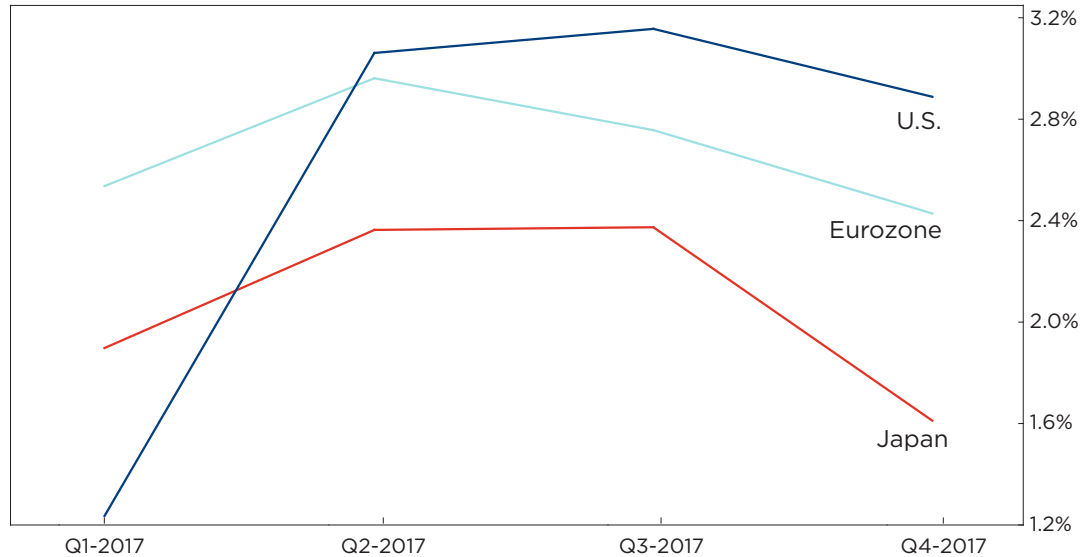
## Measures of Global Growth



The evidence comes from our Leading Index of Global Growth, which is particularly prescient about cyclical downturns in economic growth (top line). Therefore, the current cyclical downturn in this leading index, which correctly anticipated the global growth upturn in mid-2016, is especially meaningful.

Following that downturn, our measure of globalization, which rose above zero last year in the course of its cyclical upswing, has already ticked down (bottom line). Meanwhile, though year-over-year global GDP growth is still rising, it's begun to flatten out and should roll over in the coming quarters. ■

## International GDP Growth Rolling Over



Actually, the global growth downturn is becoming a fact, when you look in the rear-view mirror.

This chart shows that quarter-over-quarter annualized GDP growth rates in the three largest advanced economies – the U.S., the Eurozone, and Japan – have turned down. In all three, GDP growth peaked in the second or third quarter of 2017, and fell in the fourth quarter. This is what the start of a synchronized global growth downswing looks like.

All of this suggests that the consensus is again playing catch-up on the cyclical outlook. International central banks, concerned about overheating, are even further behind, mistaking

last year's cyclical upturn for a sustained structural shift toward a “normal” economy. Of course, hawkish shifts in the face of economic slowdowns that policy makers don't see coming rarely turn out well for the economy.

Wrapping up... ■

## Conclusions

- ▶ Long-term decline in trend growth remains intact
- ▶ Economy's ups and downs since last recession – including recent synchronized global growth upturn – are explained by cyclical factors
- ▶ Actual structural shifts concern composition of U.S. trade balance and end of globalization

So the globalization tsunami that arrived early in this century left many people high and dry in the advanced economies, but that tide has been receding since the financial crisis ended.

And the relative decline of the West ↗, which I discussed last year, is no longer driven by globalization. Yet, the long-term decline in advanced-economy trend growth, driven by demographics and productivity, isn't over, despite wishful thinking to the contrary.

But when that mistaken belief drives policy – in particular the timing of the big shift from quantitative easing to quantitative tightening on a global scale – monetary policy goes on a

collision course with the economic cycle. If policy doesn't change course, that raises the risk of a new recession.

So we'll be watching the leading indicators closely.

Thank you. ■