



## **The Danger of Mixing Up Cyclical Changes with Structural Shifts**

ANIRVAN BANERJI and LAKSHMAN ACHUTHAN

*The authors argue that the long-term structural growth potential of the major advanced economies has “fallen drastically.” They contend that misinterpreting cyclical fluctuations without considering the long-term trends leads to policy errors.*

The twenty-first century has brought profound changes to the U.S. economy, especially following the Global Financial Crisis (GFC). These economic shifts are both structural and cyclical in nature. The structural shifts will be hard to reverse and may remain part of our economic landscape for decades to come.

Reinhold Niebuhr asked for “the serenity to accept the things I cannot change, courage to change the things I can, and wisdom to know the difference.” It is on the latter—the ability to distinguish between the structural and the cyclical—that we wish to focus in this paper, because the inability to tell the difference heightens the risk of serious policy and business errors.

### MAGA IN PERSPECTIVE

A political earthquake shook America in 2016 with the election of President Donald Trump. This was, in part, a delayed reaction to the globalization tsunami (Economic Cycle Research Institute 2004) that arrived early in this century, followed by the GFC and a structural downshift in trend growth, which left many people high and dry in the United States and other advanced economies. Analyzing the survey data, however, Mutz (2018) found support for Mr. Trump to be driven mainly by the perceived

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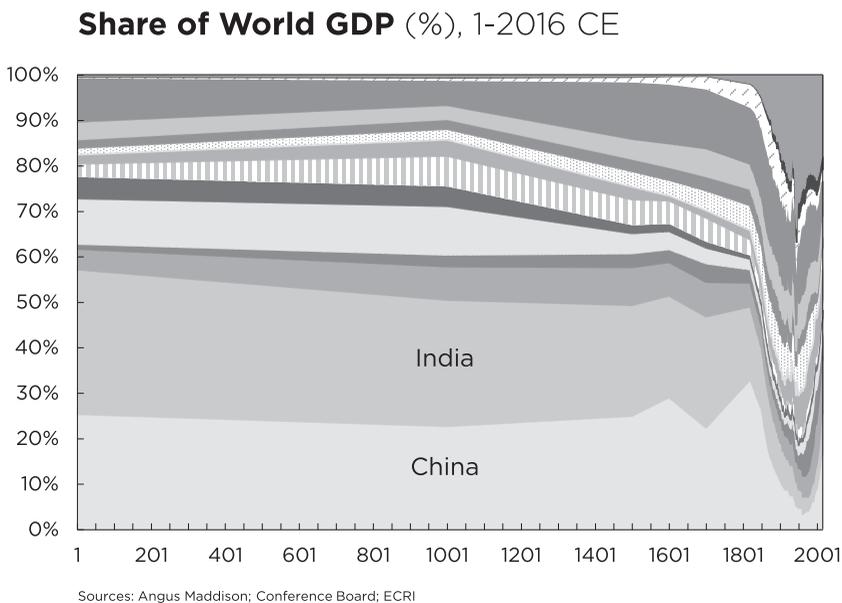
Anirvan Banerji is chief research officer at the Economic Cycle Research Institute (ECRI) in New York, and Lakshman Achuthan is chief operations officer at ECRI.

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loss of “American global dominance and the rise of a majority-minority America: issues that threaten white Americans’ sense of dominant group status” (p. 1).

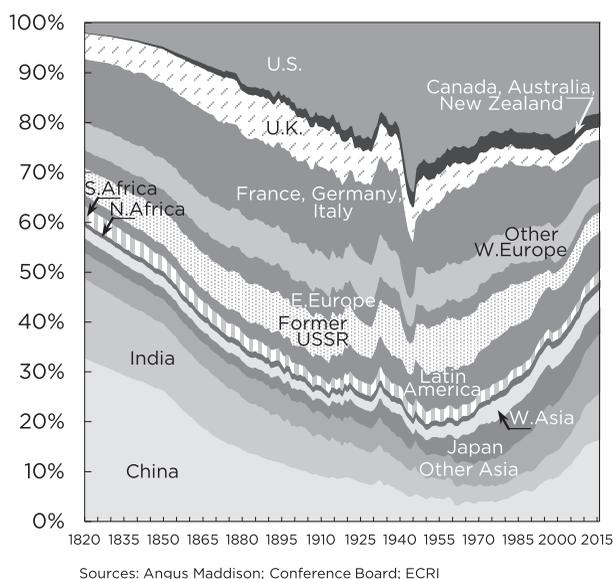
The call to “Make America Great Again” (MAGA) is rooted in that concern, and it suggests both pushing back against profound societal changes and returning the United States to the global economic dominance it enjoyed several decades ago, around the mid-twentieth century. To really understand what that means, it is 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 twentieth-first century, including the next several years; and finally, the post-GFC era. With that perspective, we can better appreciate just how distinct shorter-term cyclical developments are from longer-term structural shifts.

Understanding the evolution of economic dominance over the last couple of centuries by the United States in particular, and the West in general, is largely possible because of the life work of Angus Maddison (2007), due to which we have the requisite global economic data, going back over two thousand years. Figures 1 and 2 are based primarily on Maddison’s data. What becomes clear from Figure 1 is that, for more than 90 percent of the last 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.



**FIGURE 1** Share of World GDP (%), 1–2016 CE. Sources: Angus Maddison; Conference Board; ECRI.

## Share of World GDP (%), 1820-2016 CE



Sources: Angus Maddison; Conference Board; ECRI

**FIGURE 2** Share of World GDP (%), 1820–2016 CE. Sources: Angus Maddison; Conference Board; ECRI.

In year one, India’s share was nearly a third of global GDP and China’s was over a quarter—both bigger than the Roman Empire’s. Asia as a whole produced almost three-quarters of global output. A thousand years later those percentages had declined only a little. In essence, China and India dominated the world economy for the vast majority of this period—until a couple of centuries ago.

And then there were huge shifts with the rise of the West, which dominated the global economy by the mid-twentieth century. But, as it is clear to see, that historical “moment” was the exception in the long history of world GDP. Thus, it is worth taking a second to appreciate just how breathtakingly fast the rise of the West was and how equally swift the reversal of fortune has been.

Figure 2 zooms in on these last two centuries of rapid change. Europe’s Industrial Revolution, which started in the late 1700s and soon spread to the United States, in combination with Western colonial exploitation, was responsible for the plunge in India’s and China’s shares of world GDP between the early eighteenth and mid-twentieth centuries. In a span of just 130 years—from 1820 to 1950—the GDP share of Asia, excluding the Middle East, plummeted from nearly 60 percent to only 16 percent.

Following World War II, the United States reigned supreme, commanding over a third of the world GDP, while Western Europe’s share fell to

well under a quarter—but together, they still accounted for a record 58 percent of global GDP. So the mid-twentieth century saw the GDP share of the West at its zenith, with America dominating the West for decades thereafter. For all intents and purposes, MAGA really harks 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 percent by the turn of the century and topping 43 percent today, a 162-year high. Meanwhile, the combined share of the United States and Western Europe has fallen under one-third, to a 168-year low. And the U.S. share is now just half of its mid-twentieth-century peak. It is the headlong pace of this decline that is worthy of notice.

The far right side of the chart shows the early twenty-first century, when the pace of change really sped up. Just since the start of this century, Western Europe has lost almost a third of its global GDP share, while the United States has lost nearly a quarter.

This decline for the West in terms of global GDP shares is comparable to the fastest fifteen-year declines for China and India between the mid-nineteenth and mid-twentieth centuries. It is this swift swing of the pendulum, back from its mid-twentieth-century extreme, that provides the necessary historical perspective.

Please recall that the two key factors driving the rise of the West relative to others through the mid-twentieth century were the Industrial Revolution and colonialism. But then came the twilight of colonialism, followed in recent decades by a great deal of technological catch-up in China and India that is far from over.

With this data in mind, it is hard to argue that the relative decline of the West and the rise of the rest have really run its course. As a result, it is a tall order for the United States to get back to the more than a third of world GDP that it produced at its mid-twentieth-century peak—or even to the 22 percent share averaged over the Reagan years.

## STUBBORN STATISTICS

For the last five years, annual world GDP growth ex-U.S. has been running at just over 3.5 percent, while U.S. GDP growth has been running a little above 2 percent a year. It follows that, in order for the United States to gain back any GDP share at all, it needs to grow at almost twice its 2 percent pace on a sustained basis—a daunting prospect, as we will show.

Clearly, the decline in America's global dominance in the twentieth century has been driven partly by the resurgence of China and India. But

also, U.S. trend growth has truly downshifted. With the Economic Cycle Research Institute (ECRI) having first identified the long-term decline in trend growth a decade ago, before the Lehman Brothers collapse (Norris 2008), we explained that decline using the simple math behind potential GDP growth, namely, that it is the sum of productivity growth and potential labor force growth (Banerji and Achuthan 2016).

The Congressional Budget Office (CBO 2018) projects that potential labor force growth will average just 0.5% per year for the next six years. Normally, this would be pretty much set in stone, given the demographics. But since immigration is a key element of the Trump policy agenda, even that low potential labor force growth may be overstated, as net legal immigration, which accounts for about two-thirds of that number, could be reduced. In essence, diminished legal immigration—let alone massive deportation of undocumented immigrants—would significantly reduce potential GDP growth over the coming years.

Productivity growth averaged about 2.25 percent per year in the post-World War II period through 2008. However, as then-Fed Chair Janet Yellen noted in congressional testimony early last year, “over the last six years, business sector productivity has grown at an average of only one-half percent per year” (Yellen 2017), having ranged between  $-0.5$  and 1.9 percent while cycling between growth rate cycle (GRC) troughs and peaks. Growth-rate cycles consist of alternating cyclical upswings and downswings in economic growth.

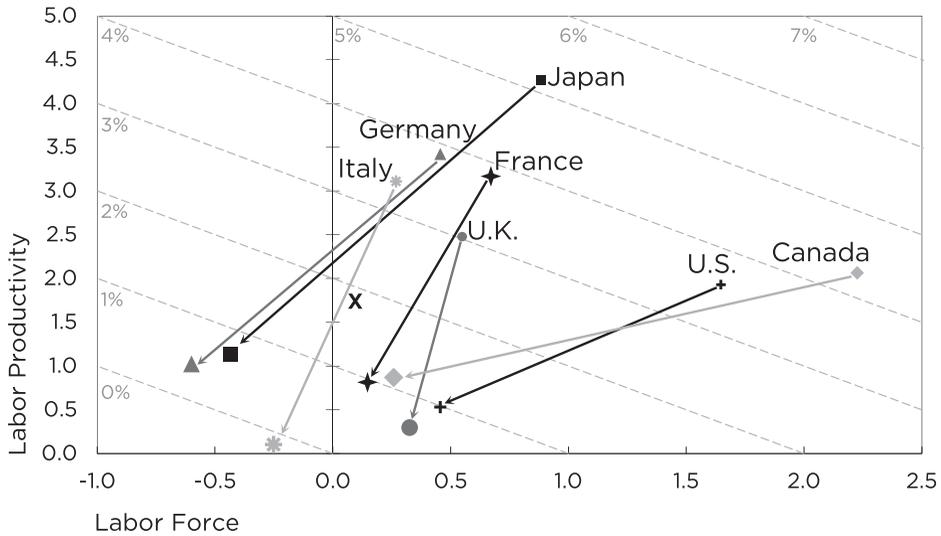
To be sure, many hope that the era of low productivity growth is over and that the U.S. economy is leaving that malaise behind. But in the GRC upturn that ended in late 2017, productivity growth hit a high of just 1.4 percent, in the third quarter before subsequently backing off a bit. As a result, it still sits squarely within that six-year range, providing little indication of a structural breakout.

This is consistent with the point ECRI has been making for some time, namely, that productivity growth is not likely to improve materially from that six-year average over the next several years (Banerji and Achuthan 2016). It is not that productivity growth cannot rise at some point in the future, merely that it is unlikely to do so anytime soon.

If productivity growth remains around that six-year average of 0.5 percent a year, and the CBO’s potential labor force growth estimate of 0.5 percent a year for the next six years is accurate, they would add up to just 1 percent longer-term real GDP growth. Indeed, achieving the “sustained 3–4 percent GDP growth” promised by Treasury Secretary Steven Mnuchin would require six times that six-year average of productivity growth, or twice what was seen over the Reagan years.

Following the GFC, building on our earlier work, we showed that the structural downshift in trend growth went well beyond the United States.

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



Sources: Conference Board; OECD; ILO; Census; ECRI

**FIGURE 3** G7 Labor Productivity and Labor Force, Growth Rates (%). Sources: Conference Board; OECD; ILO; Census; ECRI.

It was taking place in all the other major developed economies as well. We noted not only the “extraordinarily low trend growth” in the United States, but also the same “pattern of falling trend growth” in Europe (Banerji and Achuthan 2012). Once again, this was because of the simple math of demographics and productivity growth.

Using data on growth in labor productivity and the labor force, the same simple math for the Group of Seven (G7) economies becomes evident in Figure 3. 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 six years and potential labor force growth for the next six years.

The slanting gray lines—what one might call “iso-GDP growth” lines—capture the simple math. This is because the sum of the horizontal and vertical coordinates of every point on the 1 percent line adds up to 1 percent, and similarly for the 0 percent line.

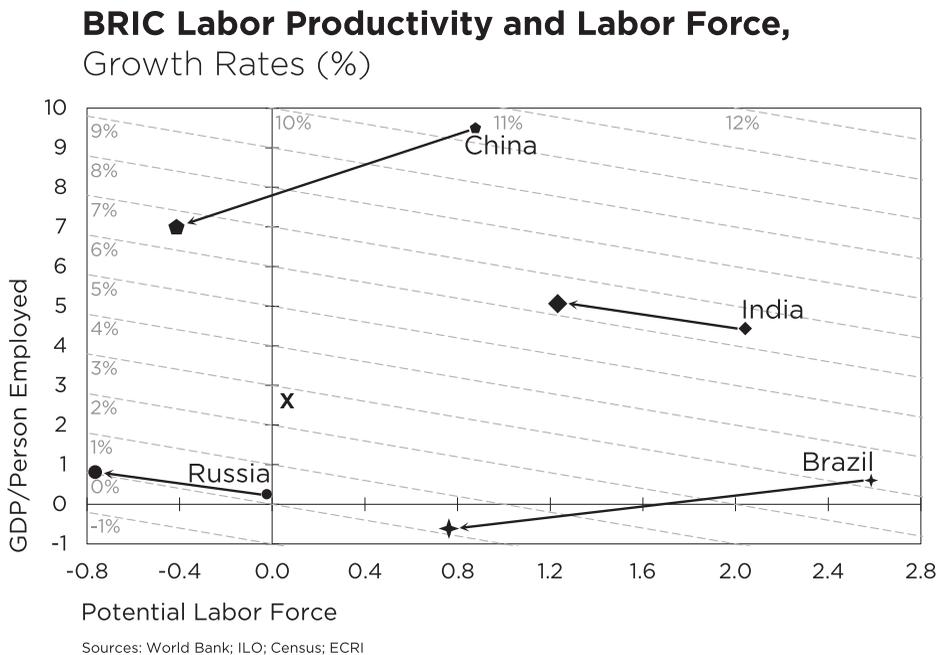
It is immediately obvious that every major advanced economy is headed in the wrong direction, converging toward a 0–1 percent trend GDP growth—the two lowest slanted gray lines near the lower left-hand corner. Since the “X” marks Japan’s “lost decades” from 1992, when its post-bubble recession began, to the eve of the financial crisis, the major

economies look to be headed for even worse predicaments. And Germany's demographic problem, the next six years' potential labor force growth, is slightly worse than Japan's, perhaps partly explaining Chancellor Angela Merkel's generosity in 2015 toward refugees, which promises to change these demographics a bit.

These 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 do not change from year to year. Of course, many look to emerging markets to drive global growth in the coming years. They will, but not as strongly as many presume.

An equivalent presentation of data for Brazil, Russia, India, and China is shown in Figure 4. The same productivity data is not available, so we substitute GDP per person 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 10.5 percent to 6.5 percent 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 actually improving, so potential GDP growth is likely to stay around 6.5 percent for the next few years.



**FIGURE 4** BRIC Labor Productivity and Labor Force, Growth Rates (%). Sources: World Bank; ILO; Census; ECR.

Taken together, it is evident that the major advanced economies' long-term structural growth potential has fallen drastically. So has China's, though it remains well above that of the West. In India's case, it is not only substantially higher but also not in decline.

It is notable that the International Monetary Fund is now coming around to a similar view. Its latest five-year-ahead GDP growth forecasts show cuts across the board to record lows for the major advanced economies: 0.5 percent for Japan, a little over 1.4 percent for the Eurozone, and just below 1.4 percent for the United States, that is, under that of the Eurozone. For China, it was reduced to a quarter-century low of just over 5.5 percent, but for India it was raised to a record-high 8.2 percent.

The key takeaway is that China and India will both continue to catch up with the West, whose world GDP share will therefore keep falling for the foreseeable future. The mid-twentieth-century "moment" of overwhelming Western global economic dominance is history and is fast receding in the rear-view mirror. A truly long view over centuries and millennia makes it painfully clear how extraordinary it was for the United States to achieve the economic dominance that it enjoyed around the mid-twentieth century. That is why the subsequent swift decades-long structural rebound of China and India is simply not susceptible to reversal.

Furthermore, considering the next several years in the light of productivity and demographics, these structural factors seriously constrain potential GDP growth, which is likely to wane substantially for the West, including the United States, in the years to come. Indeed, it is highly improbable that potential GDP growth for the major Western economies will improve significantly, given the simple math of low productivity growth and demographics. Thus, a structural revival that returns Western economies to their post-World War II pace of growth is very unlikely. These are the structural realities that will not change anytime soon.

## CYCLICAL CHANGES

Turning to cyclical fluctuations in growth that result in quite a bit of change over the shorter run, matters are different. In fact, by late 2016 and early 2017, prospects looked to be the most positive they had been in years.

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." He then pioneered the development of leading indexes for many other countries. Following the experience of U.S. stagflation in the 1970s, he also helped

create leading indexes of inflation, distinct from leading indexes of economic growth.

In the second half of 2016, based on these types of leading indexes, ECRI predicted global reflation and an upturn in U.S. inflation, followed by a forecast of a U.S. economic growth upswing. In early 2017, ECRI proclaimed the “brightest global growth outlook since 2010” (Economic Cycle Research Institute 2017a). Notably, the upturns in the leading indexes, on which these forecasts of revival were based, began well before the U.S. election.

The point is that the much-heralded synchronized global growth upturn was a cyclical event that ECRI correctly predicted based on *cyclical* leading indexes of economic growth, after flagging “global reflation” based on *cyclical* leading indexes of inflation (Economic Cycle Research Institute 2016). But few appreciated that key distinction. Inevitably, the consensus began confusing a cyclical upturn with the hoped-for structural upshift.

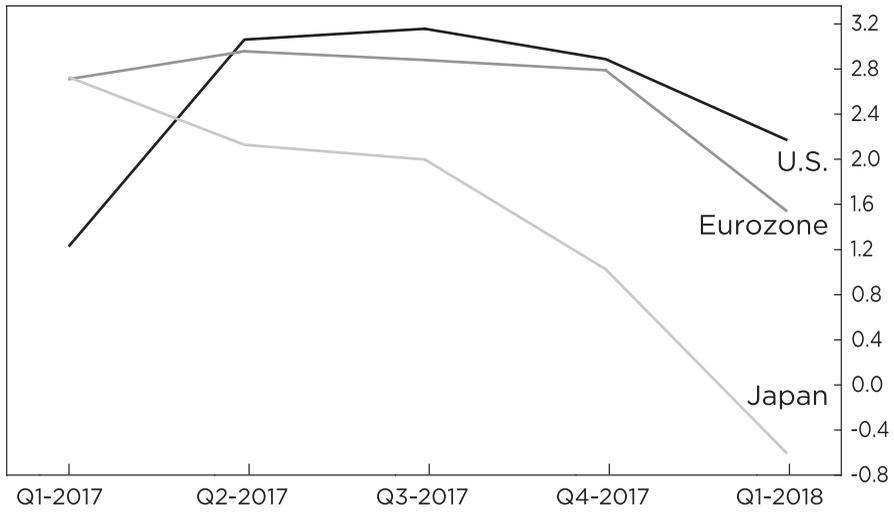
Following a few quarters of synchronized global growth and rising inflation, the impact on the mood of policymakers was palpable. By mid-2017, the world’s central bankers were increasingly convinced that we had turned the corner in a structural sense. Emerging from their group meeting in Sintra, Portugal, they all sounded more hawkish, or less dovish, about “normalization” of the world’s economies and their own policies. This was their “mission accomplished” moment and at least implicitly suggested that the era of low-trend growth and lowflation was over. In other words, they thought they were looking at a *structural* shift away from low-trend growth and “lowflation.”

But as happens with cycles, the leading indexes of global growth, which had correctly foreseen the global growth upturn, turned down. In turn, as Figure 5 shows, the quarter-over-quarter annualized GDP growth rates of the three largest advanced economies—the United States, 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 before dropping even further in the first quarter of 2018. This is what the start of a synchronized global growth *downswing* looks like.

Corroborating this view, year-over-year growth in world industrial production has also rolled over. As Figure 6 shows, it is now below where it was in the spring of 2017. This is what the beginning of a global industrial growth downturn looks like. It is no coincidence that this downswing follows the earlier downturns in ECRI’s leading indexes of global industrial growth (Economic Cycle Research Institute 2017b).

Regardless, at the time of writing, the financial markets were betting that the odds of at least three Fed rate hikes this year were overwhelming and that the chances of at least one rate hike this year were one in three in Japan and one in ten in the Eurozone following years of quantitative

### GDP Growth (%)



Sources: BEA; Eurostat; Japanese Cabinet Office; ECRI

**FIGURE 5** GDP Growth (%). Sources: BEA; Eurostat; Japanese Cabinet Office; ECRI.

### World Industrial Production Growth (%)



Sources: CPB Netherlands Bureau for Economic Policy Analysis; ECRI

**FIGURE 6** World Industrial Production Growth (%). Sources: CPB Netherlands Bureau for Economic Policy Analysis; ECRI.

easing and essentially zero interest rates. In other words, indulging in some wishful thinking, many policymakers prefer to see a cyclical upswing—which is already over—as a lasting structural shift.

## THE STRUCTURAL AND THE CYCLICAL

With our focus on economic cycles, we have a solid read on where we are in the business cycle. And, when we strip these cyclical fluctuations out of the data, what is left is largely structural, allowing us to better distinguish between economic developments that are cyclical and structural.

Because demographics are effectively set in stone for many years to come, those who believe that a lasting structural shift is under way are really betting on much higher productivity growth, which is rooted in the post-GFC “collapse in capital intensity” (Banerji and Achuthan 2016). Unfortunately, as a recent article in the *Economist* (2018) put it, “Economists understand even less about economic growth than about business cycles.”

In spite of all this, the major international central banks, eager for “normalization,” are still mistaking last year’s cyclical upturn for a sustained structural shift toward a “normal” economy. Yet, as we have explained, the long-term downshift in advanced-economy trend growth is not over.

The immediate problem is that hawkish shifts in the face of economic slowdowns that policymakers do not see coming rarely turn out well for the economy. But when that mistaken belief drives policy—in particular the timing of the big shift from quantitative easing (QE) to quantitative tightening on a global scale—monetary policy goes on a collision course with the economic cycle. And if policy does not change course in time, it raises the risk of a new recession.

## QUITTING THE QUIXOTIC QUEST: A MATTER OF MATH

The overarching reality is the relative decline of the West, which is a mega-structural reversal that has been proceeding apace for at least a quarter of a century and is not about to stop anytime soon. Within that well-established decades-long trend, the massive QE in the post-GFC period, which started as an emergency countercyclical measure, became an effort to boost economic growth permanently back to the old “normal.”

In the United States, QE has now been supplanted by Trump administration efforts, through fiscal and trade policy, to restore American primacy, even while curbing immigration. Unfortunately, as we have shown, the math does not work. This is because U.S. demographics dictate, in the absence of *increased* immigration, potential labor force growth of no more than 0.5% a year for many years to come. European demographic prospects are as poor or worse.

Therefore, the focus is on boosting productivity growth, with the United States pushing enormous debt-fueled fiscal stimulus. Thus far, there is little indication that productivity growth is breaking out, as we have noted. But even an improbable quadrupling of productivity growth from its average in recent years cannot halt the decline in the U.S. share of global GDP, given the much greater productivity growth potential in developing economies still catching up to the West.

It is underappreciated that, with exports-to-GDP ratios dropping dramatically in recent years and falling below 20 percent in both China and India, their growth is now largely domestic-driven. For this reason, even trade wars are unlikely to derail the resurgence in their global GDP shares toward historical levels.

As we have observed before, it is often “a mistake to look at the current economic situation as a departure from a more benign state of normality to which we should return in a few years, if only the ‘right’ policy is chosen” (Banerji and Achuthan 2012). Absent a truly long-term perspective on international economic history, frustration about the relative decline of the West has been giving rise to imprudent policies that could be counterproductive.

A long view of history helps to disentangle what is truly exceptional about America from the exceptional “moment” in history that the mid-twentieth century represents. In the process, it should help set more realistic expectations about the parameters of an American comeback.

Given that the U.S. population is just 4.25 percent of the world population and is set to grow slowly, while China and India together make up 36.25 percent—and at least the Indian population is poised to grow much faster—not much numeracy is needed to understand why their combined GDP share will keep increasing for the foreseeable future, unless U.S. productivity grows far faster than theirs. Of course, even if the “right” policy is chosen and causes U.S. productivity growth to revert to its pre-GFC pace, the opposite is likely, since China and India have a great deal of catching up left to do.

Understanding that Western living standards will stay well above those of China and India for a long time, especially if income inequality is reduced, it would be more helpful to quit the quixotic quest to restore U.S. global dominance and adjust to realistic growth targets, while

pursuing policies likely to boost productivity growth. That could work to sustain, and enable broader access to, the high standards of living the West has already achieved.

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