RBC Global Asset Management

Economic Compass

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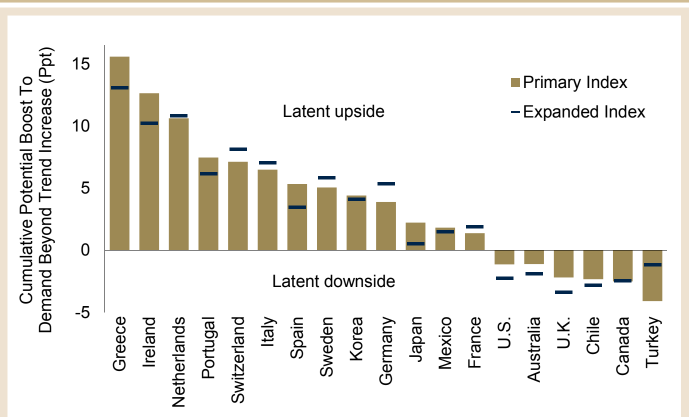
# MEASURING ECONOMIC UPSIDE

Traditionally, medium-term economic projections are generated on the basis of anticipated developments in monetary and fiscal policy. Policymaker actions are sufficiently predictable and their effects long-enough-lived that plausible forecasts can be spun for variables such as employment, wages, spending and capital expenditures, ultimately congealing into a GDP forecast. This is a standard part of our own forecasting toolkit. Nevertheless, we are always on the hunt for new perspectives. Recently, we began to wonder if this customary approach might be missing the forest for the trees, focused so tightly on the day-to-day actions of policymakers that it fails to account for what policymakers are trying to achieve.

What are policymakers' medium-term goals? Simply put, they seek to balance their budget, minimize any mismatch between demand and output, return their economy to its full potential, engage in reforms that enhance their economy's potential, and nudge their currency toward a reasonable valuation. What if we cut out the intermediate step and focused instead on these end goals? This thinking has inspired the Economic Upside Index, a novel measure that starts with the presumption that policymakers will be successful in their efforts,[1] which permits the luxury of assessing the economic consequences of those eventual victories. The end result is a metric that gauges which of 19 OECD nations are primed for unusually good growth in economic demand over the next five years, relative to their usual trajectory.

As a general (though imprecise) rule, the Economic Upside Index calculates that the countries that fared best through the financial crisis – like Canada and Australia – now have the least economic upside awaiting them, while those that suffered horribly – such as Greece and Ireland – have the potential to zoom forward (Exhibit 1).

**Exhibit 1: Economic Upside Index**




Note: These measures estimate the potential cumulative boost to demand over the next five years, beyond the normal trend growth rate for each country. The boost is assumed to come as current account imbalances, fiscal deficits, output gaps and residential investment gaps close, factoring in the effects of demographics, currency movements and structural reforms on capacity. The Expanded Index includes an additional variable that acknowledges the burden of servicing public debt. Source: Haver Analytics, RBC GAM

## Methodology

The Economic Upside Index combines seven variables that collectively assess the extent to which a country's economic demand (on the bottom solid rung of the ladder in Exhibit 2) can be elevated to greater heights.

### Faster, not fast

To be clear, the country with the most upside will not necessarily manage the fastest economic growth. In general, emerging market countries will still outgrow developed ones, and younger populations will usually outpace older ones. Rather, the winners in the Economic Upside Index are the countries most capable of exceeding their historically normal growth rate, whatever that is. This isn't as obscure a consideration as it initially seems. Financial markets are relentlessly forward-looking, pricing in expected earnings and anticipated economic growth. If fast growth is the norm for a country, more of the same provides no guarantee of financial-market fireworks. The key to outsized market returns lies in identifying those countries poised for stronger-than-usual growth, rather than outright strong growth. That is precisely what the Economic Upside Index sniffs out.

[1] And acknowledges unalterable outcomes like demographic change.

### Tallying

The beauty of (all but one of) the included economic variables is that they already speak the language of GDP. Thus, our task is a simple one: add up the effects of each variable to arrive at the aggregate economic upside.

## 1) Current-account balance

Current-account balances provide a clear assessment of which countries are living beyond (or below) their means. A current-account deficit indicates that a nation's demand races unsustainably ahead of its output, financed by perpetually more borrowing from foreigners. On the other hand, a current-account surplus reveals a country that is consuming less than it can afford. In the parlance of Exhibit 2, demand can sustainably rise up to the level of output.

### Assuming mean reversion

Inherent in the Economic Upside Model is the assumption that this extra demand will finally be unleashed. It is a fair point that current-account imbalances appear to converge upon desirable levels at a much more leisurely pace than several of the other variables, so there is no guarantee that they will have vanished in five years. Fortunately, there is reason to think that current-account imbalances will make at least some progress toward this ideal: post-financial-crisis policymakers have pushed hard to reduce the so-called "global savings glut" that contributed to credit excesses. They have had considerable success so far.

### Findings

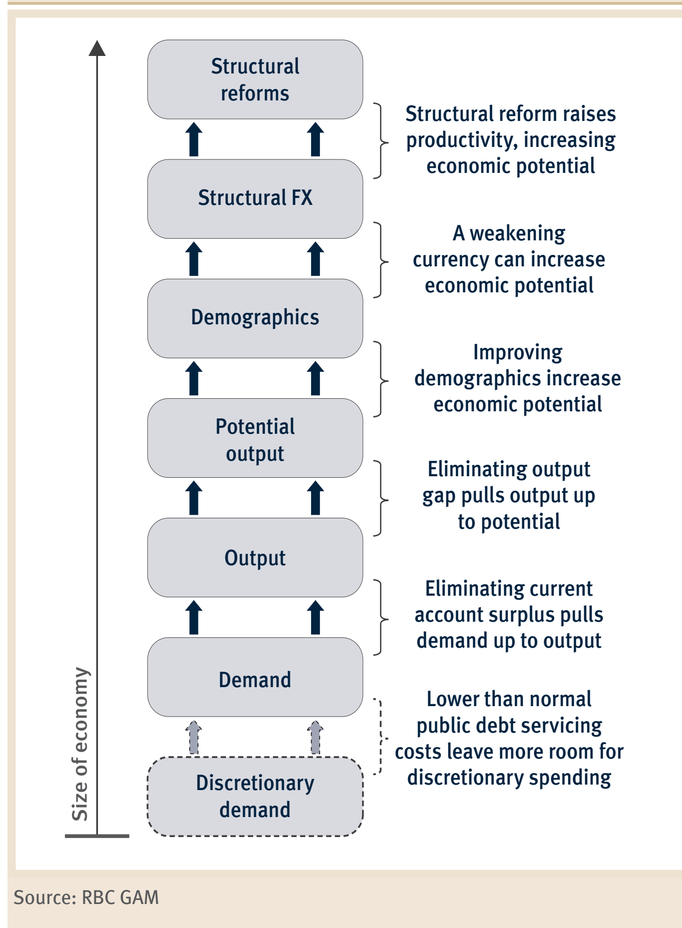
This measure bodes especially well for large current-account surplus nations such as Switzerland, the Netherlands, Germany, Ireland and Sweden. It bodes poorly for Turkey, the U.K., Chile, Canada, and Australia.

## 2) Fiscal balance

The structural fiscal balance captures how far a country is from balancing its public budget.[2] A government with a fiscal deficit can be thought of as living beyond its means, and a natural medium-term goal of policymakers is to eliminate this deficit via austerity measures. This imposes an economic toll roughly equal in size to the magnitude of the starting deficit. The structural fiscal balance reveals several interesting things. Marking quite an impressive reversal, Greece finds itself in the best position of all, with a structural fiscal surplus. South Korea, Switzerland and Germany also fare particularly well. At the other extreme, Japan's structural fiscal deficit is enormous. The U.S., Spanish, Turkish and Mexican deficits are also sizeable, requiring further austerity.

[2] Sometimes, a fiscal deficit is merely cyclical in nature, meaning that it will go away without any special effort by policymakers as the subsequent economic recovery takes hold. We only seek to capture the remaining structural part of a fiscal deficit – the part requiring hard work and economic sacrifice to eliminate.

**Exhibit 2: Economic upside ladder**




Source: RBC GAM

## 3) Output gap

The output gap measures the existence of slack in an economy. To continue with the logic of Exhibit 2, closing the output gap raises output to its full potential (in so doing, dragging demand upwards with it). Thus, the countries with the biggest negative output gaps have some of the most outsized growth prospects over the coming years as they converge upon their full capacity. Among the best positioned are the usual European suspects: Greece, Ireland, Portugal, Turkey, Italy and Spain. Those with the least output gap upside are Japan, Chile, Germany and Canada.

## 4) Residential investment

The residential investment share of GDP is a handy proxy for the extent to which housing activity is unnaturally elevated or depressed. When it is unusually low, the expectation is that it will revert to historical norms, boosting economic output.

Calculating the residential investment gap reveals several European nations with the most upside, given previously devastated housing markets, including Greece, Portugal, Ireland and Spain. Those with the least upside are countries whose housing markets never really suffered, including Chile, Turkey, Canada, Germany and Mexico.

## 5) Demographics

We now swivel toward a set of three variables that alter the sustainable potential growth rate itself, rather than merely nudging demand toward a pre-existing potential.

At its most simplistic, the sustainable economic growth rate is derived from the growth rate of workers plus the extent to which they become more productive. Demographics naturally play a central role in anticipating trends in the former. We compare each country's cumulative population[3] growth over the past five years to its expected population growth over the next five years. As it happens, demographics are set to cast a shadow on the potential growth rate of all the examined countries over the coming five years, but to varying degrees. The worst effects will be felt in South Korea, Spain, Turkey, Australia and Chile. The best (or, in this case, the least bad) effects will be in Sweden, the U.K., Japan and the Netherlands.

## 6) Currency valuation

We next consider the level of each country's currency relative to its fair value. Contrary to initial instincts, we judge that those countries with the most undervalued exchange rates to be at the greatest disadvantage. The reason for this is that the undervalued countries have been enjoying an artificial (and inherently temporary) competitive advantage and, as currency valuations revert to fair value over the medium run, those countries will suffer an economic drag. The reverse is true for countries with overvalued exchange rates.

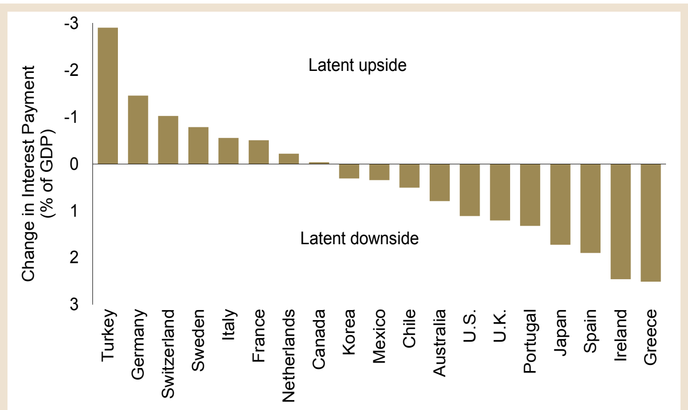
Unlike the other variables, currency misvaluations do not map directly onto economic growth. We have to translate every percentage point of expected currency movement into GDP-equivalent terms. The resulting calculations reveal that the countries in the most promising currency position (meaning the most overvalued exchange rates that can afford to decline, boosting growth) are Australia, Switzerland, Canada and Chile. The countries in the least promising position are Japan,[4] the U.S. and the U.K.

## 7) Structural reforms

Another possible avenue for faster potential economic growth comes via structural reforms. There is no simple way to comprehensively assess the progress of such reforms, gauge their future trajectory or map them onto potential GDP growth.[5] As a result, we use our own judgment to assess the likely extent and efficacy of structural reforms by country, basing this assessment on a combination of recent policy pledges, ongoing legislative efforts and anticipated trade deals.

In our opinion, the countries undertaking (or poised to undertake) the most fruitful economic reforms are Japan, Greece, Mexico, Ireland, Italy and Spain. Those undertaking the least are Switzerland, Germany, Turkey and Sweden.

**Exhibit 3: Public debt-servicing burden**




Note: Difference of public debt interest payment as % of GDP in 2019 and pre-crisis level. Source: IMF, OECD, Haver Analytics, RBC GAM

## 8) Public debt servicing

Lastly, we consider the burden of servicing public debt. This measure is actually excluded from our primary upside index, but included in the expanded index (refer back to the blue dashes in Exhibit 1).

### Choosing a public debt metric

There are a number of ways to incorporate a measure of public debt into the Economic Upside Index. At an extreme, one might argue that countries should have to pay back any debt above a "normal" level such as 60% of GDP. A more realistic option (and the one we employ) acknowledges that the debt is unlikely to be substantially paid down, and that the true burden can instead be determined by the cost of servicing all of the extra debt.

### Results

The findings are shown in Exhibit 3. They paint Turkey, Germany, Switzerland and Sweden in a positive light. In contrast, and as expected, Greece, Ireland, Spain, Japan, the U.K. and the U.S. are viewed more negatively.

[3] We equally weight the overall population growth rate (a proxy for demand) and the working-age population growth rate (a proxy for output).

[4] Although the nominal yen still looks strong versus the U.S. dollar on a historical basis, the reality is that Japan has run a much lower inflation rate than other countries, resulting in a real exchange rate that is substantially weaker than its nominal one. And when Japan's currency is compared to its trading partners (disproportionately emerging market nations whose currencies have been appreciating in recent years), it again looks much weaker than the standard analysis. We'll confess that our own suspicion is that the yen can weaken somewhat further over the next few years, but one of the purposes of the Upside Economic Index is to remove human judgment from the assessment process, and so we leave the interpretation as it is.

[5] Measures such as the World Bank's *Ease of Doing Business Index* and the World Economic Forum's *Global Competitiveness Index* make a heroic effort to partially quantify the structural environment.

## Economic Upside Index results

Taken altogether, the Economic Upside Index contains some fascinating findings. At the aggregate level, most countries – 13 out of 19 – can expect a positive economic upside (meaning above-normal growth) over the coming five years. This squares well with our expectation of global economic recovery.

### Upside

In regards to the countries with the most economic upside, it is a European sweep of Greece, Ireland, the Netherlands, Portugal, Switzerland and Italy. Spain just barely misses out, in seventh position.

### Downside

The six countries set to fare the worst are Turkey, Canada, Chile, the U.K., Australia and the U.S. All six are technically living beyond their means, with the implication that, for them, the Economic Upside Index is really more of an economic downside index.

### Proper interpretation

We'll confess that some of the Economic Upside Indexes findings don't align with several of our pre-existing views. Does this mean it is a junk index? No – it offers an unblinking consistency and farsightedness that qualitative human analysis struggles to match. We need more measures like this, though given its rigid construction it should be viewed as a complement to, rather than a replacement for other tools.

In the end, we believe it is presently transmitting a useful reminder about the substantial economic upside in peripheral Europe, just as its message about limited upside for countries including Turkey and Canada may also warrant special heed.

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