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# A More Normal World?

## The US, Chinese and Japanese economies at horizon 2016

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## Summary

China, Japan and the US appear to be heading towards a "new normal" at long last. However, the 2014-16 period will be critical to ensure that global growth is put on a sustainable path as ample challenges persist.

For the US, normalizing monetary policies stands out as the largest unknown, although there are good reasons to believe that the US will grow by 2¾% by 2016.

Downside risks appear higher for China and Japan. While Japan is expected to have obtained more robust growth without deflation by 2016 (of about 1%), dealing with its huge public debt may require much bolder structural and fiscal reforms. The new Chinese leadership is clearly targeting greener and more inclusive growth, but a cautious approach to reform combined with risks on the financial side may delay the shift towards a more sustainable growth path (of some 6½%) and potentially trigger a more disruptive slowdown.


## 1. Introduction

### Why 2016 AND WHY US, CHINA AND JAPAN?

**In any central macro-economic scenario, by 2016 the three largest non EU economies in the world are expected to settle on (more) stable growth paths.** In 2016 the US should move close to full employment and the output gap should be closing. In this context the normalisation of monetary policy is expected to lead to higher interest rates. By the same year, China should be transitioning to lower, more consumption driven and less polluting, growth. Japan, in turn, should have moved definitively out of deflation and started to address its huge fiscal imbalance.

2016 will be an electoral year in both the US and Japan. This will trigger an assessment of the policies put in place by Obama and Abe in their respective second terms. In the case of China, the release of the new five-year plan should play a similar role.

**The three largest non-EU economies in the world will have to face significant challenges to ensure that the above-mentioned central scenario materialises.**

The brief will first discuss what the new manual would look like in these three economies (in the case of US and Japan this will coincide with the closing of the output gap while, in the case of China to the transition to a lower, but more sustainable and balanced growth plateau). It will further analyse the downside risks and the challenges related to the transition to the new normal.

The possible implications of the paths followed by these countries to move to a "new normal" for the growth outlook of the European Union and the Euro Area will be briefly discussed in the final part of this brief.

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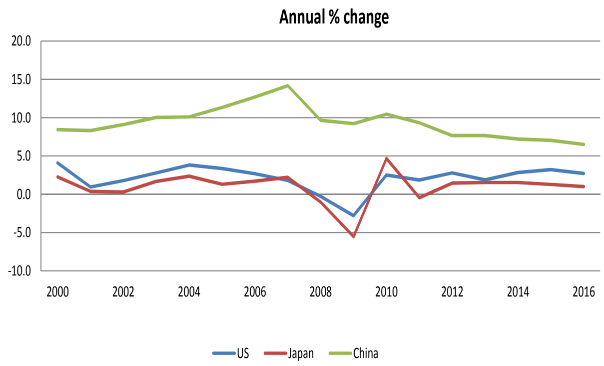
Graph 1: Real GDP Growth




## 2. The United States

**Looking at the United States, we expect that by 2016 much of the economic and political uncertainty that weighed heavily on the performance of the country in the past couple of years will have gradually faded away.** This will result mostly from three factors: (1) the deleveraging coming to an end and the decline in the unemployment rate, (2) uncertainty about monetary policy gradually vanishing, (3) a neutral stance of fiscal policy. On the downside, it is worth mentioning that the current political dividing lines will likely still be there, limiting the margins of maneuver of the Obama Administration.

**The US economy is currently recovering at a moderate pace, as the lengthy healing process associated with deleveraging is running its course.** The strength of the recovery during 2013 was hampered by a fiscal drag from earlier policy decisions. However, 2013 is widely expected to be the last year of sharp adjustment on the fiscal side (at least in this decade). Private demand has continued to recover at a relatively strong pace, despite the dent brought about by fiscal consolidation and uncertainty about the fiscal policy course. The underlying trend proved to be relatively robust, in particular that of private consumption, and in future the fiscal headwinds should gradually disappear (estimates of the fiscal drag for 2014 are around ½ percentage point, down from 1½ pps. in 2013, and fading in the subsequent years[1]). Had the episodes of volatility due to policy uncertainty been avoided, the economy could have been growing at a healthy clip by the end of 2013 already. The housing market indicators have been edging up, despite lingering uncertainty about this sector, and the unemployment rate has fallen below 6 ½ percent[2].

**On the monetary policy side, labour market strength and, to a lesser extent, a healthier housing market will play an important role in determining upcoming decisions by the Governors of the Federal Reserve.** The Fed's governors, who have full employment as well as low inflation as the two pillars of their mandate, are considering a large array of labour market indicators to justify future action and have placed emphasis on the drop in labour force participation in their analysis of the upturn. However, as these indicators have shown mixed developments, they have proven difficult to interpret. Still, most recently, employment figures have shown positive surprises. Job creation has been strengthening and both narrow and broader measures of the unemployment rate have edged down. This improvement has materialized earlier than expected, and this fact raises further questions about the future timing of monetary policy decisions.

**Economic growth in the US appears to be first moving above trend growth to reabsorb the output gap and then only gradually returning to trend.** In 2014 and 2015 robust consumer demand and business investment should be the main growth drivers. The faster pace of growth will gradually reduce the gap between potential and actual GDP. The pick-up in US growth would represent a positive contribution to global demand through the external channel, at a time when growth in emerging market economies is expected to slow down. This should in part counter the impact of possible negative spillovers on fragile emerging markets due to the normalization of US monetary policy.

1 CBO, http://www.cbo.gov/publication/45010, long term budget projections until 2024. Note that CBO does not expect GDP to return to potential before 2017.

2 The headline unemployment rate has fallen 1.2 pps ove the past year, while the broader U6 measure, which captures the underemployed and discouraged workers, has fallen 1.6 pps. However, the decline in the unemployment rate has also been accompanied by a sharp decline in labour force participation.

**The attention will turn to the communication by the Federal Reserve Board, which will be paramount to avoid setbacks in the financial markets.** Uncertainty with regard to the exact course of the exit strategy from exceptional measures taken during the crisis will probably linger for some time, and the minutes of FOMC debates are already giving some hints as to the options envisaged. Tapering of the asset purchases and therefore exiting from QE should be completed by October this year. Continued ease of financial conditions and access to credit for businesses and consumers should ultimately offset the winding down of exceptional measures.

**In the run-up to the 2014 mid-term elections and further out to the 2016 presidential elections prospects for major policy initiatives are extremely limited.** As of now, there is no majority in Congress for addressing the unresolved longer-term budgetary issues. On the one hand Republicans oppose raising taxes and, on the other, Democrats are unwilling to change the main features of the entitlement structure. The agreement on the 2013 Bipartisan Budget Deal proved that finding an agreement between both sides' interests is possible. Still, the compromise proved very cumbersome and time consuming. In addition, it triggered deep divisions inside both parties. It looks unlikely that ahead of the 2016 Presidential elections the conditions will be in place for a grand bargain on issues such as agreeing on a credible medium-term fiscal consolidation plan. Hence, it is likely that macroeconomic policy in the US will be almost exclusively driven by monetary policy choices.

## 3. Japan

**In the two decades preceding the current government led by PM Abe, Japan was stuck in a stagnation-deflation trap** that produced very low growth (yearly average real GDP growth was about 0.9%) and even a decline in nominal GDP. In the same period, Japan's general government gross debt/GDP ratio increased from 77% in 1993 to 238% in 2012. It looked as if Japan would not be able to produce a strong recovery any time soon.

**Still, in 2013 Japan exited deflation and achieved one of the highest growth rates among advanced economies.** Most of the merits for these positive developments should go to Abenomics, an economic policy paradigm shift carried out by Mr. Shinzo Abe when he became Prime Minister in December 2012.

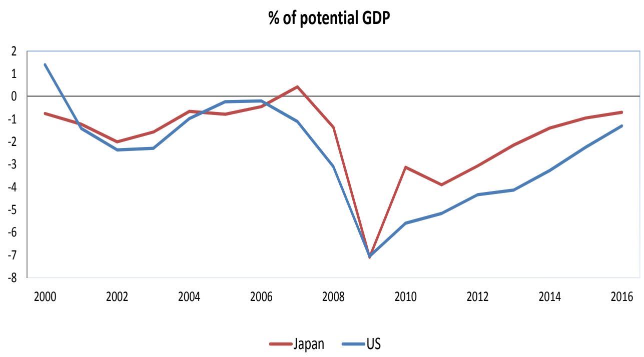
**The new economic strategy of the Japanese government is based on the so-called three arrows:** an aggressive monetary policy (arrow 1), a flexible fiscal policy (arrow 2), and a growth strategy implying a number of structural reforms (arrow 3)[3]. Compared to the economic policy approaches followed by Abe's predecessors (mostly based on broad but inconclusive structural reform programmes), the three arrows strategy puts monetary and fiscal policy at the centre of the policy action aimed at ending deflation and stimulating growth, with the structural reform arrow in support, tasked to make permanent the progress obtained through the other two arrows.

**There is no doubt that Abenomics has scored high marks in its first year** (Posen (2014b)). In the central scenario, it should continue to produce positive outcomes in the run-up to 2016. Growth is expected to be around 1.5% in 2014 and 1.3% in 2015. Given the fact that Japan's growth potential is about ¾ of a percent and the output gap is estimated at around 1.5% of GDP, the output gap will likely be closed in 2016. CPI growth, although will probably be below 2%, will remain in positive territory. The fiscal deficit should continue to decline and the debt/GDP ratio should first stabilise and then move gradually downward.

If investment picks up and, thanks to Abe's third arrow, some increase in the participation rate materializes, it is possible that the growth potential will move up a tad.

3 The third arrow (the growth strategy) is the most complex and probably less innovative of Abe's three arrows. As noted by Paul Sheard (2013), "the growth strategy has underwhelmed most observers". The strategy is based on five pillars: (i) strengthening of the economic system through institutional reform, deregulation policies and measures aimed at attracting foreign direct investment; (ii) promotion of private investment through tax incentives and changes in corporate governance; (iii) labor market reform and enhancement of the quality of human capital (in primis through the increase of women's participation rate; (iv) creation of strategic markets through structural reform; and (v) conclude negotiations on Free Trade Area with the United States and other countries in the Pacific basin (the so-called Trans pacific Partnership – TPP) and with the European Union. For the time being only part of the legislation aimed at making operational the growth strategy has been introduced and so far pillars (i) and (iv) have registered the most significant progress. New structural policy measures are expected by the end of June 2014.

Graph 2: Output gap




*Source :* IMF, WEO Database, April 2014

**Against this background, at the horizon 2016 it is likely that Japan will have reabsorbed its output gap and that we will not see a resurgence of deflation.** Therefore, by 2016 Japan should start to stabilise on a new growth path, characterised by moderate nominal and real growth (respectively close to or slightly above 2% and 1%) and quasi-full employment. Still, this outcome, which would be quite remarkable if compared to Japan's economic performance in the last two decades, will fall short of the Japanese government objective of achieving a 2% growth in real terms and 3% growth in nominal terms. In addition Japan will still be far away from solving its long term structural problems (population decline, huge amount of public debt, etc). In this respect, as pointed out by Martin Wolf, "Abenomics will disappoint", but it is difficult to see how it could be otherwise in the absence of much more radical structural and fiscal reforms.

## 4. China

**China is at a crossroad in its development path.** After a formidable economic performance since the "reform and opening up" process started in 1978[4], many of the input factors that spurred growth in the past are set to change.[5] Moreover, the current growth model has caused a sharp increase in income inequalities and carried vast environmental costs[6]. Already in 2007, then Premier Wen described China's growth model as "*unbalanced, uncoordinated and unsustainable*". Whilst the former leadership had outlined structural measures addressing these imbalances, the collapse of global trade following the failure of Lehman Brothers in 2008 triggered a U-turn in economic policies. China was generally applauded for its decisive measures to kick-start growth in 2009 (where economies around the world argued in favor of stimulating demand to avoid a global depression). Nevertheless, some of the investment-driven stimulus carried out also contributed to the financial vulnerabilities that are now emerging in China.

**A certain moderation of growth was to be expected.** The Chinese economy has been slowing down gradually since 2012 (down to 7.7% year-on-year (yoy) in 2013 or to 7.4% yoy in Q1 2014). While a certain "trend" deceleration is to be expected as the country's potential for 'catching up' is gradually exhausted, the slowdown appears to be primarily cyclical in nature.[7] Weaker export growth reflected, at least in part, lower demand from the EU and the US (China's two main export markets). Lower export growth has, in turn, contributed to overcapacity in some industries (which can no longer absorb the capacity created by sustained high investments in export-oriented manufacturing industries). In 2011 monetary policy was tightened as a reaction to soaring food prices. However, the strength of the slowdown appears to have surprised the government that in mid-2012 shifted its main policy objective from "fighting inflation" to "steady growth" in order to reduce the risk of running short-term pro-cyclical policies. This policy stance remains in place, even if the rhetoric has turned decisively in favor of reforms.

**Is a hard landing now in the making?** A number of analyses and reports have suggested that China is at risk of a much sharper correction ahead[8]. From a short-term macroeconomic perspective, risks seem to primarily relate to (i) the still relatively high pace of credit growth which is mainly taking place outside the regular banking system; (ii) the related build-up of debt among local governments as well as in the corporate sector (in particular in sectors suffering

4 Real GDP growth has averaged some 10% per year, which in turn has been critical in lifting more than 500 mio. out of poverty.

5 World Bank and the Development Research Centre, 2011.

6 Naughton, 2007

7 Bertoldi and Melander, 2013

8 See, for example, Nomura Global Market Research, 5 May 2014.

from overcapacity) and (iii) the risk of a bust in the property sector. In particular the last has the potential of becoming systemic if the price correction is large / widespread enough, given the importance of construction investment (directly and indirectly) for economic growth, the importance of property development for the health of the (shadow) banking sector and, when land sales are included, for local government finances. It is clear that the real-estate sector is in for a correction, in part policy induced as the authorities have gradually tightened policies following a public outcry over soaring housing prices in 2010. Price decreases on newly constructed housing are becoming more common and inventories are building up, especially in smaller cities, while excess demand is concentrated to the four largest cities, where affordability concerns also come into play.[9] On current trends, the authorities have tools to counteract a downturn (for instance by relaxing some of the tightening measures introduced over the past years, extend infrastructure investment further and speed up social housing investment) and the short-term risks appear manageable. Concerns about economic activity and job creation may, however, make the government more cautious in implementing a bold programme of structural reforms.

**So far there has been a lot of "reforms talk", but the actions undertaken have been less impressive.** The new Chinese leadership under President Xi and Premier Li, which officially came to power in spring 2013, started to advocate broader and more far-reaching reforms in a whole range of areas, recognising the importance of addressing the many imbalances the current growth model has caused. The outcome of the "Third Party Plenum" meeting in Nov. 2013 surprised many China watchers positively. While the key role of State-Owned Enterprises was not called into question, the Plenum stated that the market is set to play a "decisive" (and not, as in the past, a "basic") role ahead, suggesting a better pricing and allocation of resources. A readiness to allow for orderly defaults aims at addressing moral hazard and reigning in the most reckless lending behavior. The devil is in the details and the guidance given by the Plenum will still have to be translated into concrete proposals by the Government. To achieve the sought-after result, the Party Plenum created a new "Leading Small Group on Comprehensively Deepening Reform" to facilitate coordination, to navigate vested interests and, not least, to ensure implementation of the reform process. The "leading group" is headed by President Xi Jinping himself in order to ensure that resolute and timely efforts are made to implement new policies. In March 2014 the National People's Congress also endorsed the government's aim for both growth and reforms. However, the long-awaited urbanisation plan presented this spring lacked precision on new concrete measures. Similarly, while the Shanghai free-trade zone is to act as a reform laboratory for a leaner, more business-friendly governance model in certain sectors, progress appears mixed so far.

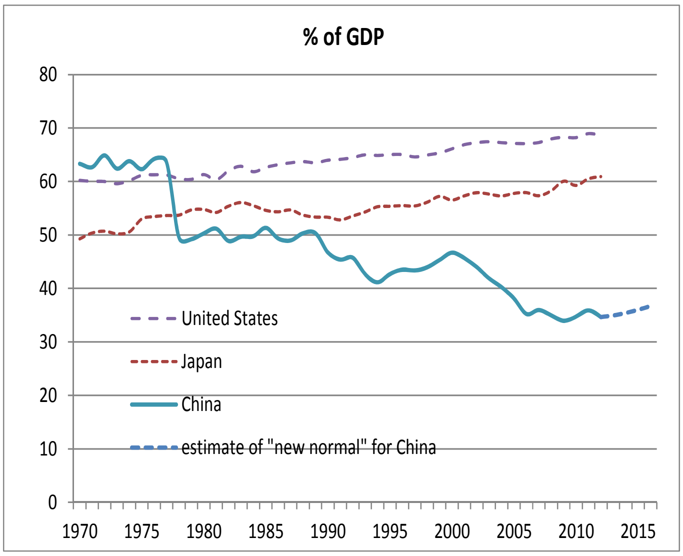
**By 2016, China should be well underway towards a new growth equilibrium (of around 6½%).**[10] At the same time, it is likely to also become a more "volatile economy", where periods of undershooting potential growth cannot be excluded. Managing this change and related risks will be critical. The leadership will need to communicate differently on its macroeconomic policy stance. Recognising that the scope and pace of (implementing) reforms will be decisive for China's medium-term economic outlook, an orderly transformation to a lower growth plateau at around 6½% is not a given outcome.[11]

9 In May 2014, new home prices fell in 35 out of China's 70 largest cities according to the National Bureau of Statistics. In weighted terms, this would imply the first monthly drop for at least two years.

10 How could trend growth of about 6½% look like in China? Given an increased competition from other emerging Asian economies (at least at the "low end") and a growing import content of domestic demand, little if any support can be expected from net exports. Domestic demand should become more dynamic as consumption is set to be favored by the new reform approach (e.g., better coverage of health, sickness and unemployment insurances which, over time, may reduce the need for sustained high precautionary savings). Given the demographic changes under way, the increase in disposable income will have to be driven by wage growth. Based on historic trends, consumption growth has provided a contribution to GDP growth of 3.2 pps. Assuming a less skewed distribution of resources towards investment and exports and a policy setting more conducive to the needs of the household sector, an annual growth contribution of some 4 pps. per annum could be within reach (and would still imply an exceptionally low consumption share). Investments are the most difficult component to predict. A shift towards more market-driven pricing of capital together with the already high investments-to-GDP and capital-labour ratios ought to reduce investments contribution to growth. Fostering a more broadly based urbanisation and a greening of growth will require sustained investments in some sectors and regions, however. As a "rough indicator", halving the contribution from investments of the past 15 years would reduce its contribution to about 2½ pps. Because of the reforms undertaken, would make for an overall GDP growth of some 6½% (the new growth plateau).

11 The possibility of multiple equilibria cannot be excluded in this transition phase. In the ECFIN Economic Brief no 18, China's medium-term outlook was articulated around three scenarios with GDP growth to either (temporarily) rebound to levels close to 9% per year if the earlier slowdown was primarily cyclical; to move rapidly below 7% in the "tip of the iceberg scenario" where structural weaknesses come to the fore; or to grow between 7-8% in the com-

Graph 3 : China's consumption share exceptionally low




*Source*: World Bank, China's National Bureau of Statistics, own calculations

## 5. Will the three economies succeed in their respective transition?

### 5.1 The United States

**While 2014 started with negative growth because of abnormally cold weather conditions and de-stocking, overall, in the coming two years, the US economy is widely expected at around or above 2½ - 3 percent.** Still, this baseline scenario may be derailed if one or the other of the following grains of sand get into the wheels:

**Specific information about the Fed's path for normalizing monetary policy will provide an important piece of guidance.** The FOMC has been very cautious in indicating the path for exiting the unprecedented measures in support of the economy during the crisis, and it has strengthened its forward guidance parallel to the tapering actions. The Committee is doing its utmost to make the financial environment as predictable as possible for investors. Nevertheless, 'normalizing' unconventional monetary policy is not without risks, not least in an environment where PCE inflation is projected to remain below the Fed's 2 percent target through 2016, due to still considerable slack in the labour market, whilst at the same time, the timing of the hike in the benchmark rates is widely expected to occur earlier (in the course of 2015). How different factors such as financial stability concerns, inflation and labour market indicators may influence the pace of tapering and future interest rate decisions is still a source of debate within the FOMC[12] and among economists.

**Whether or not the financial markets have returned to normalcy is still an open question, even if equities have been growing steadily (providing momentum, through wealth effects, to investment and consumption), bond markets have been stuck in the low-yield mode, and other financial market segments have had to adjust to a new regulatory environment.** However, equity markets could have run ahead of fundamentals and a downward adjustment (or several small downward corrections) could take place once QE is rolled back. An additional factor that could slow the transition to a new normal is related to the fact that financial regulators and supervisors have become more alert to excessive risk-taking, and the financial and banking environment appears to have come out of this crisis in a sounder shape, but also somewhat more constrained and less conducive with respect to the financing of economic activities. On the other hand, most analysts agree that more needs to be done, both in the US and globally, as certain market segments were left outside the scope of the reformed financial regulations[13]. The unregulated segments of the financial sector (shadow banking and non-bank financial sector) have attracted activities such as maturity transformation, and increasing flows to these sectors should be carefully monitored. Disruptions there could trigger a re-pricing of risks and have consequences on corporates. More needs to be done to reform the market for derivatives, the Credit Rating Agencies, mortgage rules on risk retention, pay / bonus packages. Short term funding is still an issue (with highly interconnected large money market mutual funds, commercial papers and securities markets), and capital, leverage and

ing years as the Chinese leadership enables a restructuring towards a more sustainable growth model.

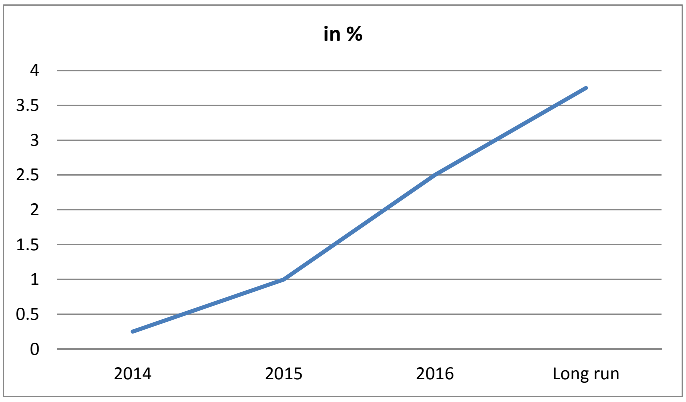
12 cf. Minutes of the recent FOMC meetings, and http://www.imf.org/external/pubs/ft/wp/2013/wp13245.pdf, IMF working paper on labor force participation and monetary policy, Erceg and Levin, December 2013.

13 Regulatory reform, stability and central banking, Paul Tucker, Brookings, January 2014.

liquidity ratios/rules need to be modernized in order to reflect the evolving nature of systemic risk[14].

**Risks related to the unwinding of the exceptional measures taken during the crisis, and to the new financial stability environment exist.** More fundamentally, as developments in the financial markets are essential to the financing of the real economy and to risk-taking by investors (where the legacy of the sharp global financial crisis has left some scars), it could mean that the financing of innovation by entrepreneurs will be harder to mobilize in future. If this risk materializes, it would durably affect the rate of accumulation of capital and growth potential of the US economy. As the first quarter 2014 GDP outcomes have shown, it may also take more for consumption to return to historical patterns. Taken together, it appears that the new equilibrium growth rate in the US may well be slightly lower than thought[15].

Graph 4: Target Fed Funds rate at year end as of June 2014




*Source:* Authors' interpretation of the latest FOMC's dot diagram

14 "How Can the SEC Address Systemic Risk?", Kara M. Stein, US Securities and Exchange Commission, speech at the Peterson Institute for International Economics, Washington, DC, June 12, 2014.

15 CBO has potential growth at 2.1% currently, the IMF at 2%, while US Treasury sees it at 2.3%.

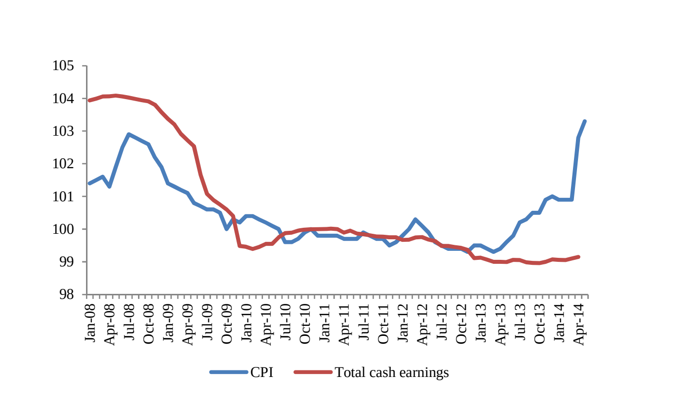
### 5.2. Japan

**In Japan, over the next three years risks will be on the downside, Abenomics will have to face a number of short and medium-term challenges that, if not addressed properly, may undermine some of the positive outcomes so far achieved.**

The recent reforms unveiled in June by Prime Minister Abe (reduction of the corporate tax rate reform of the Government Pension Investment Fund, reform the agricultural sector, measures to stimulate female participation in the labour market, easing of immigration requirements), while welcome, do not seem to live up to the expectations created by Abenomics and do not appear to be a game changer for Japan's growth prospects

**In the short-term, Japan will have to deal with the challenge of wage dynamics**. During 2013 consumption has risen, mostly driven by positive expectations about growth. However, at least until the autumn, wages and households' disposable income have stagnated. If this trend continues, in 2014, in presence of higher inflation and a significant increase in the consumption tax, it is unlikely that feel-good factors alone will be sufficient to keep consumption growth afloat. Therefore wages and disposable income need to grow faster than inflation, otherwise the recovery could suffer a serious setback. The wage increases agreed during shunto (trade union's "spring offensive") provide a mixed picture. Pay hikes were around 2.2% for the year (including seniority pay hikes). Still negotiations mainly concern major employers, accounting for about 20% of the workforce and for the time being it seems that only a fraction of the hike will concern the remaining 80% of the work force. Should growth weaken significantly in 2014 because of weakness in domestic demand, the new consumption tax increase planned for October of 2015 would be put at risk. Furthermore, in presence of a too weak wage increase, there is the risk that downward pressure on prices will return and, even without returning to deflation, the BoJ's target of 2% inflation could be largely missed, with negative repercussions on its credibility. If wages continue to stagnate, Japan would find itself on a low growth, low inflation path, with in addition the strong chance of missing its medium-term fiscal consolidation objectives. This explains why the Japanese government and PM Abe himself have taken the rather unusual step of making pressure on firms to raise wages, but so far the results have been meagre.

Graph 5 : Japan's CPI and total cash earnings (2010=100)




*Source*: Statistics Bureau : MHLW

**However, the most important challenges for Abenomics are related to the medium-term.** As already mentioned, the Japanese government has set the objective of achieving an average nominal growth of 3% and a real growth of 2%. Yet currently the growth potential is below 1%, the output gap is likely to disappear in 2016 and the working population has started shrinking. To counter the decline in the working population and its negative impact on growth, the Japanese government is strengthening services and childcare facilities and provide incentives to companies that promote the active participation of women. Still, these measures could prove insufficient to achieve the objective of increasing significantly their rate of participation (from 68% in 2012 to 73% in 2020). Even with an increase in women's labour participation, to achieve its growth objective Japan would still need a larger labour force, both skilled and low skilled/unskilled (not least to take care of the ageing population). In this respect, a general relaxation of immigration rules would help. As a result, demographic trends would not hinder growth excessively (and there would be also positive effects on cost containment in health and elderly's assistance expenditures). However, Abe's third arrow foresees a relaxation of immigration rules only for high-skilled workers, which is likely to produce only limited effects and will not be able to reverse significantly the current labor force trends. Therefore, although back to a positive nominal and real growth trend, it looks unlikely that the 3% nominal and 2% real growth targets are going to be reached in 2016 and beyond. Should this be the case, there could also be negative repercussions in the process of gradual fiscal consolidation (Bertoldi (2014)).

**The issue of bringing Japan government debt/GDP to sustainable levels has only partly been addressed, and Japan still lacks a credible medium-term fiscal consolidation strategy.** The increase of the consumption tax in 2014 and the additional hike expected for 2015 are steps in the right direction, but further increases look unavoidable. However, in order to support a balanced and growth friendly consolidation, additional resources have to be found among those who have mostly benefited from income redistribution in the last decade and are keeping at least some of the accumulated financial resources and wealth idle. The Japanese government also needs to act on the expenditure side. In this respect, the objectives presented in both the second and third arrow remain still too vague. An effort is made to contain the growth of healthcare costs (although, as already mentioned, more could be achieved through a different immigration policy), but on other areas (e.g. pensions) in the reform blueprint there is very little. Overall, while Abenomics is on the right track to bring Japan on a debt/GDP declining path thanks to the change in macroeconomic conditions and the increase in the consumption tax, there is still a lot of ground to cover before achieving such a result on a permanent basis. In particular a credible and coherent fiscal consolidation strategy is badly needed if the country wants to avoid that sooner or later changing conditions on the Japanese government debt market become a major brake to Japan's economic growth (IMF (2014b)).

**There is the risk that Abenomics' successes will not last,** in particular if the third arrow is not strengthened further (Posen (2014a)) and a credible fiscal consolidation plan is put in place. Therefore, if downside risks materialize, the nominal and real growth path of Japan could be significantly lower and more unstable than that in the central scenario described in the previous section. Should this happen, it could become difficult to maintain confidence in the Japanese government bonds, which in turn could create distress in global financial markets.

### 5.3. China

**How plausible is a transition to a lower and more sustainable growth level of some 6½% by 2016 in China?** Judging from China's past track record, the government has been very effective in generating economic growth and job creation, thereby enabling the most marked poverty reduction since the Second World War. On the other hand, it has been less successful in internalising environmental costs and addressing differences between the urban and rural population or between the coastal and inland regions.

**Will the transition ensure or endanger "stability" and how advanced will reforms be by 2016?** The new leadership's reform plan, as outlined in the 3rd Party Plenum "Decision", would go a long way towards securing a better allocation of resources, a more even distribution of growth across the country and with greater care on its environmental impact by 2020. Questions can be raised, though, on how far China can be expected to have advanced in only two years, given the size of the transition challenge and the preference of successive Chinese leaderships for "gradualism" and "experimentalism". The new government's tough stance on corruption and the creation of a "reform group" to coordinate and oversee the implementation of reforms bodes well for its willingness to press ahead with reforms and to take on some potentially strong vested interest groups. The expected impact of reforms on "stability" might ultimately be decisive for how quickly and broadly the government can be expected to act. In an "orderly" transition, (most of) the surplus labour (e.g. from sectors with overcapacity to other sectors) can be absorbed relatively fast. Still, a sizeable impact on employment, whether by a stronger-than-expected increase in unemployment or difficulties in improving mobility across sectors or regions, may reduce the enthusiasm for reform. Similarly, a bold reform approach may be hampered by short-term risks that China faces (whether from shadow banking, the need for deleveraging or (local) house-price bubbles). Managing a transition to lower growth might also bring policy trade-offs to the fore. The central scenario is based on the assumption that the Party has embraced the idea of reforms as an essential criterion to ensure "stability" ahead, which in turn is critical for its own legitimacy. Generating "sufficiently high economic growth and enough new jobs" will have been replaced by ensuring a policy / governance system that is targeting "improving people's situation" in a broader sense, addressing also inequality and environmental sustainability.

**Different risks suggest that growth can both turn out stronger and weaker ahead.** While China's transition cannot be considered in isolation (and a conducive external environment can facilitate reforms), where China is heading to in the next couple of years largely depends on the scope, pace and sequencing of its domestic reforms: (i) a slower pace, a more narrow scope or a reform agenda overtaken by the need to address short-term risk factors may all allow growth to accelerate at first, but would fuel (financial) imbalances and risks of a disorderly correction kicking in by 2016 (of esp. investments and with GDP growth falling well below 6%)[16], thereby putting a brake on global growth and carrying systemic risks for the stability of the Chinese society; while (ii) a faster pace or more broad-based scope of reforms could allow GDP growth to move towards the new equilibrium faster and become more consumption driven, inclusive and environmentally friendly.

**Against this background, for China the question of the transition to a new normal is not whether it will take** place (in principle it will), but rather of how and when (and if the new normal will be stable). The outlook for China is surrounded by a significant degree of uncertainty reflecting the many challenges China is facing at the current juncture. Although, China is (or should be) heading for lower and less resource-intense growth, it remains to be seen whether it will be able to avoid the middle-income trap. The coming two-three years will be critical for China to transition to a different growth path. The 13th five-year plan expected in 2016 should stabilize the economy on the new path, which would become the "new normal" for China, at the condition however that the reform process has gone far enough by then.

## 6. Conclusions

**This brief argues that it is likely that by 2016 the three major global economies outside the EU will have transitioned (or will be in the process of transitioning) to a "new normal", i.e. to growth regimes more stable and sustainable.** However, the 2014-2016 period will be critical to ensure that this happen in a relatively smooth and non-disruptive way. All three economies are still facing major

16 For example, Peking-University Professor M. Pettis argues that a rebalancing of the Chinese economy may well happen, but in a "quick, catastrophic way". His baseline scenario foresees a sudden correction when imbalances become unsustainable. In such a case they would be set to reverse their course and would follow a dramatically different path, pointing to a growth rate of closer to 3% per year going forward. In such a case, China would become another emerging-market economy stuck in the “middle-income trap”

macro-economic and structural challenges. Downside risks are higher for Japan and China than for the US.

**For the US, the biggest challenge appears to be on the monetary side, namely the gradual normalization of monetary policy and the management of certain financial segments that is still pending.** The US also has to deal with other problems, *in primis* the absence of a credible medium-term fiscal consolidation strategy, which will need to be tackled in the coming years in order to ensure the stability and sustainability of the "new normal" further out. Other US problems are more fundamentally linked to future sources of growth as the economy reaches a speed limit.

**For Japan, the "new normal" means first and foremost a growth regime without deflation and with more robust economic activity.** Still, it would be difficult to argue that Japan can hope to be by 2016 on a sustainable and balanced growth path. The daunting challenges of the consolidation of the huge public debt and the increase of potential growth have only started to be addressed and much bolder and ambitious structural and fiscal reforms are needed down the road.

**With regard to China, the economy will still be transitioning towards a different growth model, more consumption-driven and environment-friendly.** The 13th five-year plan that will be released in March 2016 should give the opportunity to define the policies to set the economy on this growth path, provided that sufficient reforms in the right sequence have been introduced and implemented in the years before. The transition presents major risks, especially on the financial side (shadow banking, local government finances and/or a burst of some of the multiple real-estate bubbles). China's "new normal will still be a transition process, which however will have the advantage of being more resilient, less imbalanced and less damaging to the environment.

**The "new normal" in the US, Japan and China will have important implications for the EU and the Euro area (EA).** By 2016 the EU and the EA should also be on their way to a "new normal", although with a lag due to the sovereign debt crisis (therefore monetary normalization in the EA will start later than in the US). Since the recovery in the EU and the EA is expected to proceed only at a moderate pace, a favorable external environment from the three economies considered (which are among the EU major economic partners) is of paramount importance to facilitate the ongoing adjustment processes and the emergence of the "new normal" in Europe, which inevitably will take longer. Higher and more sustainable growth in the US and Japan, as well as more stable, sustainable and balanced growth in China can have significant positive spillovers on the European economy. Taken together and assuming that the developments of the world's three largest economies are not atypical, global growth excluding the EU could be expected to be around 4.5% by 2016 (up from 4.1% in 2015).[17]

**On the other hand, if these economies are not able (or are only partially able) to address the transition challenges mentioned in this brief, the EU and the EA would also be affected, albeit indirectly, possibly slowing the transition to its "new normal".** The downside risks, which could materialize in the coming 18 months, are threefold: (i) should Japanese and Chinese growth disappoint (and with them inevitably the economic performance of East Asia), the weaker activity would be transmitted to the European economy primarily through the trade channel; (ii) should monetary policy normalization in the United States cause surprises, such shocks would likely create financial and exchange rate volatility also in Europe, making the recovery more uneven; and (iii) whilst their impact is more difficult to assess, negative surprises from the US, China and Japan could also dampen EU business and consumer confidence, which would not be a welcome development, since the recovery is still fragile.

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17 The estimate for global growth excl. the EU for 2016 is based on the IMFs medium-term projections from Apr. 2014, where the forecasts for the US, Japan and China have been replaced by our assumed "new normal" of about 2¾% for the US, 1% for Japan and 6½% for China and is compared to the EU Commission's spring forecast as regards 2015.

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