

SLOWDOWN IN THE PEOPLE'S REPUBLIC OF CHINA

*Structural Factors and the Implications
for Asia*

SLOWDOWN IN THE PEOPLE'S REPUBLIC OF CHINA

*Structural Factors and the Implications
for Asia*

Edited by

Justin Yi-fu Lin
Peking University

Peter J. Morgan
Asian Development Bank Institute

Guanghua Wan
Institute of World Economy, Fudan University

Will the People's Republic of China Be Able to Avoid the Japan Syndrome?

Yang Yao

© 2018 Asian Development Bank Institute

The Japan Syndrome

- The Japan Syndrome is characterized by **three symptoms**:
 - (i) the **growth rate** of gross domestic product (**GDP**) experiences **cliff drops** after a prolonged period of high growth;
 - (ii) the economy enters a period of **secular deflation** after the economy stops growing;
 - (iii) a long period of **bullish markets** leads to asset bubbles that finally burst and are followed by a long period of **declining asset prices**.
- This section will first provide evidence of those symptoms and explanations by relating them to **two major factors**:
 - (i) substantial **adjustment** to **the world market**;
 - (ii) a **fast-aging population**.

The Japan Syndrome

- The **US economy** was in a period of **painful adjustment**; **Europe** was trying desperately to deal with the problems caused by the **welfare state**; and **Latin America** was in deep trouble caused by **the sovereign debt crisis**.
- The only group of countries/region that could beat Japan's growth were the **East Asian Tigers** and several other newly industrializing Asian countries.
- Japan became a world leader of innovation during this period when “Japan No. 1” was a catchphrase.
- Indeed, because of the continuous **appreciation of the yen against the dollar** and inflation in Japan, the Japanese economy grew by an annual average **12.9% between 1974 and 1993** when measured in dollar terms.
- As a result, Japan **gained** tremendous **purchasing power** in the world market during this period.

The Japan Syndrome

- The **first cliff drop** of Japan's growth rate occurred immediately after **the oil crisis**. The world market was severely hit by the crisis and **demand for Japanese products declined**.
- The **second cliff drop** occurred in 1993 when Japan's **real estate bubble burst** and domestic prices stopped rising.
- In the **21 years from 1994–2014**, Japan's economy only managed to grow by a total of 18%, or an **average 0.8% each year**, when measured in yen.

The Japan Syndrome

- The **first cliff drop** of Japan's growth rate was clearly **related to the oil crisis** that forced the world market to undergo a major adjustment.
- **Japan's export-led growth could have lasted a bit longer** had there not been the Crisis.
- But even in that case Japan's growth would have ultimately been brought down by its **loss of competitiveness** and **rising wages**.
- What **the Crisis** did was to **accelerate the transition** in a more dramatic manner.

The Japan Syndrome

- Many analysts **blame Japan's central bank** for creating and **blowing up the asset bubbles**.
- Japan's central bank may have **mismanaged** the **interest rate policy**—initially it set low interest rates attempting to **off set** the contracting effects of the **yen's appreciation**, and subsequently **when asset bubbles were forming** it **raised the interest rate too fast**.
- But the formation of the bubbles was unlikely to be avoided, as without them it would have been difficult for the country to digest the sudden and big increase of purchasing power.
- But **bubbles burst eventually** and the **sudden interest rate hike** probably just made this happen more quickly.

The Japan Syndrome

- The **second cliff drop** of Japan's growth rate occurred **after its asset bubbles burst**.
- Between the two cliff drops, Japan still **benefited from the forces of convergence**.
- But the bursting of the **asset bubbles triggered the end of convergence**.
- After that, according to the neoclassical growth model, **Japan should have embarked on a steady growth path**, with a per capita **GDP rate** of growth equal to **its rate of technological progress**.
- Should Japan have had similar economic institutions and a **demographic structure** comparable to **that of the US**, Japan's economy **could have grown at a similar rate**.
- But this was clearly not the case and the gap in per capita income between the two countries has risen since 1993.

The Japan Syndrome

- Japan's economic institutions are clearly less geared toward gaining high economic efficiency than those of the US.
- In particular, the **Japanese labor market** was much **less flexible than the US labor market**.
- Job remuneration is much more egalitarian in Japan than in the US, although labor market flexibility has increased markedly in recent years due to the increased share of part-time employment and dispatched workers.
- The Japanese economy is also much **more regulated than the US economy** and Japan does not have the kind of **super-efficient financial market the US has**.
- Those are the impediments that **prevent Japan from becoming as innovative** as the US.

The Japan Syndrome

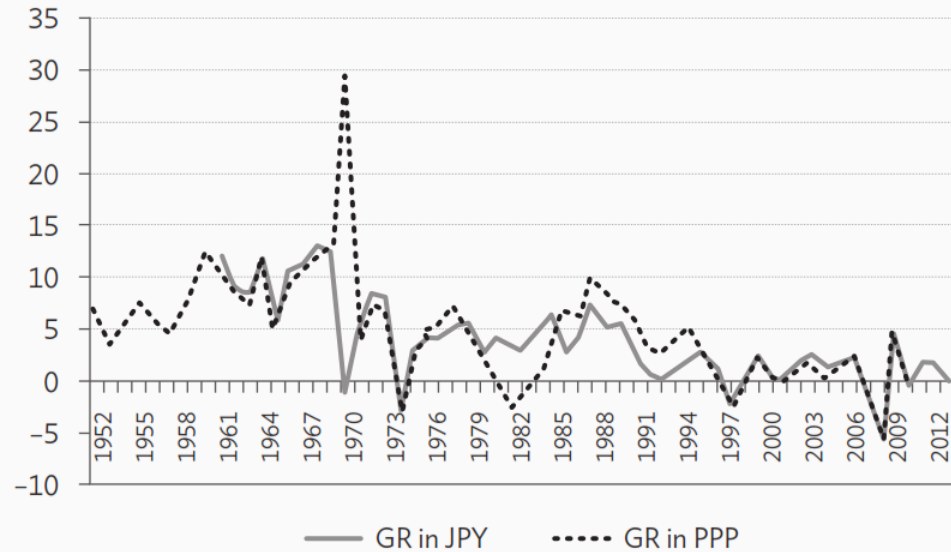
- What really **distinguishes Japan** from **the US** is its **demography**.
- While the **US population is growing at a healthy rate**, the Japanese population is **shrinking and aging quickly**.
- This contrast shows that **Japan's growth potential** has been constrained by the **declining size of its labor force**.
- On the demand side, aging probably is also a drag on the Japanese economy because it **limits the growth of domestic demand**.
- Figure 3.6 presents Japan's **working-age ratio** against its **domestic price level** and **real exchange rate**.
- Since 1980, Japan's **domestic price level** and **real exchange rate** have **moved closely** in line with its **working-age ratio**.

The Japan Syndrome

- The **current old generation** holds **most of the wealth created** in the **1970s and 1980s**.
- They are now **slowly selling off the assets** they **accumulated** when they were young.
- Comparatively speaking, this generation of old people in Japan is **wealthier than its counterparts in other industrial countries**, but its **consumption is limited**.

The Japan Syndrome

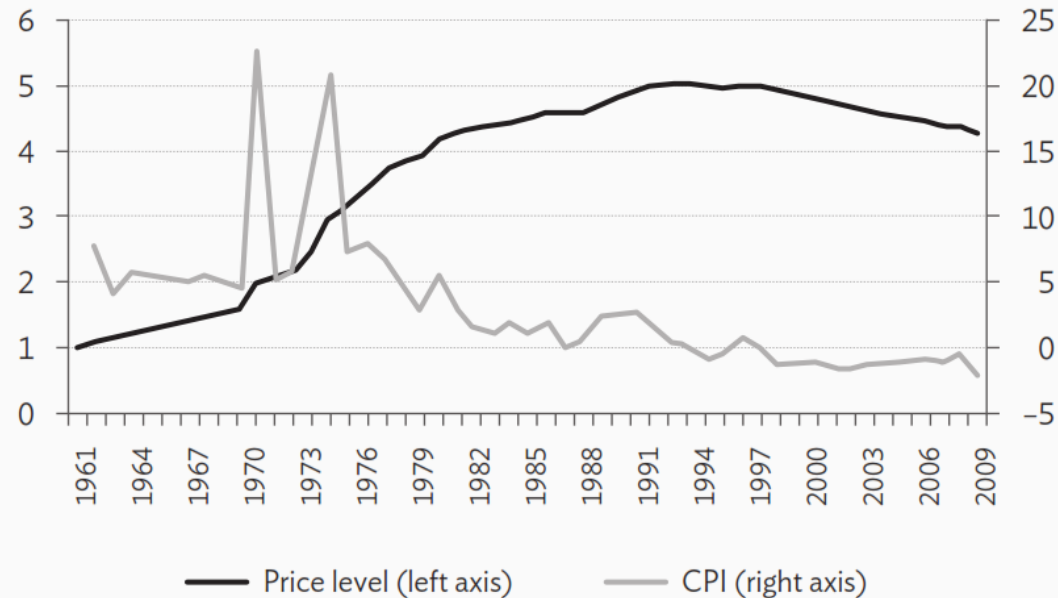
Figure 3.1: Japan's Gross Domestic Product Growth Rates in Yen and Purchasing Power Parity (%)



GR = growth rate, PPP = purchasing power parity.

Sources: Figures measured in PPP are from Penn World Table 8.0; figures measured in Japanese yen and US dollar are from World Development Index.

Figure 3.2: Japan's Path from Inflation to Deflation

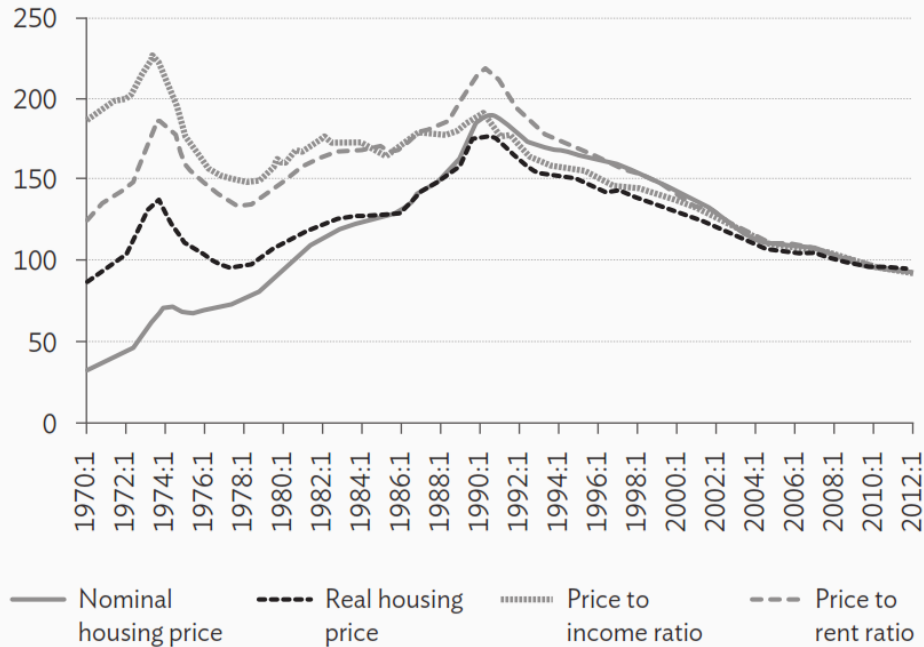


CPI = consumer price index.

Source: World Development Index.

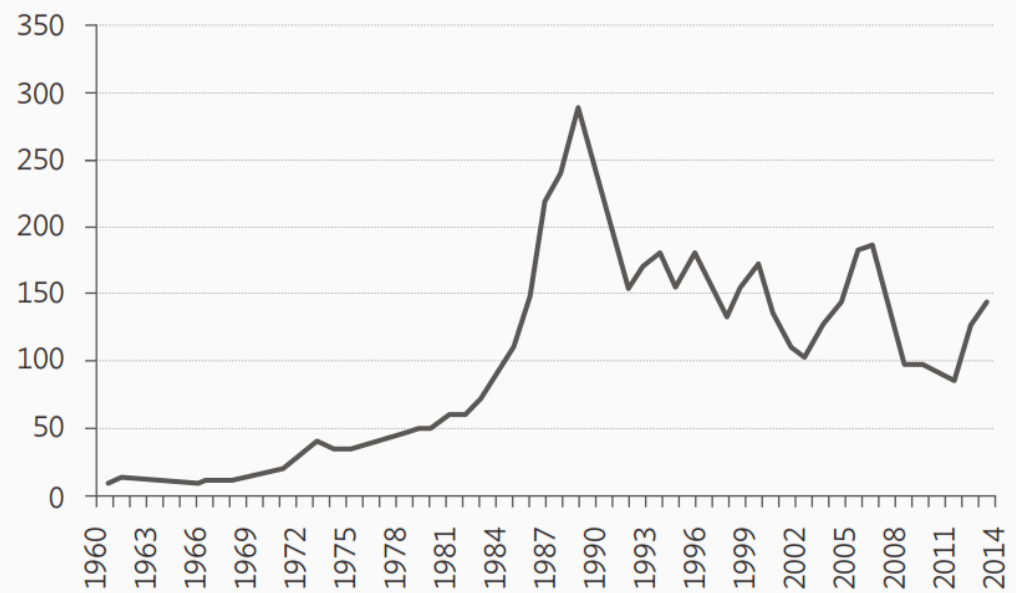
The Japan Syndrome

Figure 3.3: Prices of Japan's Housing Market (2010 = 100)



Source: OECD Statistics.

Figure 3.4: Japan's Stock Price Index (2010 = 100)



Source: OECD Statistics.

The Japan Syndrome

Figure 3.5: Current Account Balance and Exchange Rate in Japan

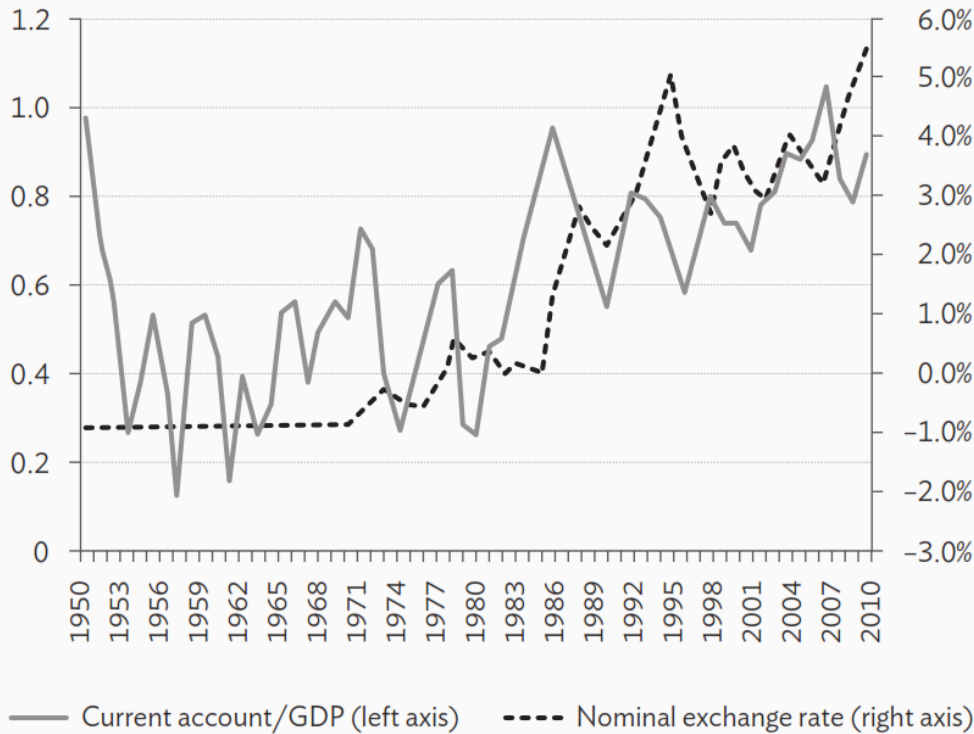
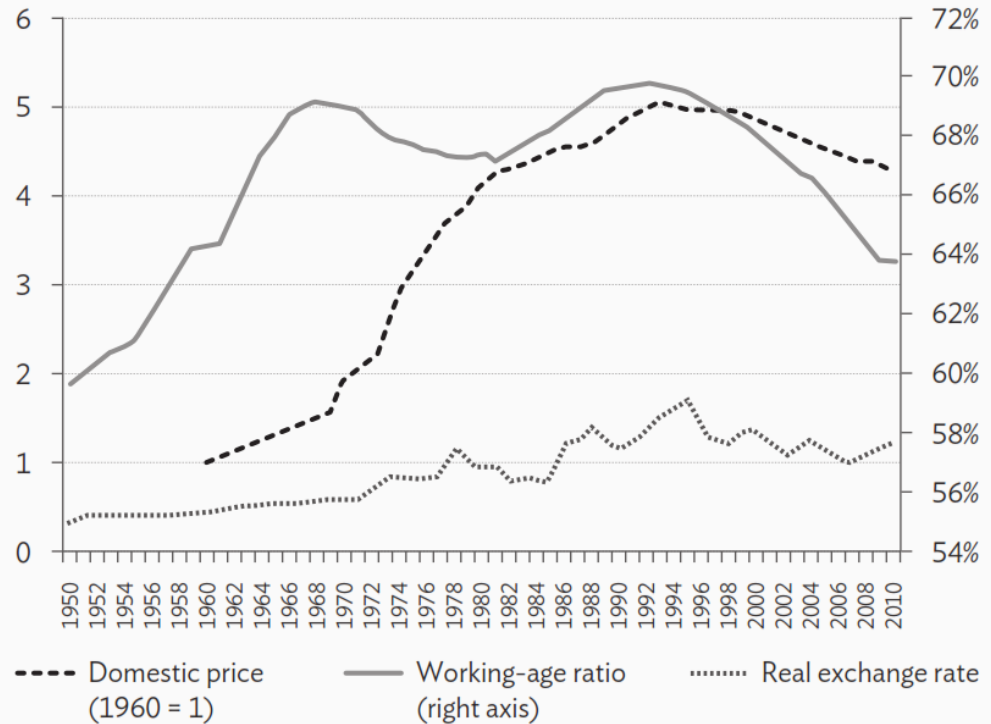


Figure 3.6: Impacts of Aging on Domestic Prices and the Real Exchange Rate in Japan



Note: The exchange rate is dollars for 100 yen.

A Comparison between the PRC and Japan

- The PRC began to adopt the **export-led growth model** in the **early 1980s**.
- But it was only after 2001, when it **joined the World Trade Organization (WTO)**, that the PRC began to enjoy **large benefits** from **this model**.
- Exports grew at a respectable rate before 2001 (averaging 17% per year in the 1990s), but this was dwarfed by the growth between 2001 and 2008 when the PRC's **exports grew five-fold** and began to enjoy **persistent and large trade surpluses**.
- Persistent trade surpluses inevitably result in an **appreciation of the yuan**.

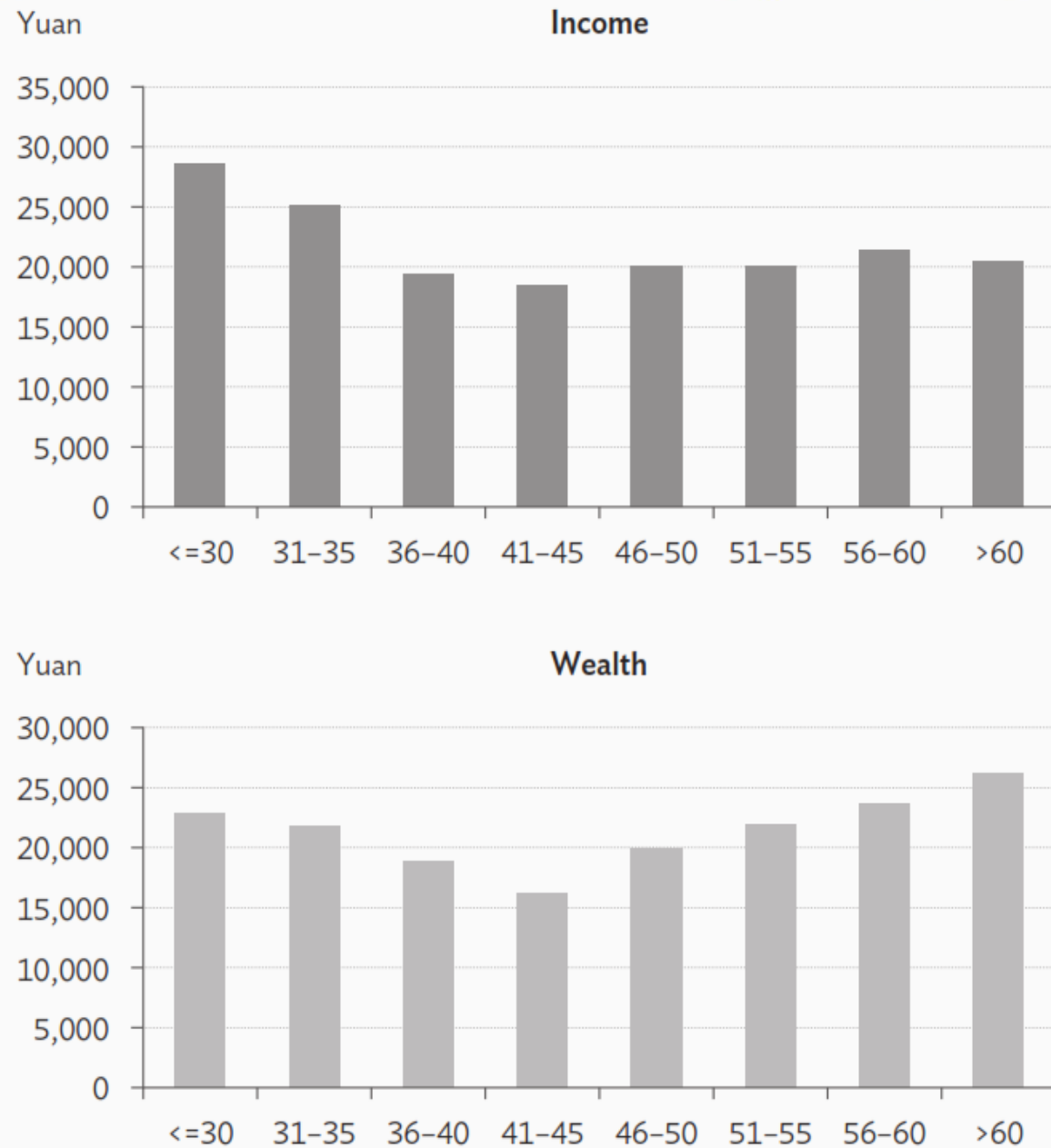
A Comparison between the PRC and Japan

- The **PRC resembles Japan** in **several respects**.
- First, the PRC has followed Japan's **export-led growth** model to develop its economy and has **accumulated** a large amount of **wealth through this model**.
- Second, as in Japan, the **wealth created by the export-led growth** model is **held mostly by the generation** that is the **largest among the age cohorts**.
- Third, the PRC's **domestic consumer** and **asset prices** have **followed Japan's path** before 1993 and so have the PRC's **nominal and real exchange rates**.
- So there are **good reasons to worry** that the PRC would also be affected by the Japan Syndrome.

A Comparison between the PRC and Japan

- The **PRC's case may even be worse** than that of Japan because the PRC faces more serious challenges in its **demographic transition**.
- The PRC has **begun its path of aging** at a **much lower income level than Japan**.
- The **age cohort** that **owns large parts of the wealth** created by the export-led growth model accounts for a **larger share of the population** in the **PRC than in Japan**.

Figure 3.10: Distributions of Income and Wealth by Age Cohorts (2012)



Source: CFPS (2012).

Table 3.1: Shares of Population, Income, and Wealth by Age Cohort

	Population	Income	Wealth
<=30	42.66	50.87	44.39
31-35	7.46	7.81	7.35
36-40	9.32	7.54	8.04
41-45	9.10	6.98	6.70
46-50	7.18	5.99	6.49
51-55	6.17	5.16	6.13
56-60	5.80	5.19	6.26
>60	12.30	10.46	14.64

Sources: CFPS (2012), Census 2010.

A Comparison between the PRC and Japan

- It was a surprising finding that the **age profiles** of both **income** and **wealth** are **U-shaped**.
- In the case of per capita income, **the youngest** households whose heads were 30 years old or younger (born in or after 1982) were **the richest**, and the age cohort of **41–45 years old** (born between 1967 and 1971) were **the poorest**.
- The cohort of **41–45 years old** also had the **smallest stock of wealth**.
- The **oldest cohort** (born before 1952) had the **highest stock of wealth**.
- **Young people** accumulated wealth from their higher levels of **income**, and **older people** did it by **saving more** of their income and **saving longer**.

A Comparison between the PRC and Japan

- Judged by the facts presented above, **the PRC's future problems** will probably be **different from those Japan** faces at present.
- In Japan, the **decline of housing prices** probably has been caused to a greater extent by **excessive supply released** by the aging population.
- In the PRC, it would be caused to a greater extent by **lack of demand if housing prices were to drop**, because **young people** will **already have accumulated** a substantial stock of wealth.

A Comparison between the PRC and Japan

- **Demand for consumer goods will also fall** in the PRC because of aging, and its decline is likely to be **more severe than in Japan**, for two reasons.
 - First, the PRC is **aging faster than Japan** did between 1974 and 1993.
 - Second, the PRC's future old generation, the **baby boomers** who are now **between 40 and 55 years old**, own disproportionately **smaller stocks of wealth**. This will **constrain their consumption**.
- Therefore, the **PRC's aging problem** is likely to place a **more severe constraint** on economic growth than Japan's.

A Comparison between the PRC and Japan

- In summary, because the **PRC has followed Japan's export-led growth model** and faces **more severe aging problems** than Japan, it is reasonable to conclude that the **PRC will not be able to avoid the Japan Syndrome**.
- There is a **high probability** that the PRC's growth in the medium term **will be similar to Japan's growth pattern** between 1973 and 1993 until the country reaches its steady state.
- The PRC's **real estate prices** are already **very high** and the **stock market** has experienced **several rounds of boom and bust** in the last 15 years.
- The **PRC's PPI** has been **below zero** since early 2012 and its **CPI** has also been **close to zero**.
- However, it remains a question **whether the PRC's growth rates will drop to the levels seen in Japan** between 1973 and 1993.

Policy Recommendations

- To avoid the secular deflation that Japan has experienced since 1993, the PRC has to find ways to stimulate domestic demand.
- In this regard, **several measures** will help.
- First, **accelerating the pace of urbanization** will greatly increase domestic consumption. The PRC's pace of **urbanization** has clearly **lagged** its pace of **industrialization**.
- Second, **postponing retirement ages** will **not only increase the supply** of labor, but **also increase consumption**.
- Third, there is still much room for the PRC to **improve its infrastructure**, particularly in **inland provinces**. In fact, the PRC government needs to encourage **more investment to fight recession**.

Policy Recommendations

- Fourth, **reforms to lift to service sector entry barriers** will also **boost domestic consumption**. Job certificates, licensing, and **administrative approvals hinder** the development of a more **vibrant service sector**.
- In summary, to realize its growth potential, the PRC must take **bold measures** to **offset the strong headwind** of **demographic change**.