

OPINION

China can avoid 'Japanification' with prompt action

Focus should be on fallout from bursting of asset bubbles and falling population



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A Country Garden construction site in Tianjin on Aug.18: The impact of a bursting bubble will be significantly affected by how quickly policy authorities react. © Reuters

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In recent months, many economists have talked about the possible "Japanification" of China's economy.

Chinese economic activity has been weak this year after getting a temporary lift when the authorities ended their strict COVID containment measures last December.

China is now an important outlier in a world struggling with elevated inflation. In China, the consumer price index dropped 0.3% in July from a year before while the producer price index declined 4.4%. At the same time, the country's real estate market has been softening while debt levels remain quite high. Importantly, the nation's population began to fall last year.

Outwardly, conditions in China resemble those of Japan in its post-bubble period. This observation is generating renewed interest in the lingering question of whether China's economy will suffer the same fate as Japan's.

To assess this question of the possible "Japanification" of the Chinese economy, it is important to understand three key factors in Japan's growth slowdown.

First, the bursting of Japan's asset bubble in the late 1980s hit its economy hard. The scale of the blow was unprecedented in modern economic history.

The decline in the combined value of Japanese property and stocks amounted to about 230% of the country's nominal gross domestic production. By comparison, the corresponding decline in the value of U.S. assets after the global financial crisis was 100% of nominal GDP.

Second, demographic change has had a huge impact on Japan. The country's working-age population has fallen 15% since its peak in the mid-1990s.

The impact on GDP growth has been quite straightforward. Consider that average Japanese GDP growth per working-age resident is the highest among Group of Seven countries while Japan's overall GDP growth is among the lowest. This reflects how the growth rate of the working-age population is a determinant in the overall rate of economic growth, even if productivity growth is not bad.

Third, the social contract underlying Japan's economy and society, which places great emphasis on stability, has not meshed well with the progress of globalization driven by the integration of socialist economies into global markets since the early 1990s.

The custom of lifetime employment, which is still prevalent in Japan, has tended to delay the necessary reallocation of workers from declining companies and industries to rising ones. This has constrained Japanese companies' ability to fully reap the benefits of globalization and technology advancement.



Morning rush hour in Beijing in 2021: As a country's working-age population declines, demand for housing decreases, affecting property prices. © Reuters

Looking at the prospects of the Chinese economy in light of the causes of Japan's growth slowdown, one can observe both differences and similarities between the two situations.

As to the impact of the bursting of China's bubble, we do not really know how large the bubble is or how far it has burst. Its contraction will be significantly affected by how quickly policy authorities react and undertake needed measures such as the recapitalization of troubled banks.

These measures can be unpopular and hard to implement in any country. Forging a reasonable consensus can be quite a daunting task, particularly in democratic countries. In this respect, China's one-party state appears to be in an advantageous position compared with Japan, but public sentiment may still have an impact.

At the same time, China is in a disadvantageous position because of its sheer size. The presence of China today in the global economy and trade is larger than Japan's was in the late 1990s when it went into full-blown financial crisis.

In terms of GDP, China today is slightly more important than Japan was then. China represented 18% of the global economy last year. That compares with Japan's 14% in 1997. In terms of global trade, the figures were 20% for China and 7% for Japan at its peak.

When its bubble burst, Japan did not have to face a serious feedback loop with the global economy. Indeed, the global economic boom prior to the global financial crisis enabled Japan to eventually succeed in eliminating the excesses stemming from its domestic bubble.

In contrast, China could be faced with serious feedback problems from the global economy because of its sheer size if its own economy stalls. On top of that, today's global economic conditions are more challenging than those Japan faced.

As for the population issue, it is widely understood that China is following Japan with a lag of 15 to 20 years in terms of demographic change. We should also not forget the linkage between demographic change and asset bubbles.

The peak of the Japanese bubble coincided with the end of the country's demographic dividend. As a country's working-age population declines, as China's is now, demand for housing decreases. That in turn affects residential property prices and creates a burden on the economy.

In China's case, it can learn from Japan's experience and take preemptive measures. The Chinese authorities have intensively studied Japan's experience with demographic change as well as its asset bubble and its collapse.

While concern about Chinese deflation has risen in recent months, most observers miss an important point. The real worry is whether China will experience acute deflation like that which the U.S. experienced in the 1930s, not the kind of mild deflation that Japan experienced. This will not happen unless China's financial system collapses so the key issue is whether Beijing can contain the damage from the bursting of its bubble.

In regards to a mild deflation scenario, an interesting issue from the longer-run perspective is what effect a declining population will have.

Expectations about an economy's future population determine current demand, especially investment. But current demographics determine an economy's current supply capacity. Any resultant demand shortage will exert downward pressures on prices. But again, mild deflation should not be seen as an additional fear factor; it is just a symptom of underlying demographic challenge.

At this point, it is unclear whether the fate of China's economy will echo that of Japan's. Ultimately, it will be a matter of how China copes with the bursting of its bubble and with demographic change and even more importantly, the will and capacity of its government and society to act promptly.