Japan Research Institute

JRI Research Journal

https://www.jri.co.jp/en

Vol.6 No.8

September 11, 2023

The "Japanization" of Chinese Economy and Fears of Prolonged Stagnation

— Repeated Postponements of Structural Reforms Raise the Possibility of the Country Experiencing a "Three Lost Decades" —

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<Summary>

- In China, the economic recovery that followed the abandonment of the zero-COVID policy ground to a sudden halt, and uncertainty about the future is increasing. Furthermore, economic phenomena very similar to those seen in Japan after the bursting of its bubble economy are beginning to be seen in China. They include deflation, an "employment ice age," and a real estate slump, and there is growing concern that the economy will fall into a prolonged stagnation much like the "Three Lost Decades" that Japan experienced.

- Of course, the Chinese government has been studying the history of the Japanese economy. It has tightened its control over the property market and so far managed to prevent a real estate bubble burst. As a result, there has not been a sharp deterioration in consumption and investment stemming from balance sheet adjustment. Furthermore, the Chinese government has embarked on structural reform, having acknowledged that economic growth to date has been overly reliant on investment. However, the steps taken have not been sufficient, and the transition from an investment-driven economy to a consumption-driven economy is not going smoothly. Structural reform has been repeatedly postponed, and this has contributed to a decline in the economy's ability to grow. As happened in Japan, a sense of stagnation caused by the lack of progress with reform seems to be sapping the vitality of the Chinese economy.

- The prescription for China's economy to avoid prolonged stagnation is to not delay structural reform and to make steady progress with efforts to correct its investment-oriented economic structure. To that end, even if the economy worsens, the long-standing structure should not

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be preserved by easing real estate regulations and expanding infrastructure investment as a quick-fix economic stimulus measure. So far, the Chinese government has remained cautious, refraining from implementing large-scale economic measures. Measures to support the real estate sector through deregulation and other measures have been small-scale, with priority placed on shoring up balance sheets through real estate market adjustment.

◆ However, pressure for a correction in the property market has been rapidly intensifying recently, and the risk of a chain of corporate failures culminating in a real estate crisis can no longer be ignored. The high-tech industry, which was supposed to replace the real estate sector as the driver of future economic growth, is also struggling to grow amid tighter control by the Chinese government and stricter regulation by the U.S. government. If the twin dangers of a real estate crisis and sluggish growth in the high-tech industry result in a serious economic downturn, the Chinese government is likely to switch its policy focus to short-term economic support, backsliding into real estate deregulation and infrastructure investment expansion. While such measures will help avoid a sharp economic downturn, they will also entail the postponement of structural reform and increase the likelihood of prolonged economic stagnation.

- **This is a English version of "中国経済の「日本化」と長期停滞の懸念 — 繰り返される構造改革先送り、「失われた 30 年」に陥る可能性 — " in JRI Viewpoint (The original version is available at https://www.jri.co.jp /MediaLibrary/file/report/viewpoint/pdf/14411.pdf)**

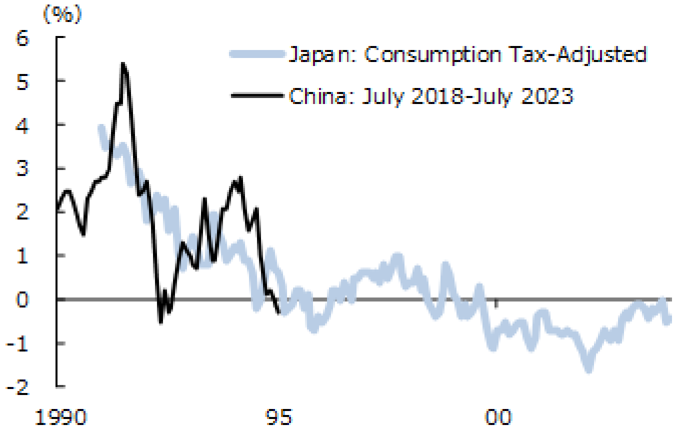
1. Introduction

In China, concerns about an economic slowdown are growing rapidly. GDP growth slowed to +0.8% quarter on quarter (QoQ) in April-June (compared to +2.2% QoQ in January-March) as the economic recovery that followed the scrapping of the zero-COVID policy ground to a sudden halt. Although a reason was the rebound in consumption after the economy reopened petering out sooner than anticipated, the current phase has also seen rising expectations of deflation, worsening unemployment, and deteriorating conditions in the real estate market. These problems closely resemble those experienced by the Japanese economy in the 1990s, and it would appear that not only cyclical factors but also structural problems have contributed to the weakness of the Chinese economy. The Chinese government must have learned a great deal from the Japanese experience, and realized that it needed to address the risk of long-term stagnation, but it has so far been unable to come up with effective policies. This paper examines the causes of the increasing "Japanization" of the Chinese economy and whether the Chinese government can find a prescription for it to alleviate the risk of China also experiencing a "lost 30 years."

2. Similarities between China today and Japan after the bursting of the bubble

As will be discussed below, China's economy is currently experiencing 1) falling prices, 2) an "employment ice age," and 3) a real estate slump, putting it in a very similar situation to the one that Japan once found itself in.

Figure 1. Consumer Price Index in Japan and China (Year on Year Change)



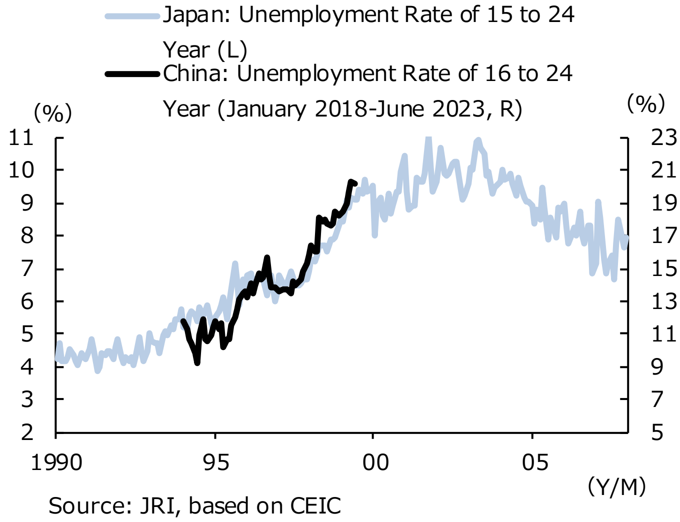
Source: JRI, based on CEIC

The first similarity with post-bubble Japan is the growing deflationary trend. Despite high inflation worldwide, with prices of all sorts of goods and services rising, China is an outlier, with deflationary pressures mounting rapidly. China's CPI for July was down 0.3% compared with a year earlier, dropping into negative territory for the first time in two years and five months (Figure 1). The current decline in prices is due to lower energy prices as well as sluggish demand, and the index is expected to either continue falling or only increasing at a low rate. As expectations of lower prices grow, there is a danger that households will opt to defer consumption. And as Japan's experience demonstrates, intolerance of price hikes among consumers will put pressure on corporate earnings. This could translate into downward pressure on the economy by making firms less inclined to develop high-value-added goods and services and more inclined to cut costs.

The second similarity is employment instability. In June, the youth (16-24 years old) unemployment rate reached 21.4%[1] (Figure 2). In Japan, the youth unemployment rate climbed rapidly in the late 1990s, leading to a phase known as the "employment ice age," during which companies experiencing deteriorating business performance pared back their hiring of new graduates. And in China now, firms are also limiting their recruitment of young people. This will reduce the propensity to consume among the younger generation by making them more uneasy about their futures, and companies that have scaled back their hiring will find themselves short of the human resources they will need in the future, which will make them less competitive.

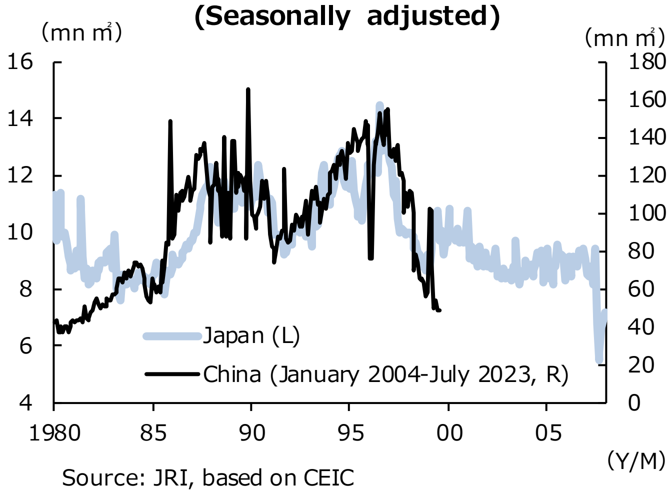
The third similarity is the floundering real estate market. In July, housing starts fell sharply by 33.5% year on year, putting them at the same level as 2005 (Figure 3). The boom in housing construction in China had gone on for a long time, to the point that the real estate market was regarded as overheated, but recently the build-up of housing inventory has become a serious issue, especially in rural areas. As happened in Japan, real estate demand will likely continue to decline in China in the future due to the added factor of a shrinking population. And this will have repercussions elsewhere, as the anticipated decline in housing prices may further cool personal consumption through the reverse wealth effect.

Figure 2. Youth Unemployment Rate in Japan and China (Seasonally adjusted)



Source: JRI, based on CEIC

Figure 3. Residential Floor Space Started in Japan and China (Seasonally adjusted)



Source: JRI, based on CEIC

3. Has China failed to take lessons from Japan's experience?

Chinese policymakers are said to have been studying Japan's economic policies intently in order to avoid following in the footsteps of the Japanese economy, which suffered from a prolonged period of stagnation. So

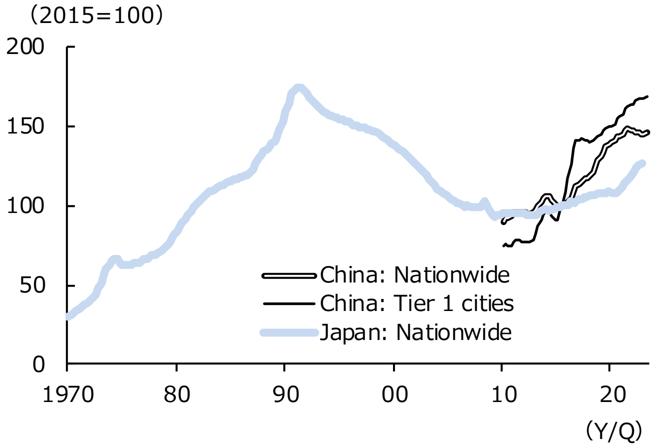
[1] The National Bureau of Statistics of China announced that it would suspend the publication of unemployment rates by age from July 2023 to seek to improve an optimize it following changes in Chinese economy and society.

far, a definitive bubble burst in the real estate market, like the one that occurred in Japan, has been avoided, and there have been moves to address structural problems.

(1) A bubble burst was prevented, but ...

Although the Chinese real estate market has long been viewed as a bubble, so far its bursting has been avoided (Figure 4). In Japan, a rapid series of interest rate hikes by the Bank of Japan beginning in May 1989 (which raised the official discount rate from 2.5% to 6.0% by August 1990), coupled with the imposition in April 1990 of quantative restrictions on the extention of real estate loans, triggered a sharp decline in housing prices. This sudden asset deflation strained the balance sheets of households and companies, which in turn piled downward pressure on consumption and investment as debts were repaid and new borrowing was curtailed. In China, however, with the aim of gradually deflating the bubble, de-leveraging was encouraged through tighter regulation of housing transactions and real estate-related borrowing. But whenever there has been a deterioration in the economy, the rules have been relaxed to avert a sharp correction in the housing market. Because a bursting of the bubble has been avoided, balance sheet recesstion has not occurred, so downward pressure on consumption and investment triggered by the curtailment of borrowing by households and firms has been averted.

Figure 4. House Price Index in Japan and China



Source: JRI, based on CEIC and OECD

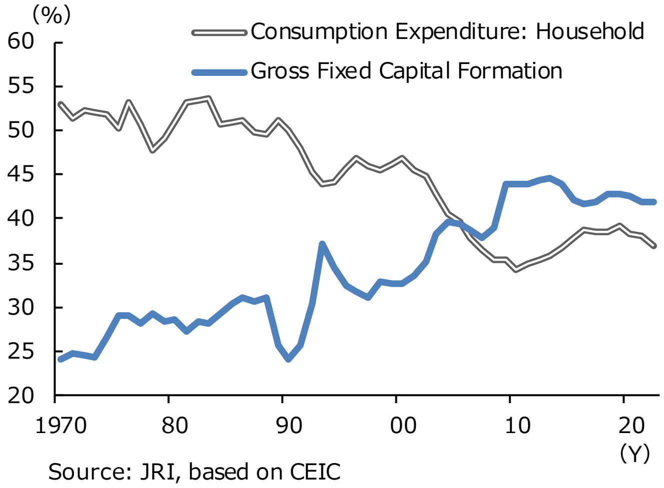
(2) Structural reform has remained piecemeal and investment-oriented economic growth has reached its limits

However, no matter how hard the government tries to prevent the bubble from bursting, China's structural problems appear to be slowly eroding its economy. With regard to Japan, many studies have concluded that the lack of progress with structural reform in the face of major changes in the domestic and international economic environment, rather than the bursting of the bubble, was what led to the prolonged stagnation (e.g. Hoshi and Kashyap [2011], see Apeendix).

In the case of China, a significant structural problem is that the economy is overly dependent on investment, particularly on real estate. This characteristic of the economy became particularly pronounced after the global financial crisis of 2008. At that time, a massive, RMB4 trillion stimulus package and large-scale monetary easing allowed the economy to recover, but the excess liquidity brought about by these expansionary economic policies subsequently led to overheated investment, especially in the real estate sector. The bubble that emerged hampered China's long-term growth potential by, for example, prolonging the life of declining industries and zombie firms, and this problem still exists today.

The question of how to pivot from investment-driven to consumption-driven economic growth has therefore been a frequent topic of discussion in China. During the March 2012 session of the National People's Congress, the expansion of domestic demand, especially consumption, was positioned as the top priority for macroeconomic management aimed at achieving stable economic development. Furthermore, domestic demand expansion based on consumption is the key pillar of the new "dual circulation" economic model proposed by President Xi Jinping in May 2020. Nevertheless, as of 2022, fixed capital formation still accounted for 42% of China's GDP (Figure 5). This exceeds the 37% for personal consumption, and reflects the lack of progress with structural reform.

Figure 5. Consumption and Investment in China (% of GDP)



Source: JRI, based on CEIC

4. The rekindling of the real estate crisis and sluggish growth in the high-tech sector will likely to be obstacles, causing structural reform to be postponed yet again

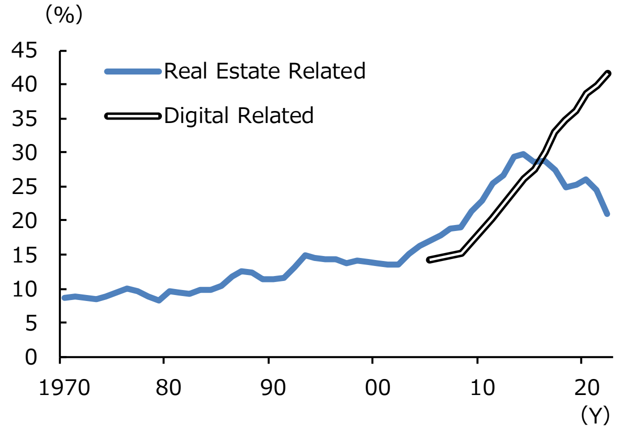
So while the Chinese government has learned from Japan's bubble experience and successfully avoided a crisis, it has failed to adequately address structural reform, an omission that could contribute to the same sort of economic stagnation seen in Japan. The limits of investment-oriented economic growth and the sense of stagnation that goes with it are putting increasing downward pressure on the Chinese economy in the form of deflation, rising unemployment, and a real estate downturn.

The prescription for China's economy to avoid prolonged stagnation is to stop delaying structural reform and to make steady progress with efforts to correct its investment-oriented economic structure. To that end, even if the economy worsens, the long-standing structure should not be preserved by choosing the quick fix of economic stimulus measures such as easing real estate regulations and expanding infrastructure investment. At present, the Chinese government is staying cautious by refraining from implementing large-scale economic measures.

However, the following two factors are expected to obstruct the continuation of this policy of patience: The first is the rapidly intensifying pressure for a correction in the real estate market. With Chinese real estate giant Evergrande Group filing for bankruptcy in the U.S. on August 17, concern about instability in the property market is growing. Support for the real estate sector through deregulation and other measures has been small-scale, with priority placed on shoring up balance sheets through real estate market adjustment. In addition, although the People's Bank of China cut interest rates on August 21, it has left the five-year rate, a benchmark for mortgage rates, unchanged. However, several real estate companies are rumored to be at risk of defaulting on their debts, and if a chain of failures unfolds, it will be difficult for the authorities to stay enthusiastic about structural reform.

The second is that growth in the high-tech sector is likely to stagnate in the face of domestic and external pressures. While China has been slow in implementing structural reform, its high-tech industry has been growing exceptionally fast since the mid-2010s. China's digital-related industries' share of value added in GDP has been rising rapidly, surpassing that of real estate-related industries (Figure 6). A resurgence of the high-tech sector, which includes digital-related industries, could alleviate downward pressure on the investment sector caused by structural reform. Furthermore, China has been successful in creating new, Internet-driven consumption styles, such as ride-sharing and home delivery, at a considerably faster pace than elsewhere in the world.

Figure 6. Real Estate/Digital Related Activities' Share of GDP in China



Source: JRI, based on CEIC and China Academy of Information and Communications Technology (CAICT)
Note: Real estate related activity is estimated by real estate value added, value added of construction/Equipment investment and their economic ripple effects (see Rogoff and Yang[2020]). Digital related activity includes both the ICT sector and parts of traditional sectors that have been integrated with digital technology.

Domestically, however, the Chinese government's "common prosperity" policy has resulted in growth in the high-tech sector being increasingly stifled. IT companies have been particularly hard hit, with the government strengthening its control over them, having pointed the finger at them for reaping huge profits by taking advantage of their dominant positions. A prime example of this occurred in April 2021, when e-commerce leader Alibaba Group was slapped with a fine for violating antitrust law. Internationally, meanwhile, the U.S.-China rivalry has been boiling over, and the U.S. has tightened controls on the sale of high-tech products to China. In areas such as advanced semiconductor industries and artificial intelligence (AI), downward pressures on growth are rapidly mounting.

As the above discussion would suggest, it has become increasingly difficult for the high-tech sector, including digital-related industries, to replace the real estate sector as the support pillar for economic growth. Therefore, in the absence of a driving force for the economy, advancing structural reform is expected to prove trickier going forward. If the government once again switches to an investment-oriented policy to support the economy in the short term and postpones structural reform, it will be able to avoid a sharp deterioration in the short term, but a slide into long-term stagnation like that which occurred in Japan would also become a realistic prospect.

5. Conclusion

Economic policy management is now more of a challenge for China than ever before, and big political decisions will be needed to navigate this phase. Given that repeated postponement of structural reform has led to a crisis in the form of the prospect of prolonged stagnation, when considering the direction it should take, the

Chinese government ought to place priority on structural reform. In reality, however, concerns about the economic outlook are growing rapidly against the backdrop of a sluggish real estate market, and there is a strong need for measures to prevent an economic downturn. From a political standpoint, too, the government must exercise caution with regard to drastic structural reform, as a worsening economic downturn could lead to instability not only in the economy but also in society at large.

In addition, the government's recent moves to tighten its grip on the economy, as exemplified by control of the high-tech sector, will also need to be modified. Since 1978, the Chinese government has publicly pursued a policy of "reform and opening up", and this accelerated economic growth through the 2000s. However, economic growth driven by such strategies is now a thing of the past, and in recent years, the emphasis has been on achieving growth while maintaining control of the economy. Amid tighter economic controls, the main growth drivers will be fiscal policies such as infrastructure investment and deregulation of the real estate market. Without a policy shift toward resilient economic growth through private-sector vitality within a free market, it will be difficult to correct the investment-oriented economic structure. Under these circumstances, it will be even harder for the Chinese economy to avert a "Three Lost Decades."

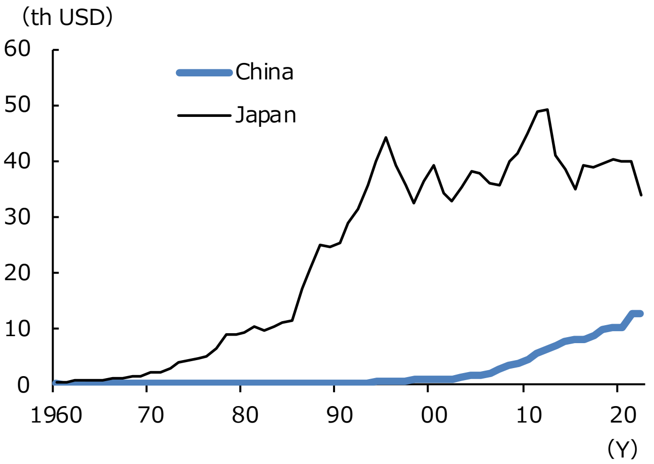
Appendix: The structural factors behind Japan's economic stagnation by Hoshi and Kashyap [2011] and comparison with the Chinese economy

Hoshi and Kashyap [2011] argue that the main cause of Japan's economic stagnation was its failure to adjust to the various challenges that emerged starting as far back as 1970s. They contend that Japan had structural problems prior to the bubble period, including 1) the end of high growth due to economic maturity, 2) the rapid aging of the population, and 3) the limits of export-oriented growth, and assert that the bursting of the bubble then brought these problems to the surface, leading to long-term stagnation. Hoshi and Kashyap [2011] also identify the policy factors that hindered the growth of the Japanese economy over the long term, pointing to the protection of inefficient firms (the problem of "zombie companies"), insufficient deregulation, and inappropriate monetary and fiscal policies (such as the allocation of fiscal spending to inefficient sectors). They argue that reforms were needed to address these factors.

Since China is facing a declining population and confrontation with the U.S. on trade, 2) and 3) can be considered as commonalities between Japan and China. Japan also needed to pursue structural reform due to these factors, but struggled in responding to structural changes. For example, it was slow to deal with the problem of non-performing loans (even after passing financial reconstruction law in October 1998, which authorized the injection into banks of up to 60 trillion yen in public funds, little progress was made, and it was only when the government settled on its Program for Financial Revival in October 2002 that bad-loan disposal accelerated). The problem is that China, despite learning from Japan's experience, has so far been unable to break away from its dependence on investment in real estate and other assets.

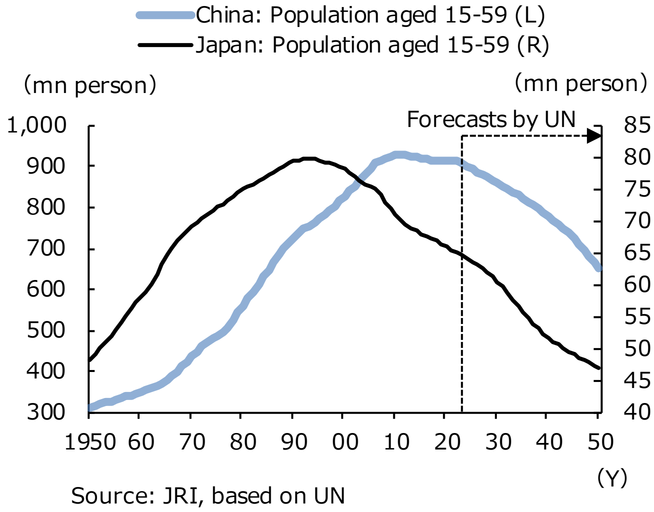
On the other hand, the Chinese economy today remains at an immature stage compared to Japan's back then, so 1) constitutes a key point of difference from the Japanese economy. Per-capita GDP exceeded $20,000 in Japan in 1990, but was only about $10,000 in China in 2022 (Figure 7), and income disparities in China are still large. Even so, the labor force is expected to decline at a fast pace, putting downward pressure on the potential growth rate (Figure 8). The Chinese government abolished its "one-child policy" in 2016, allowing couples to have up to two children, but this did not lead to a sustained increase in births. In 2021, it further loosened birth restrictions, and has recently taken various measures to increase the birthrate, including subsidies for families with multiple children, yet there are still no signs of a reversal in the declining birthrate trend. Japan's experience also shows that this is not an easy problem to address, but the Chinese government has yet to even find a starting point for a solution, as it has not taken any proactive steps to address the declining birthrate, such as accepting immigrants. Looking ahead, a decline in China's potential growth rate is inevitable, and the fiscal burden may increase due to the need to assist low-income groups coupled with increased support for the elderly. This could make China's economy more fragile. Its point of difference compared with Japan, namely "the economy that grow old before it grows ritch," may also prove a major impediment to structural reform in China in the future.

Figure 7. GDP per capita in Japan and China



Source: JRI, based on World Bank

Figure 8. Labour Force in Japan and China



Source: JRI, based on UN

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