Prospects

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CHINA is not 1980s Japan and this is both good news and a big problem

Real estate crisis, demographic problems, trade tensions with the United States, concerning debt levels: multiple comparisons can be drawn between China today and 1980s Japan, sparking fears of a "Japanification" scenario for the Chinese economy. Such a scenario is characterised by a slowdown in economic activity caused by a drop in private consumption, the advent of a negative, deflation-fuelling price-wage loop and a decline in potential growth.

And yet, Japan never really recovered from its "lost decade": the country, which economists in the 1980s saw as the world's leading economic power, ultimately experienced nearly two decades of stagnating growth and prices.

China is not 1980s Japan, which both gives it an edge and poses a problem. It gives it an edge because it has more leeway in conducting its economic policies. It raises a problem because its level of development and wealth – and therefore resilience – is much lower, exposing it to ultimately harsher scenarios.

That said, China could learn from Japan in order to avoid making the same mistakes, starting with the adoption of clear and transparent communication on policies implemented to re-anchor expectations and restore confidence.

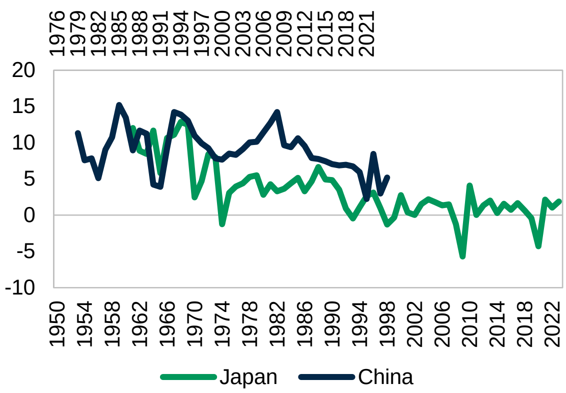
While these parallels may be compelling, if any lessons can be drawn, the nature of China's regime and tightening of ranks around the party and its leader Xi Jinping mean that China will never completely resemble either 1980s or modern-day Japan. Furthermore, the country is still far from overcoming the obstacles in its path in order to revive its growth trajectory.

What do China and 1980s Japan have in common?

The three characteristics of 1980s Japan are the combination of low growth, low inflation and low interest rates, against a backdrop of trade tensions with the United States, a stronger yen[1] and an accelerated ageing of the population. Drawing a parallel with today's China is therefore far from absurd.

First, in terms of growth: Japan maintained average annual growth of 9.2% between 1956 and 1973, then 4% between 1974 and 1991 before falling to 0.8% during the "lost decade" and the great financial crisis (1992-2012). The same orders of magnitude can be seen in China: 10% over the 1979-2011 period and 6.3% between 2011 and 2023. The IMF forecasts average annual growth of less than 4% over the 2024-2028 period, significantly revising the country's growth trajectory in recent years: the Fund was still expecting average growth of more than 4.5% over this period back in 2022, and more than 5% in 2021.

China's growth trajectory looks very similar to Japan's



Sources: World Bank, Crédit Agricole S.A/ECO

Above all, Japan's growth strategy stemmed from a **development model based on exports and industrial upgrading** (known as the "flying geese" model), high investment and savings rates, and financing led more by banks than by the markets. These characteristics are very similar to what we have seen in China, especially since the country joined the WTO in 2001.

[1] See the Plaza Accord below.

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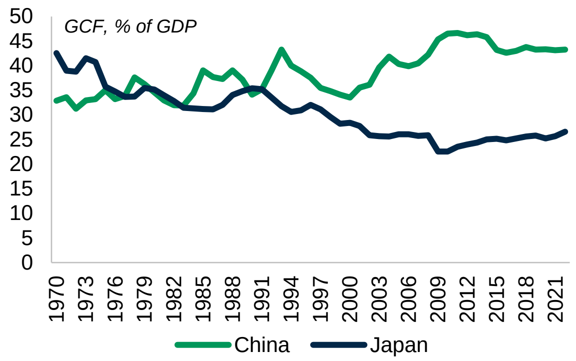
At its peak in 1988, Japan accounted for 9.8% of world exports. Interestingly, its best performance came just before the crisis in the 1990s. Aside from a slight rebound in the mid-1990s, helped by the depreciation of the yen, the country has never again grasped such a high market share. In 2022, it accounted for only 3.2% of world exports.

China's integration proved even faster and more intense, climbing from 4.1% of world exports in 2001 to 19% in 2021. This level fell in 2022 (16.1%), due in particular to the health restrictions that led to congestion at Chinese ports, but still remains very high. On the other hand, it is likely that an all-time high was reached in 2021. It remains to be seen whether China will maintain its dominance in global trade, or whether it will lose market share as new competitors enter the playing field.

China, Japan: a growth model based on investment



Sources: World Bank, Crédit Agricole S.A/ECO

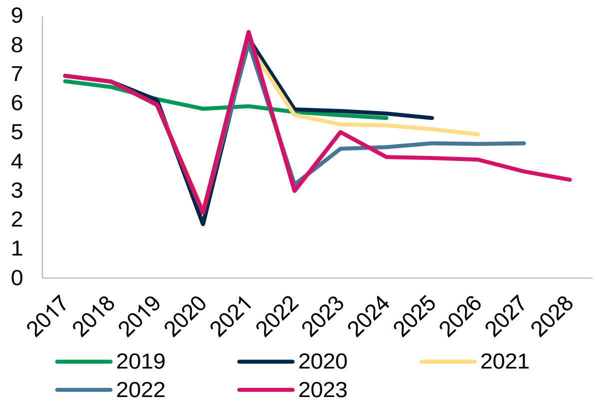
China, Japan: integration into international trade

Sources: CNUCED, Crédit Agricole S.A/ECO

Managing the growth trajectory in a centrally planned economy

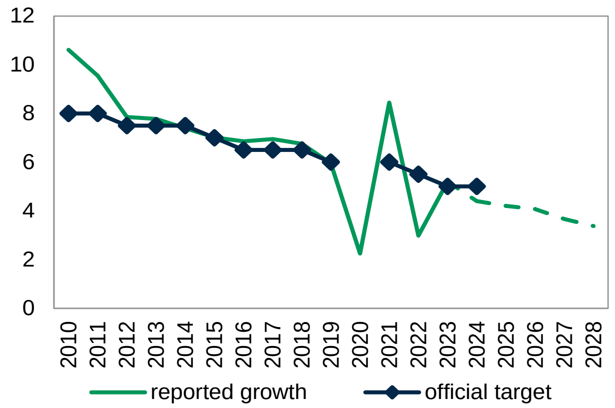
In a planned economy like that of China, controlling the growth trajectory is critical because the growth target is set each year and is announced during the parliamentary meeting in March. Faced with a slowdown in growth, Chinese authorities have a tricky road to navigate as they trade off between credibility and confidence, i.e. setting a target that is not too high (in order to remain credible), but also not too low (demonstrating that supporting the economy remains a top priority). This year, the authorities erred on the side of option two: growth of "around 5%", whereas the consensus was significantly lower. In general, China's view has changed significantly over the past five years, as reflected in IMF forecasts. In 2021, the IMF was still expecting growth rates above or close to 5% through 2026. This trajectory changed in 2023, with a forecast of 4% for 2026 and 3.4% for 2028.

China: worsening growth prospects



Sources: IMF, Crédit Agricole S.A/ECO

China: growth forecasts



Sources: IMF, Crédit Agricole S.A/ECO

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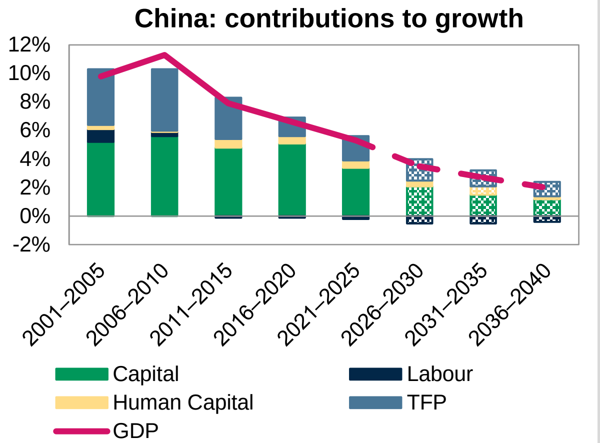
In the tradition of centrally planned economies, the expectation is that the target will not only be reached, but often exceeded, as was the case each year in China with the exception of 2020 (no target set due to Covid) and 2022 (target of "around 5.5%" and actual growth of 3%). However, this target is never revised during the year, meaning it cannot be adjusted in response to any unexpected cycle turnarounds. The concept of an economic cycle does not really exist in this type of economy, as it is unthinkable to announce a negative target, which would point to expectations of a recession.

After achieving annual growth of more than 10% from 2000 to 2010, the authorities changed their tone, introducing the idea of "qualitative growth" to justify the reduction of targets over the following decade. A debate then emerged on the trajectory of Chinese growth, introducing the concept of a "hard" or "soft" landing, i.e. China's ability to control the slowdown in growth as well as growth drivers. It was at this time that the need to transition from a growth model based on investment and foreign trade to a model driven by domestic consumption emerged.

Unfortunately, Covid ended up exacerbating the economic imbalance in favour of an investment-driven model. And, despite talk of the need to deleverage the economy, justifying more timid stimulus measures than in previous downturns, investment should continue to serve as a growth adjustment variable: it is the only driver that can be directly controlled by the government. By stimulating short-term growth in a bid to reach the target through investment, there is a risk of seeing a decline in the effectiveness and profitability of capital. The other option would be to set less ambitious but more credible growth targets. In both cases, this behaviour illustrates the excesses of a slowing administered economy, faced with a decline in its potential growth: factor productivity has deteriorated and labour is expected to contribute negatively to growth due to the demographic slowdown.



Sources: ADB, Crédit Agricole S.A/ECO

On the demographic front, China's situation is perhaps even more worrying than that of Japan: the population began to decline in 2022, with **China losing a little over two million inhabitants in 2023**. China's fertility rate has even fallen below that of Japan, with 1.09 children per woman in 2022 (compared to 1.26 for Japan). According to UN projections, China's population will be virtually cut in half by 2100, while India's population will stabilise at around 1.5 billion.

Demographics are a key element of potential growth, however, for two main reasons. First, because the working population has a greater propensity for consumption than pensioners. Second, because the labour factor is an important component of growth, especially in a country like China where the availability of labour has played such a large role in the economic take-off.

Faced with an ageing population, China first tried to end the policy of controlling births by relaxing and then removing the one-child rule, ultimately having little effect on the birth rate. The key may be in the **retirement age**, which is still between 50 and 55 for women and 60 for men. The elderly dependency ratio has already more than doubled since the turn of the century, from 10% in 2000 to 22% in 2022. According to UN projections, it is expected to exceed 50% by 2050.

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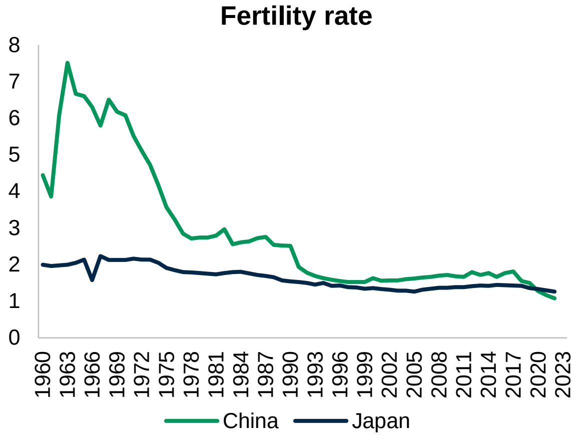
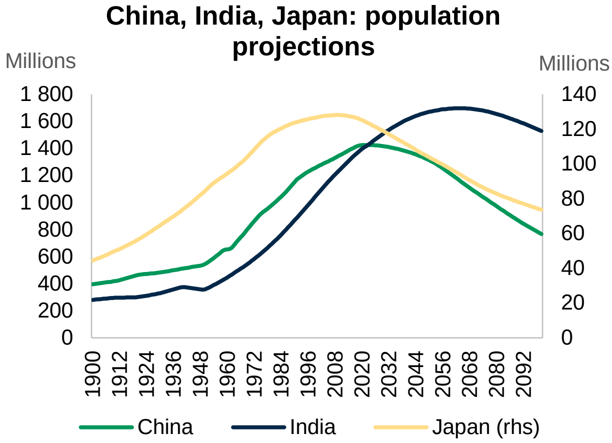


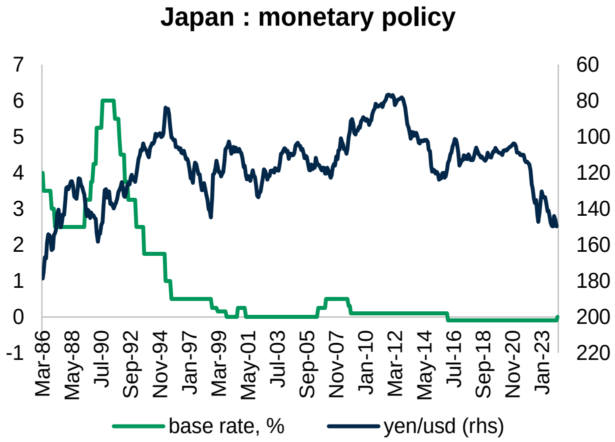
Sources: World Bank, Crédit Agricole S.A/ECO



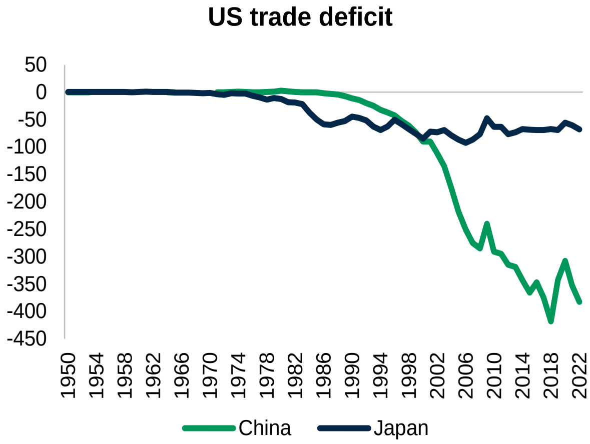
Sources: Nations Unies, Crédit Agricole S..A/ECO

The third point in common is the existence of trade and monetary tensions with the United States. In 1985, the Plaza Accord allowed the dollar to depreciate against a yen that was considered undervalued. The aim was **to reduce the US current account deficit and reduce Japan's trade surpluses as well as its investments in the United States**. Large quotas on Japanese cars, as well as the obligation for certain brands – in particular Toyota – to develop production sites in the US had also been imposed on Japan.

However, although the yen did manage to appreciate by more than 50% against the dollar in two years, the Plaza Accord also led **Japanese economic agents to repatriate a large part of their USD-denominated foreign savings**. These surplus savings, coupled with financial deregulation measures and expanded lending, caused **the formation of a real estate and financial bubble that was expected to burst at the end of the decade**.



Sources: BoJ, Crédit Agricole S.A/ECO



Sources: IMF, Crédit Agricole S.A/ECO

The same arguments were used by the United States regarding China, accused of monetary dumping by Donald Trump as the US trade deficit exploded. In 2015, the year before Trump's election, the US trade deficit with China reached nearly 50% of its total deficit. Starting in 2018, both countries introduced a series of customs duties on increasingly large export volumes. Then, in 2019, China was accused of allowing its exchange rate to depreciate too sharply against the dollar in order to offset losses related to the introduction of tariffs. The Phase-1 agreement, signed in 2020, failed to eliminate trade tensions between the two countries.

Tariffs remained at high levels. Donald Trump, once again vying for the US presidency, has stated that he wants to introduce 60% tariffs on Chinese products.

Meanwhile in Europe, there are also calls to restrict China's access to the single market, particularly for products related to the ecological transition, starting with solar panels and electric vehicles.

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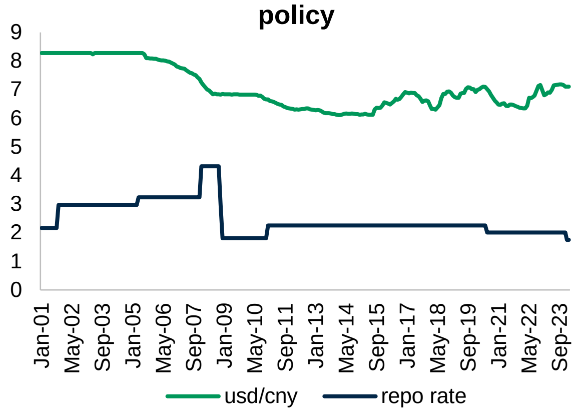
Modern-day China today, however, is not equivalent to 1980s Japan

Three key points differentiate China from 1980s Japan: the real estate crisis is not accompanied by other speculative asset bubbles; the risk of bank failures is limited, and the authorities have the means to shore up the most vulnerable banks (particularly regional banks) if necessary; **China's capital account remains very closed**, which protects it from capital movements as well as foreign exchange pressures.

Of these three points, the most important is the capital account, which was the main channel through which imbalances accumulated in Japan. **China thus retains control over the level of its exchange rate**, a tool that it uses to maintain competitive prices during slowdowns in foreign trade thanks to central bank interventions.

As the yuan is not convertible, **export-related revenues pass through the central bank, which has thus built up colossal foreign currency reserves** (more than $3,200 billion), allowing it to manage the yuan's exchange rate when necessary. Although the exchange rate is not officially pegged, as it was until 2005, the central bank appears to have set upper and lower limits not to be crossed. As a result, it is unlikely that China will allow any pressure to be exerted on its exchange rate, as was the case for Japan after the Plaza Accord.

China : exchange rate and monetary policy

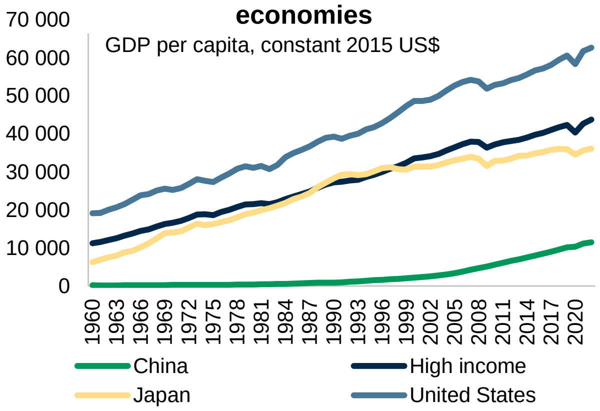


Sources: PBoC, Crédit Agricole S.A/ECO

By keeping it capital account closed, China also **has little exposure to capital movements**, whether in terms of outflows or inflows. While it is true that China has experienced significant capital outflows in recent months, stemming either from portfolio flows to direct investments, this can be attributed not only to **a decline in the profitability of Chinese assets but also the high level of geopolitical tensions,** leading investors (in particular US investors) to withdraw from China. Even so, the amounts of net outflows (around $65bn in 2023) are not large enough to destabilise the Chinese economy, though they do send a very bad signal about the country's appeal to foreign investors.

Unlike the Japanese, **the Chinese also have few external assets** and are thus not exposed to a wealth effect linked to currency fluctuations. In general, stock markets and financial savings products are not highly developed. **Market capitalisation sits at around 60% of GDP, compared to more than 150% in Japan and 190% in the United States**; it is also relatively uncorrelated with growth trends. This reduces the risk of a speculative asset bubble - another difference with 1990s Japan.

China is still far from high income economies



Sources: World Bank, Crédit Agricole S.A/ECO

China has three things going against it, however.

The first is the **level of development, as illustrated by GDP per capita**. In the early 1990s, Japan's GDP per capita (in 2015 constant dollars) was already $28,915, compared to China's current GDP per capita of $11,500. In other words, Japan was already a high-income economy, while China is still a middle-income economy. China thus faces a risk of **remaining stuck in what economists call the middle-income trap**, which describes a situation in which the majority of a country's inhabitants cannot access the middle class. While China has succeeded in overcoming extreme poverty, around 600 million people still live on less than $150 per month.

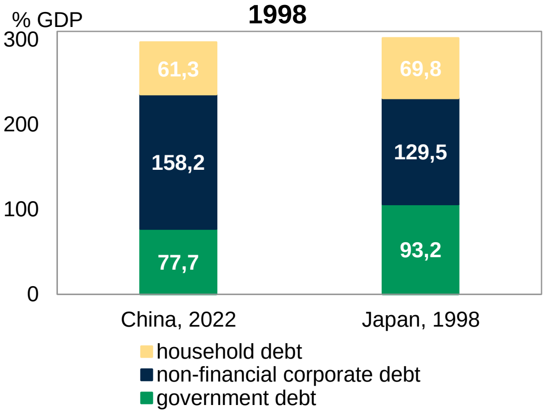
China's development model is also constraining wage growth. By choosing to take part in global trade based on price competitiveness, China must negotiate a trade-off: move upmarket to create more added value, develop structural competitiveness and therefore have more leeway to increase wages, or stick with pure price competitiveness and thus put the brakes on wage growth as well as exchange rate appreciation. At this stage, China appears to be veering towards the latter, which also explains the weakness of inflation, even though investment efforts are being made to develop higher-tech sectors in the transition and digital fields.

This is also where we see **the stakes of moving towards a consumption-based growth model**, which would reduce dependence on the rest of the world, responsible for absorbing the overcapacities of an economy **that is incapable, for the time being, of relying on its own domestic market due to the inadequate standard of living experienced by part of the population**.

The second thorn in China's side is the level of debt, which is already comparable to that of Japan in the late 1990s, but with a lower level of wealth. **The Chinese economy's total debt stands at 300% of GDP** versus 333% in France and 255% in the United States according to the BIS – excluding the financial sector. The slowdown thus raises the question of the "snowball effect" of debt, even if China's closed capital account reduces the risk of a potential domestic debt crisis spreading to the rest of the world.

Moreover, **the majority of Chinese debt is issued by companies and not by the government**, although it is mainly concentrated in State-owned enterprises (SOEs). **However, the financial opacity of SOEs and the Chinese government's refusal to clearly define its role as lender of last resort** call for keeping a close eye on how this debt evolves. One point that mitigates this risk is the fact that China's debt is domestic and denominated in local currency.

China is as indebted as Japan in 1998



Sources: BIS, Crédit Agricole S.A/ECO

Lastly, **the weight of the real estate sector in China is much greater than it was in Japan.** Taken as a whole – i.e. including certain upstream and downstream activities, ranging from construction to furnishing and insurance – it accounts for more than 20% of Chinese GDP, 25% of bank exposure and 70% of urban household wealth. Land sales made up nearly half of the resources recorded by certain areas until 2019.

In addition, the real estate sector has been the subject of intense speculation among certain multi-owner households, causing a very rapid price rise, particularly in top-tier cities such as Shanghai, Shenzhen and Beijing. In smaller cities, speculation has led to a sharp increase in the vacancy rate (22% nationally), with homeowners betting on rapidly climbing real estate prices to make their properties profitable without even renting them out.

The only mitigating factors are **the household savings rate** (35% vs. 11% in Japan in 1990), which reduces the prospect of a rapid rise in defaults, and a lower urbanisation rate (61% vs. 77% in Japan), which offers hope for a possible long-term decline in the vacancy rate and a recovery in demand in certain urban areas.

In the short term, however, **it will take some time to break out of the real estate crisis**: there has been no improvement in metrics for the last three years, and the crisis is weighing heavily on Chinese growth prospects.

	China (2023)	Japan (1990)
Mortgages as % of GDP	31%	22%
Loan/deposit ratio	30%	22%
Real estate as % of urban household assets	70%	54%
Property price/income ratio	23,4 (Beijing) 26,7 (Shanghai)	18,1 (Tokyo) 18,4 (Kyoto)

Sources: Goldman Sachs, Crédit Agricole S.A/ECO

Lessons learned from Japan

Three main lessons can be drawn from Japan in the past.

The first is that, during an economic downturn, when growth and inflation expectations become adrift, **communication from the authorities centred on economic policy is essential**. Its objective is above all **to improve the predictability and coordination of economic players**, in particular with regard to their investment decisions.

A twofold mistake was made in Japan: the poorly anticipated and excessively sharp rise in key interest rates (+350 basis points in 18 months), coupled with the withdrawal of fiscal support measures, precipitated the bursting of the real estate bubble. Although the Chinese authorities have not committed to such a "purge", **their communication has nevertheless been rather flawed in recent months**.

For one thing, the markets were expecting a stronger response on the fiscal front, as seen in previous slowdowns (2008 and 2015). They were disappointed by the tempered announcements made by the government, which had said that deleveraging the economy remained a priority.

Moreover, **the credibility of the China's official statistics is increasingly being called into question**. The decision to no longer publish data on youth unemployment, an indicator that has been widely discussed in recent months due to its decline, and then to change its calculation methodology to bring it back to more acceptable levels, is one of the

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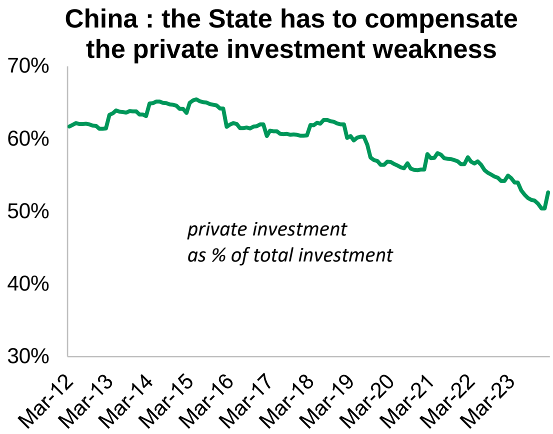
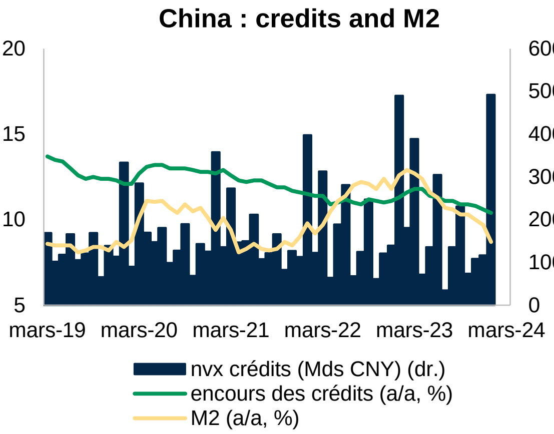
more **avoidable communication errors for the Chinese authorities**. Similarly, the 5.2% growth target announced in 2023 has raised eyebrows, given the weak momentum seen in private investment in 2022.



Sources: NBS, Crédit Agricole S.A/ECO

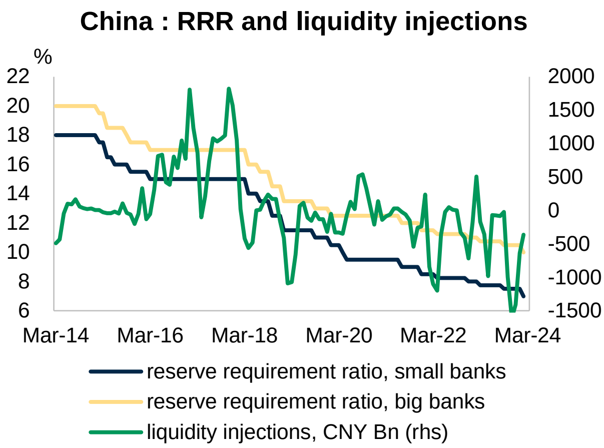
Finally, though sometimes deemed insufficient by the markets, **measures have been implemented to support the real estate sector**, from easing purchasing conditions to offering aid to property developers.



Source: PBC, Crédit Agricole S.A./ECO

The second lesson is to avoid having **commercial banks assume the burden of deleveraging the real estate sector alone** in order to preserve their lending capacity. In this regard, it makes **less sense to draw a parallel with the Chinese system.** As the country's major banks are State-owned, it is the State that bears responsibility as lender of last resort and, as such, can organise the failure or restructuring of struggling institutions, as it has done in the past by creating defeasance structures to manage non-performing assets.

Conversely, **banks have benefited from liquidity injections in recent months**, mainly arriving through the reduction of mandatory reserves, issues of new securities and the recapitalisation of regional structures, which are considered more fragile. These injections were not as high as they were during the last slowdown in 2016, but still helped shore up the sector.



Source : PBoC, Crédit Agricole S.A./ECO

In China, the challenge stems more from a lack of bankruptcy mechanisms, with failure being an underdeveloped concept in centrally planned economies. With nearly 50% of Chinese property developers in default, **negotiations between debt-holders and creditors are progressing very slowly.**

After two to three years of unsuccessful talks, **Hong Kong courts have begun handing down court-ordered liquidations** against some of the most emblematic groups, including Evergrande. These rulings pertain to the *offshore* – and most often dollar-denominated – portion of developer debt, amounting to $155 billion for the entire sector – currently valued at $20 billion. However, almost all developer assets are located in mainland China and could therefore only be seized if the country's courts agree to cooperate, which is far from being a done deal.

In general, **the authorities seem to assume that the sector's losses are absorbed by company shareholders, either foreign or domestic.** They also assume that forced deleveraging can "set an example" to punish an industry in which **personal enrichment may have been a little too fast and easy**, and more importantly, achieved to the detriment of households that have increasingly struggled to find housing – and, by extension, to start or expand their family.

The third lesson taught by Japan is to be very careful in **implementing wage management policies**, in order to prevent a decreasing wage/price loop from taking hold. In Japan's case, the upward pressure placed on the yen by the United States led to a slowdown in wage growth as companies sought to maintain their price competitiveness, eroded by exchange rate levels.

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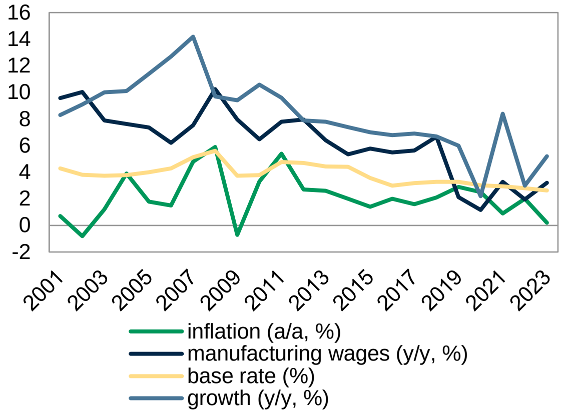
This type of depressive loop leads to wait-and-see behaviour by economic agents (investors and consumers), who expect the economy to deteriorate or, once the spiral has begun, prices to fall, thus electing to delay their investment decisions. Taken together, these behaviours create a self-fulfilling prophecy, effectively reducing actual demand and thus the economy's potential growth. This is what happened in Japan, creating a situation of deflationary stagnation from which the economy struggled to emerge.

Deflation, combined with the uprooting of inflation expectations and persistently ultra-low interest rates, also make deleveraging excessively painful. A policy of persistently low interest rates can also weaken the banking system by weighing on the margins of financial institutions.

All these parameters lead to difficult trade-offs in the steering of monetary policy.

China: wages, inflation and growth

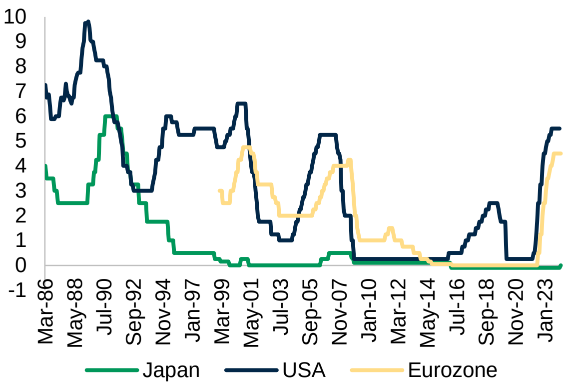


Sources: NBS, Crédit Agricole S.A/ECO

Is "Japanification" a lesser evil when faced with harsher scenarios?

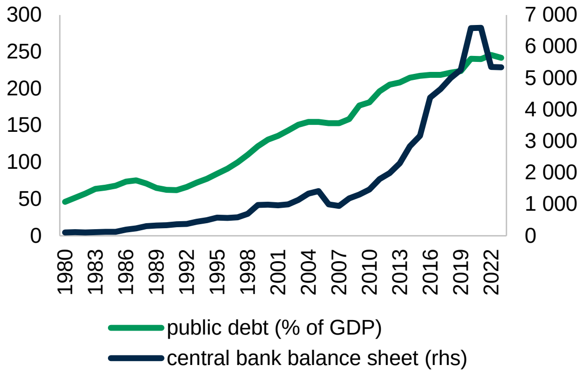
The Japanese crisis of the 1990s left deep scars, not only in terms of growth but also the conduct of monetary and fiscal policies. The fall in wages and appreciation of the yen fuelled very low inflation and a structural decline in household demand. The central bank therefore opted for a very accommodative monetary policy, choosing to maintain a zero short-term interest rate in a bid to stimulate economic activity. Japan's key rate fell below 1% as from 1995, while Fed rates remained above 5%. They reached 0% in 1999 and have never climbed back above 0.5%.

Japan: 20 years of zero-rate policy



Sources: Central Banks, Crédit Agricole S.A/ECO

Japan : higher debt, higher balance sheet



Sources: BoJ, Crédit Agricole S.A/ECO

As deflation continued, and as there was no monetary leeway available, **budget was the tool used to revive activity, leading to a very rapid rise in the public debt ratio**. In order to maintain fiscal sustainability, long rates also needed to become zero, so the central bank committed to a massive asset purchase policy, prompting an increase in the size of its balance sheet.

Though it did not come out of the "lost decade" unscathed, the Japanese economy nevertheless had an advantage that China currently lacks: namely a domestic market of consumers with high purchasing power, an admittedly mature market but one that spared Japan an even more violent correction in its growth. That said, "growth" is ultimately a recent concept in China, and what it must avoid at all cost is **the return of stagnation**, a situation that prevailed until 1979[2].

Before the arrival of Deng Xiaoping, GDP per capita at purchasing power parity was more or less the

[2] See data from the Maddison Project, which generates statistics on GDP per capita over a very long period.

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same since the year 1000, sitting at around $1,000 per capita. Unfortunately, Xi Jinping's China is looking less and less like the country imagined by Deng Xiaoping, and increasingly like Chinese imperialism of old. **A paternalistic government, responsible for the safety of its people, but with no accountability**. **An increasingly centralist State, at the risk of causing paralysis (as seen in the real estate sector) or overreaction (as seen during Covid at the local level).**

By asserting that he is fighting against the excesses of capitalism, be it "Chinese" capitalism or otherwise, whether referring to the emergence of large private groups capable of rivalling the power of the State (Alibaba, Tencent, etc.) or the rise in inequalities, **Xi Jinping has set aside the goal of prosperity implied by the new Chinese social contract**. A social contract combining a repressive government (Deng Xiaoping gave the order to repress the democratic protests held in Tiananmen Square) with a more liberal approach, promoting a better balance between stability and prosperity.

Placing the Party at the centre of economic life, however, did not allow Maoist China to take off. Quite the contrary. This is why 1990s Japan is ultimately not comparable with today's China: **economic protests may be similar, but the political framework is very different.** And that is what will determine the level of priority given to the economy while addressing the many other demands of a country like China, which also has to cope with the demands of stability and power. All things considered, we can expect some tough times ahead for the Chinese economy. ■

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