Pathfinder Economic Alert

Lessons from the Japanese Stagnation: How China will Tackle the Economic Slowdown?

The Shared Experience

Both Japan's post-World War II recovery and China's resurgence over the last three decades were export-driven. Manufacturing, based on low-cost labour, was the key determinant of the initial transformation process in both instances. Both countries also used under-valued currencies to provide exporters with the competitive advantage. Japan and China promoted exports at the expense of domestic demand (household income and consumption). Both countries were able to attain very high levels of domestically financed investment. Both generated extremely large trade surpluses which were invested abroad, particularly in US securities. This enabled them to achieve the twin objectives of avoiding upward pressure on their exchange rates and of helping the US and others to purchase their exports.

Japan

The Plaza and Louvre Accords (mid-1980's) compelled Japan to revalue the Yen. This reduced Japanese growth and exports. Policy-makers sought to revive growth by engineering a credit-driven investment boom to mitigate the effects of a stronger Yen. This resulted in a bubble in asset prices (property and stock market) that eventually collapsed generating large imbalances in the Japanese economy. The upshot was the emergence of large budget deficits, a very high level of government debt and enlargement of the Central Bank balance sheet to finance the government and support financial asset prices.

China

It is noteworthy that the Chinese authorities have resolutely resisted a sharp appreciation of the Yuan. This is likely to be based on a desire to avoid the Japanese experience ex-post the Plaza and Louvre Accords. However, some of the policy measures initiated by the Chinese authorities in the wake of the global financial crisis, in response to a fall in exports and a slowdown in growth, have been similar to those adopted by Japan in the mid-1980's. For instance, as in Japan in the early-1990's an investment boom has been driven by a rapid rise in credit.

Similarity and Divergences

As in Japan in the earlier period, investment levels in China are currently high in similar sectors, such as property and infrastructure. Chinese investment at 50% of GDP is even higher than the 40% recorded by Japan. A point of divergence is that China has used bank lending to targeted projects rather than budget deficits to maintain high levels of growth. However, the reliance on overvalued-assets as collateral as well as infrastructure projects which could generate insufficient cash flows to service debt means that many loans may not be repaid. This could make the Chinese banking system vulnerable. If non-performing loans escalate, a banking crisis would absorb a significant portion of China's large pool of savings and incomes. China has the fiscal space to deal with a banking crisis. However, the growth potential of the economy could be reduced.

At the outset of its crisis, Japan was richer and more technologically advanced than China. Japan's manufacturing skills and intellectual property in electronics and heavy industry made it less reliant on cheap labour. This helped to cushion the effects of the prolonged downturn. However, China still relies to a greater extent on cheap labour to assemble or manufacture products for export using imported material. Labour shortages and rising wages are reducing competitiveness. This attaches high priority to innovation and technological upgrading to maintain China's growth momentum.

China needs to ensure that its credit-driven investment boom in response to the financial crisis does not result in unsustainable domestic imbalances, misallocated capital leading to unproductive investment as well as loan losses at government-owned banks.

Lessons for China from Japan

Japan achieved robust growth, with only brief interruptions, until 1990. After the bubble burst, the country has experienced two decades of economic stagnation. It is hoped the more aggressive monetary and fiscal stance adopted by the current Japanese regime would finally lead to a breakthrough.

In the meantime, the new more technocratic Chinese leadership is faced with three major challenges if it is to avoid a slowdown in China's remarkable growth record over the past thirty years. The priorities for reform are the following:

- Shift from external to domestic demand
- Shift from investment to consumption (including the construction of a social safety net to boost consumption at the expense of savings)
- Reduce the disparities between the coastal areas and the interior regions.
- Deepen economic reforms as pronounced at the last Congress of the Communist Party.

Conclusions

These changes are already underway. However, powerful vested interests, including the export lobby, are likely to make these transitions challenging. The Chinese leadership needs to learn from the Japanese experience and take bold and decisive action early. Hitherto, the Chinese authorities have displayed an impressive capacity to be proactive. They need to continue to demonstrate this trait going forward.

At the present time, the world needs China to achieve sustained growth of 7-8% (as opposed to the double digits recorded in the past); for the US recovery to gather momentum for that economy to grow at 2.5% - 3%; and for Japan to break out of its prolonged downturn. This becomes even more important as Europe is expected to experience a prolonged downturn.

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