China Will Be The Next Japan

Xi should have studied Japan in the early 1990s rather than the breakdown of the Soviet Union.

By Harald Malmgren and Nicholas Glinsman

Will China economically be the next Japan? Will it face a repeat of Japan's experience in the early 1990s? Our answer is a resounding yes. China's household debt surged to 62 percent of GDP last year from 28 percent a decade before. That compares with Japan's experience of climbing to over 60 percent in 1989 from about 26 percent in 1971 (see Figure 1).

China's corporate debt has remained high, at around 160 percent of GDP—above the 145 percent peak in Japan in the mid-1990s.

Furthermore, China's demographics are changing even faster than Japan's, with population growth stepping down and an aging problem that's bigger than Japan's at a similar development stage. Indeed, it was recently reported that China's population has dropped for the first time in six decades, the latest warning bell to sound over the country's demographic crisis.

China's demographic turning point puts it on the same path as Japan, where the population began to decline in 2010 and has fallen every year since. The United Nations has projected that China's population will fall

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to 1.31 billion by 2050 and 767 million by the end of the century. The 2050 estimate would make China 3.5 times larger than the United States, which is projected to have 375 million people by then. At present, it is 4.3 times larger than the United States.

Another area of comparison is the bursting of the Chinese real estate bubble. Of course, there are some big differences between both countries. Beijing has much greater oversight of the housing market through administrative controls than Tokyo did in the 1990s. China's financial system remains dominated by the state sector. And its capital account is largely closed, leaving Chinese households with fewer options than Japanese households had.

The problems constraining both the supply of and demand for housing in China are not getting resolved. In the longer term, even if property sales stabilize, the downward adjustment from the peak will still mean a lower level of construction activity and materials demand in coming years. That leads to the comparison in Figure 2.

The question then is whether or not the Chinese authorities can orchestrate more than a mere bottom of stability. Recent measures in China will alleviate the developers' debt pressure and improve their liquidity, but unfortunately, they may have little or very limited positive effect on the sector itself. The core problem is that there is weak household interest in buying new homes.

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Given the relevance of the property sector to Japan of the 1990s and modern-day China, the comparison is striking. One model that we have seen is none too optimistic about Chinese real estate. It is worth emphasizing that housing is a pillar industry in China, accounting for 20 percent of fixed asset investments and 30 percent of total funding for local governments.

According to the Center for National Balance Sheet's estimates, housing accounted for 40.4 percent of Chinese households' total assets in 2019, down from a peak of 53.5 percent in early 2000s (Figure 3). Of note, the People's Bank of China's survey in 2019 showed that housing accounted for nearly 60 percent of urban households' assets. A major housing market correction will have a direct drag on growth (a 5 percent deceleration in real estate investment will drag GDP growth by 0.6–0.7 percent), and increase financial vulnerabilities.

China's housing market activity has fallen to the weakest on record, and the likelihood of the market bottoming and returning to 2020–2021 levels is quite low. In other words, the housing market will seek a new equilibrium path after experiencing a major contraction, in line with the assessment that fundamental housing demand will continue to contract by 4 percent annually (JPMorgan forecast) in the coming decade.

From a macro perspective, this suggests that housing will no longer be a lifting power for economic growth and domestic consumption in the medium and long run, even should the housing drag become significantly smaller going forward.

Xi's New Team

IN: Li Qiang *as premier of the People's Republic of China.*

ATTRIBUTION: CHINA NEWS SERVICE

IN: Wang Huning *as Chairman of the Chinese People's Political Consultative Conference.*

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OUT: Li Keqiang *as premier.*

OUT: Liu He *as vice premier.*

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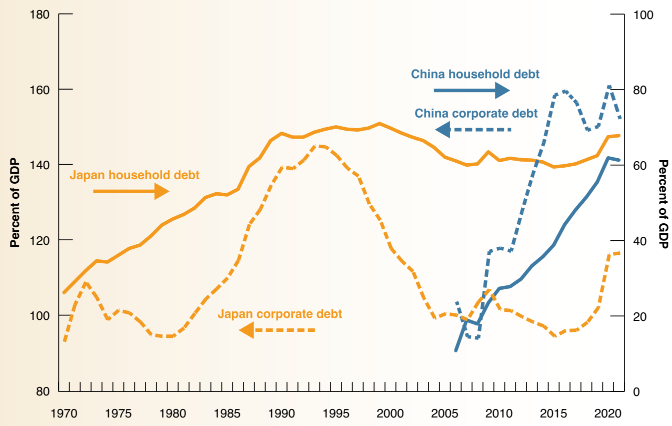
Figure 1 Non-financial, non-government debt



Source: Bank for International Settlements

Will this lead to a large descent of China's growth, similar to that of Japan in the 1990s? Well, reduced reliance on the housing market is perhaps desirable for Chinese policymakers, along with their objective to promote high-tech, upgraded manufacturing, a greener economy, and new infrastructure. The divergence between strong performance in these policy tailwind sectors versus a poor housing market is notable this year, and will most likely continue to be so in the coming years as a policy effort to promote economic transformation, but it is unlikely to compensate for a weakened and potentially weakening real estate sector. How could it, given the aforementioned footprint in the Chinese economy?

So in sum, yes, China is looking increasingly like Japan of the 1990s, implying a possible lost decade, especially when you also consider the demographic time bomb that literally started to kick in recently in terms of data.

Perhaps Chinese President Xi Jinping should have studied Japan's lost decades and why they occurred, rather than focusing his efforts and those of the Chinese Communist Party on understanding all aspects of the collapse of the Soviet Union.

However, none of this is to say that Xi has been inactive. As we know, he consolidated his leadership back in October of last year, when he rid himself of practical specialists and replaced them with political ideologues. Out went economics specialists, such as Li Keqiang and

Xi's government is shifting its priority to demand-side policies (countercyclical policy stimulus).

Liu He, to be replaced by political theorists, such as Li Qiang and Wang Huning.

These changes announced in October did not actually take place until the week of March 6, during the annual National People's Congress legislative session. President Xi went through a *de facto* lame duck period, of course with Chinese characteristics!

During this period, the public's unhappiness with the zero covid policy and lockdowns became very evident. There were city-wide protests, in which citizens banged kitchen pots and screamed their displeasure out the windows. This was followed by demonstrations in factories, some of which became violent. And finally, we saw the "white paper" protests—where demonstrators held up blank sheets of white paper—in public, which initially began with single individuals and quickly evolved into large demonstrations across cities and towns. The protestors became highly disciplined, avoiding legally prohibited actions but showing pervasive discontent, particularly with the government's zero covid policy lockdown.

Thus Xi found himself in a situation whereby the public was no longer submissive to his will and dictates. Furthermore, the leadership clearly understood that when such public protests were not organized, but were spontaneous, action had to be taken to quell this pressure of public dissent. Hence, the sudden complete reversal of the zero covid policy, along with the removal of all related restrictions, particularly mandatory testing.

However, Xi felt the need for a new explanation of what the government was intending, as new leadership assumed their responsibilities. In mid-February 2023, Xi published an article in the CCP's magazine of record, *Qiushi*. It is not uncommon for *Qiushi* to republish Xi's old articles or speeches, often in revised form. For instance, before the 20th Party Congress last October, *Qiushi* published Xi's speech at the Fifth Plenary in 2020 to map out his political and economic strategies in his third term. Such updated articles often carry new messages that policymakers deliberately want to emphasize. In addition, there might be clear differences between the old and new versions and those different words/expressions can be used as a key reference in analyzing the revised policy intentions of Chinese policymakers.

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Compared to the Central Economic Work Conference statement (which included an excerpt of Xi's speech) two months ago, the policy tone of Xi's article is clearly more accommodative. Stabilizing growth is declared to be the number-one goal of Beijing's economic policies in 2023. In the new version of the CEWC speech published by *Qiushi,* Xi put growth stability in the post-pandemic era on the same level as China's crisis management in 1998 (the Asia financial crisis) and 2008 (the global financial crisis). It is an extraordinary message for Beijing's pro-growth stance, even though the specific policy approach in 2023 might be different from that of 1998 and 2008.

Xi intends to draw all private business into the central planning system for the economy as a whole. There are great risks implicit in this drive for centralization.

For this purpose, Xi's government is shifting its priority to demand-side policies (countercyclical policy stimulus) from supply-side policies. Before covid, "supply-side economic reform" was a special term used since late 2015 to summarize Beijing's policy efforts to reduce industrial overcapacity and to de-risk those highly leveraged economic sectors such as housing and shadow banking. During the three-year-long pandemic, however, supply-side policies mainly referred to policy measures (tax relief, credit support, loan guarantees, and so forth) to support corporate firms affected by the pandemic and to alleviate supply chain disruptions. On both occasions, demand-side stimulus was relegated to secondary policy measures.

Xi's article emphasized that the shortage of aggregate demand is now the key challenge facing the Chinese economy, and pledged to boost domestic consumption and public investment to anchor public expectations and improve business confidence. Some key points:

■ Restoring and expanding consumption demand is the number-one priority. Xi stressed that it is critical to improve the spending capacity of low- and middle-income households, who have a high propensity to consume but have been greatly affected by the pandemic. Xi said government policies should aim to increase household income and to expand consumption credit (for example, mortgages, car loans, credit card loans, and so forth). On specific consumption items, Xi stressed demand for housing, new energy vehicles, elder care, education, medical care, and more.

■ Xi also vowed to lift overall investment growth through government investment in public infrastructure. He stressed that government investment is a forceful instrument to offset weak expectations of private investors in dealing with the volatilities of the business cycle. The specific sectors of government investment include transportation, energy, water conservation, agriculture, information and telecommunication, and other key public works, under the framework of China's 14th Five-Year Plan (2021–2025).

■ On exports, Xi said that China needs to stabilize exports to developed countries and expand exports to emerging markets. Compared to consumption and investment, however, exports clearly are not considered a main driver for China's 2023 growth in Xi's article, given rapidly slowing external demand and the decline of export growth in late 2022.

Why did Xi publish such a high-profile article on economic policies at this time? We believe that it reflects the evolving thoughts of policymakers on China's current economic conditions and growth strategy. Beijing views its decisive exit from zero covid policy as a big success, but macroeconomic policies need to adjust to economic conditions in the post-pandemic era. Furthermore, there is recognition by the Chinese leadership that trade amongst the advanced economies will disappoint.

In a Politburo Standing Committee meeting in mid-February, the CCP's leadership declared a "major and decisive victory" in its Covid-19 prevention and control since November 2022. Although this process of covid exit was chaotic and controversial, it is also undeniable that China has reached herd immunity faster than expected and the economic reopening has been relatively smooth so far. The feared second covid wave, a big public concern before and during the Chinese New Year holidays in late January, has not happened.

Figure 2 China's construction decline is comparable to Japan in 1973 and 1997
Construction starts, volume, 1 year moving average, T0=100

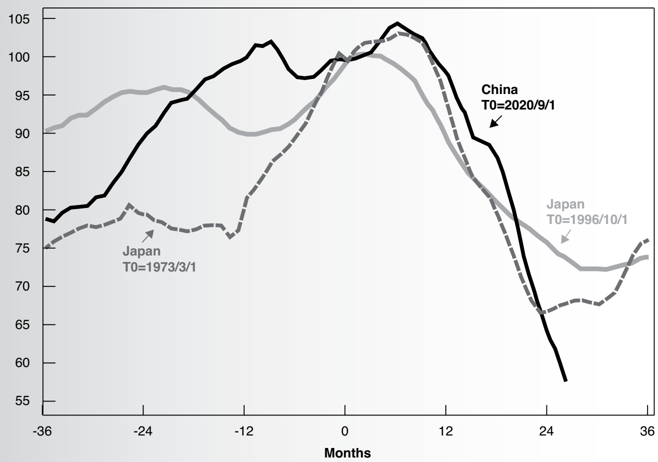
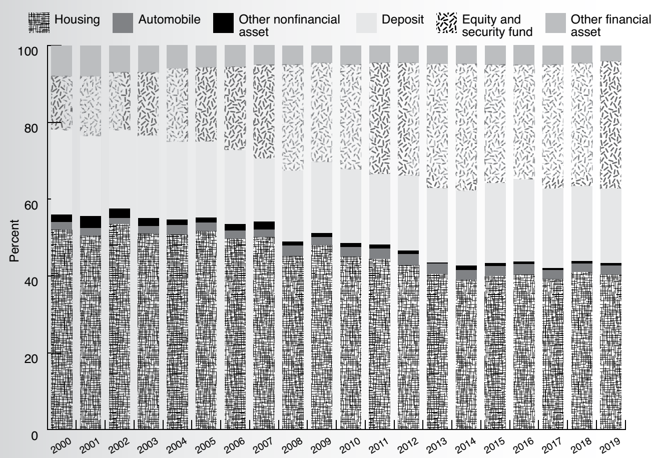


Figure 3 China household assets



Source: CNBS

From the leadership's perspective, the covid wave after the exit from zero covid policy is over and there is no room to question any of the decisions over the last several months. Now Beijing's priority is shifting from covid control to economic recovery. In terms of specific policy measures, the government is pivoting from the rescue of troubled corporate firms to stimulus for aggregate demand.

How will Xi and the CCP leadership accomplish return to significant economic growth by primary reliance on strengthening internal demand? Can China really achieve anticipated growth targets solely on the basis of domestic consumption, without any boost from trade surplus?

In an important speech on February 28, 2023, ahead of the National People's Congress legislative session, Xi said the party would roll out plans for "deepening structural reform" in the financial sector and exercise more control over science and technology work—key strategic areas as the United States moves to prevent China from obtaining advanced computer chips and other high-tech products. He also said his administration would "step up party-building work" in private companies and "give specific requirements on party-building" in industry associations and chambers of commerce, without elaborating. Part of the plan, which was approved by the party's Central Committee, would be submitted to the legislature.

Exports clearly are not considered a main driver for China's 2023 growth.

This speech lays out the ways in which Xi intends to draw all private business into the central planning system for the economy as a whole. It also explains the intention to bring advances in technology into that same central planning system. Thus, Xi is now revealing that his earlier calls for closer coordination of public and private economic efforts will be undertaken in line with the long preferred centralization of the entire economy favored by his party ideologist, Wang Huning.

There are great risks implicit in this drive for centralization. The experience of the Soviet Union with centralization was that adaptation and innovation became suppressed as staying within the scope of central directives was essential. Deviations were penalized, or even treated as a threat to political harmony. In light of recent spontaneous objections across China, it would appear that the people of China will work against all forms of coercion with which they feel uncomfortable, working around centralized directives simply by showing disrespect and ignoring them.

The Soviet Union found its centralized economic plan was simply too big to manage, that the system reached criticality, and it simply broke down. ◆