

## China is no 1990s Japan - but it could have been

Talk of deflation for China is well wide of the mark, and obsessing over historical growth rates misses the point that 5% growth is sustainable and about the right pace of growth for an economy of China's stage of development



### 5% growth from China - get used to it

China will probably grow by about 5% this year. And for those for whom GDP growth is the only goal worth pursuing (it really isn't) this sounds nothing short of disastrous. There have even been some media articles questioning whether China is entering a phase of stagnation similar to that experienced by Japan in the 1990s after its bubble burst. This has been spurred by Chinese CPI inflation figures that are hovering at around zero. The D-word (deflation) is being brushed off.

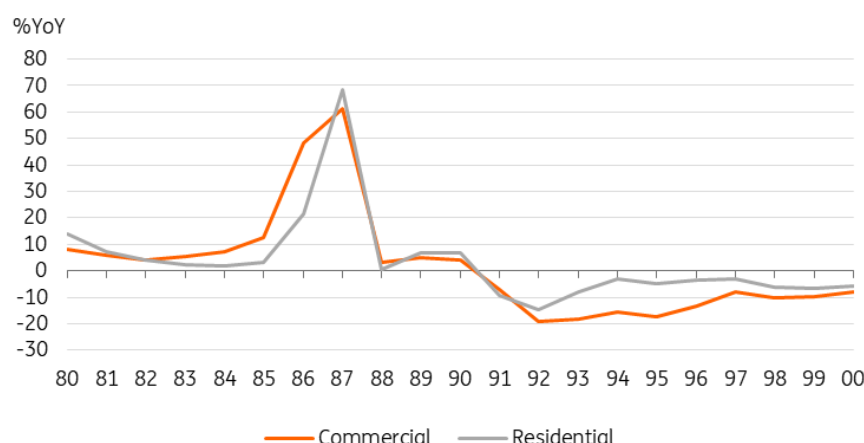
But let us be very clear, China is not on the brink of deflation, and the situation between Japan in 1990 and China today is very different. Indeed, there is a strong argument to support a slower, less debt-fuelled and in all senses more sustainable rate of Chinese economic growth over the coming years, than to provide an artificial jolt of stimulus, after which, will come the inevitable question..."What do we do when that stimulus runs out?"

Japan's answer was to do it again, only larger, and then again, and again. And that is why today, they have a government debt-to-GDP ratio of around 263%. For all the talk of stimulus plans that fills the newswires each week, there is nothing wrong with China sticking to its current path.

## Recap of Japan's bubble and subsequent burst

Let's start with a recap of the Japan bubble. The received wisdom today is that this followed a period of over-accommodative monetary policy by the Bank of Japan (BoJ) following the Plaza Accord, after which the yen rallied, prompting the BoJ to keep rates much lower than they would otherwise have done, and which in turn, fed an aggressive property boom and then eventual bust.

## Tokyo land prices 1980-2000

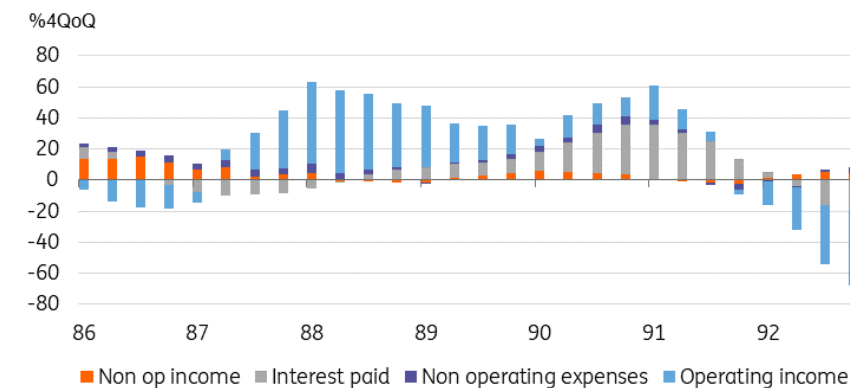


Source: CEIC, ING

## Much of the wealth created was illusory

That boom created a lot of paper wealth, in which corporates appeared to be making large profits, often just based on unrealised property gains or stock market investments while their operating profits actually dwindled. Banks got sucked into this, financing projects whose main criteria for success was often just the underlying land price or cross-shareholding exposures. And when eventually, the BoJ started to respond to what it perceived as threatening inflation, it popped what had evidently become a massive financial bubble which encompassed not just the property market (real assets) but financial assets and the banking system too.

## Contribution to profits in Japan 1986-1992

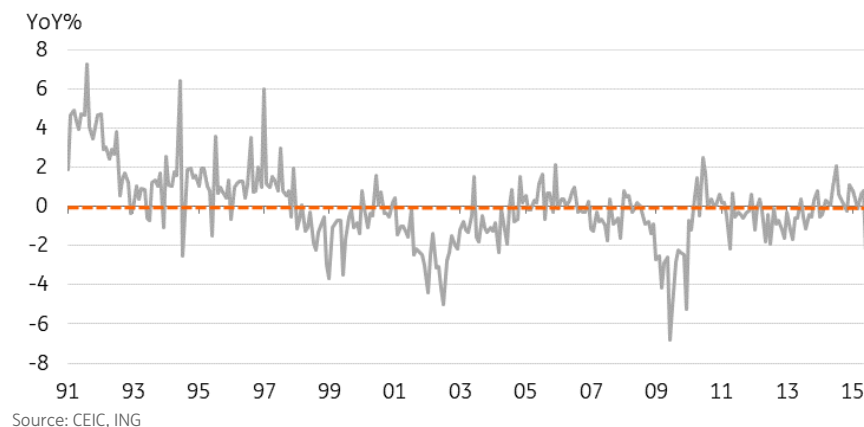


## A burst bubble is a lot worse then slightly weaker growth

The stock market crashed and stayed low. Firms went bankrupt and insolvent banks were merged with larger more solvent ones under the so-called “convoy system” which meant that even previously healthy institutions were hobbled. The pain was lessened, but it was more widely distributed. Biting the bullet on bad loans and pulling the plug on zombie companies took a very long time which also prolonged the stagnation and delayed the eventual recovery.

The economy of course contracted and remained stagnant for years. Consumer price inflation turned negative and even nominal wages declined. It has taken decades for the economy to pull itself out of the mire that this bubble created, though it appears to be doing so now.

## Nominal wages growth 1991-2015



## Would we spot a bubble forming this time round?

Looking back on it, the causes of the bubble and its subsequent crash are not as obvious as the convenient explanation I have just provided. Policy rates were not all that low relative to inflation, and the appreciation of the JPY following the Plaza Accord should have provided a substantial degree of financial tightening too. Broad money growth also was not so obviously out of control, at least relative to previous decades. It is hard to say we would definitely avoid doing something similar again now, even with the benefit of hindsight.

That said, there is no arguing with the carnage that followed. Japan suffered a textbook case of genuine deflation – a term that is often misused, experiencing widespread and deep declines in the general price level, by which we mean not just consumer prices, but real assets, financial assets, and nominal wages.

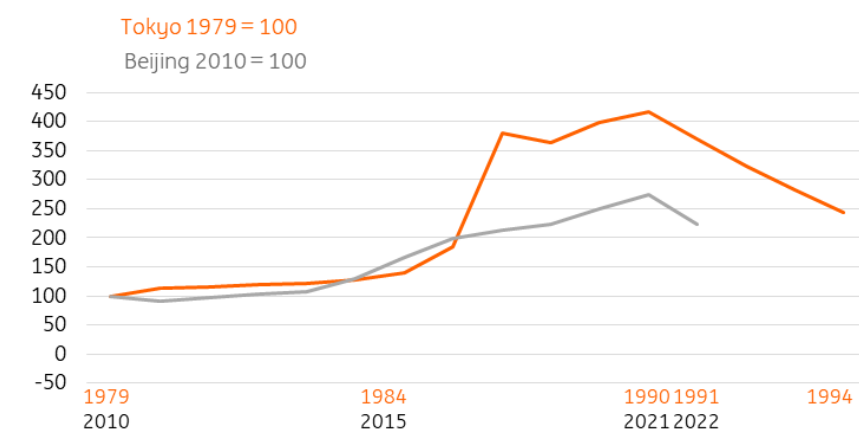
## Is there any sign of something similar in China?

So let's take a look at what is happening in China and pick apart the deflation argument. Firstly, let's look for evidence of a bubble because if we are going to argue that it is about to burst, it needs to be there in the first place.

In 1984, land prices for commercial property in Tokyo grew at a respectable 7.2% annual pace. The following year, this accelerated to 12.5%, and the year after that, to 48.2%. By 1987, commercial property land prices were rising at a 61.1% YoY pace. It was once suggested that the 1.5 square kilometres of land surrounding the Imperial Palace in Tokyo, were worth more than all the land in California. And whether or not that calculation stacks up (it sounds highly questionable), it shows just how extreme things had become.

Yes, Japan had a bubble. If we use similar land price data for Beijing for both residential and commercial property, then there are certainly periods when prices accelerate sharply. The most recent period where this happened was between 2014 and 2017 when residential property prices accelerated at about a 20% annual pace. But it has slowed since and is showing small declines now.

## Tokyo vs Beijing residential property prices



Source: CEIC, ING

## No bubble, no bust

What is missing from the chart above is the sort of exponential growth that typically characterises a bubble, after which there is then a catastrophic drop as participants realise that the “Emperor” has no clothes after all. China has had occasional and short-lived periods of excessive property price growth in the past, that is all. What follows is likely to be a period of much slower property price growth or even some slight declines. From an aggregate point of view, that is neither particularly worrying nor all that undesirable.

Turning now to the equity markets. If we superimpose the recent price developments of the

Shanghai composite index onto the Tokyo stock exchange in the period running up to the bubble, what we see is that China's stock market has for some time been extremely average. There is no sense at all here of an excessive surge that requires a long period of dismal performance to compensate. That's not to suggest a particularly bright future for Chinese stocks, but it beats a Japan-style collapse.

## China's stock market performance has been moribund



Source: CEIC, ING

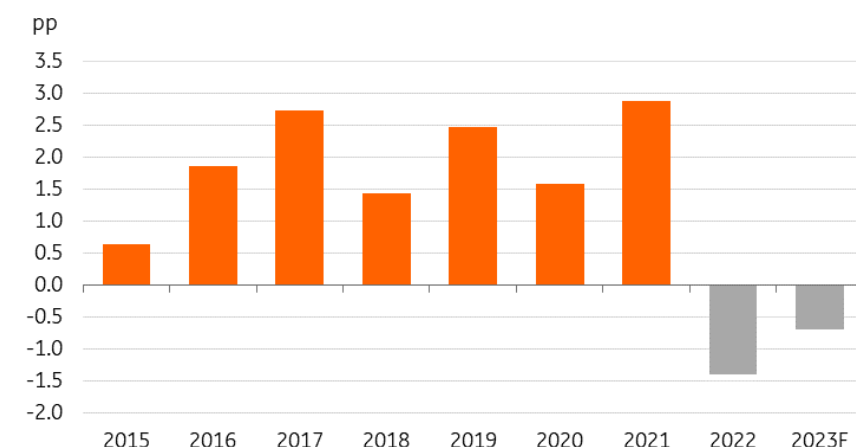
## Growth will be slower, but more sustainable without a construction boom

Ruling out a deflationary collapse is clearly a positive standpoint. But we also don't see Chinese growth at much more than 5% over the coming few years. And we have a tough time explaining to people why this is actually a perfectly reasonable growth rate which doesn't require a panicked response. But here goes...

In previous years, China's GDP growth had taken a disproportionate boost from property development. Not only does construction provide a substantial direct boost to activity and labour demand, but it also requires a lot of inputs from industry: cement, steel, copper, aluminium, PVC etc. That also provides a big boost to things like energy demand. And new property sales also require furnishings, and that in turn pushes up this aspect of retail spending.

But the amount of growth that construction was delivering to the economy had grown to totally unsustainable levels. In some years, in nominal terms, construction contributed up to almost three percentage points of total GDP growth, often about a third of the total.

## Contribution to Chinese nominal GDP growth from construction



Source: CEIC, ING

## Disaster potentially averted...

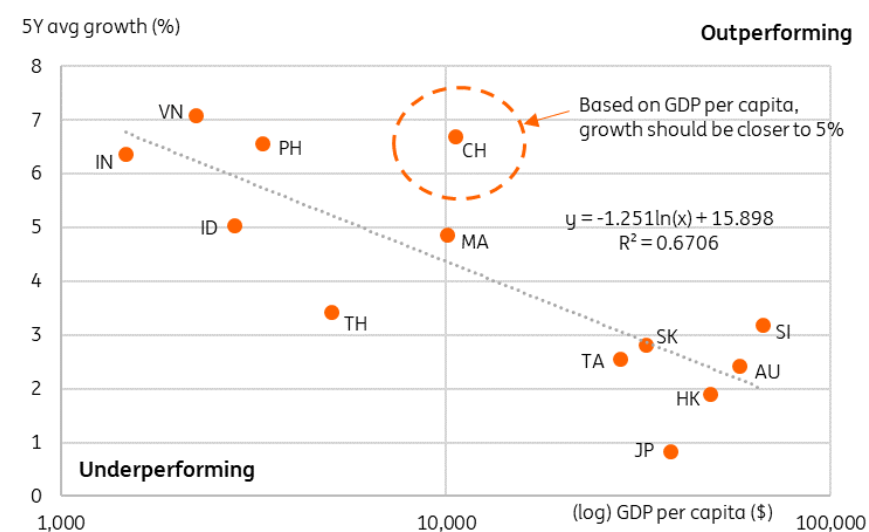
To try to highlight how anomalous this was, if you look at average Asian GDP growth rates pre-Covid relative to GDP per capita, China was a huge outlier, growing several percentage points faster than you would expect for an economy of its state of development. And that deviation can be largely put down to growth generated by excessive construction activity. This was essentially construction-driven GDP “bought” with debt and ultimately, unsustainable.

Maintaining this sector at pre-Covid growth rates could have ended up in disaster. Maybe a Japan-style disaster. What the Chinese authorities have done, quite sensibly, is to nip this in the bud before this happens, though this of course is going to mean reversion to slower (more sustainable) growth rates that are more in line with an economy of China’s stage of economic development.

The property development sector is currently being kept on life support – allowed just enough access to credit to finish the vast stock of unfinished properties which they have sold in advance to a quite understandably nervous household sector. It is unlikely that they will embark on much in the way of new investment until this process is complete. And it is also not clear that Chinese household’s love for property as an investment asset will rapidly, or fully recover after this experience.

So if we can no longer rely on construction to power the economy ahead, then growth will likely average something closer to 5% than the 6-8% China averaged pre-Covid. And in our view, that is surely superior to faster debt-fuelled property-led growth for a few years, followed by a Japan-style collapse. Because while China’s current situation is far from that of Japan in 1990, that is not to say that that future could not have happened if things had run on unchecked as before.

## GDP per capita and average GDP growth rates for Asia



Source: CEIC, ING

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