Talking point

China: Will China follow Japan?

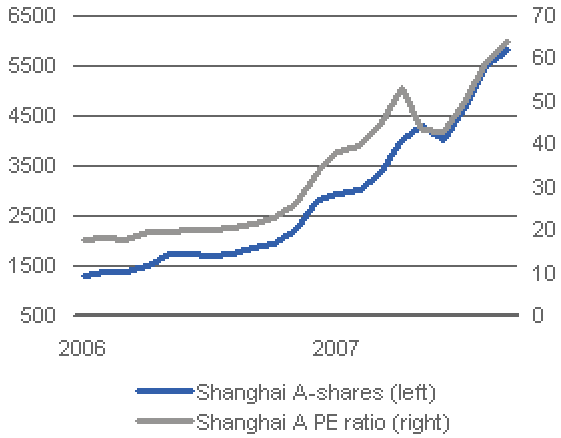
November 26, 2007

Striking parallels between China today and Japan in the late 1980s suggest China faces the risk of a Japan-style downturn. China's top policymakers seem aware of the potential pitfalls, which explains their gradualism in implementing reforms. In our baseline scenario, they will succeed in engineering a soft landing. The risk of a sharp correction in China's asset markets when the economy slows down should not be overlooked, but it should not necessarily lead to a prolonged and deep economic recession as in Japan during the 1990s.

Striking parallels between China today and Japan in the late 1980s

- **Strong loan growth**. In both countries, bank loans were/are growing faster than nominal GDP growth. In addition, lending decisions were/are not always based on creditworthiness considerations. Although there has been a reduction in state-directed bank lending in China, legacy loans are still substantial. As in China today, strong loan growth to the real-estate and construction sectors was also observed in Japan in the late 1980s.
- **Low/negative interest rates** provide a big incentive for borrowing and lending/investing and a disincentive for saving, giving rise to more liquidity to fuel the growth of asset bubbles.
- **Frothy asset prices**. China's Shanghai A shares were trading at 69 times and Shenzhen A shares at 72 times price/earnings (P/E) at end-October 2007. The P/E of Japanese equities in 1990 was 50 times. For comparison, the S&P 500 P/E is around 16 times. Also, Japan's real estate prices rose 150% between mid-1986 and mid-1991. China's real estate prices rose 49% (nationwide) and 61% (Shanghai) from mid-1998 to mid-2007.
- **Undervalued exchange rate, massive external account surplus and rapid accumulation of foreign reserves.** The strong surplus in the external accounts should normally lead to currency appreciation. As the authorities resist it, FX intervention injects liquidity into the financial system, some of which ends up feeding into the asset bubbles.
- **Excessive rate of fixed investment**. This is a consequence of heavy lending and high asset prices. The share of investment to GDP in Japan was 31% in 1988-1990 (18.9% in the US); it was 42% in China in 2006.
- **Low core CPI**. This can be seen as a consequence of massive capacity expansion.

The amazing rise of Shanghai A share index & PE ratio



Source: CEIC data

But there are also differences

While the imbalances in China are reminiscent of those in Japan in the late 1980s, there are some fundamental differences that are worth highlighting as they may influence the type of "landing" that China may have.

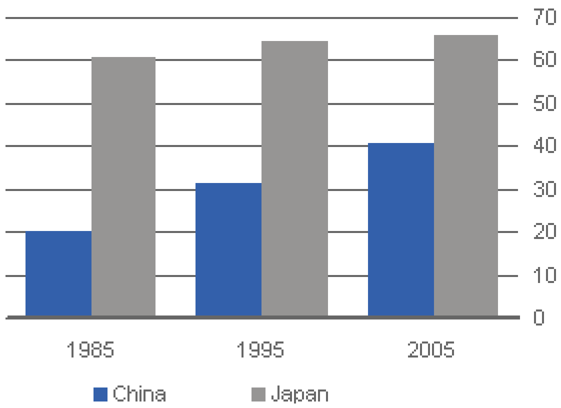
- **China is a much larger country** in terms of physical and population size and, importantly, it has higher long-term GDP growth potential.
- **The Chinese economy remains largely protected from sharp swings in portfolio investments, which reduces the risk of volatility from global financial markets.** Although the Japanese collapse in demand was largely a domestic problem, triggered by a domestic factor (as opposed to the 1997 Asian financial crisis, which was triggered by outflows of foreign hot money), the relatively sheltered nature of the Chinese economy makes it easier for that government to influence domestic market psychology. Moreover, China has capital controls while Japan did not.

- **Larger disparity in China's urban-rural divide gives room for reallocation of resources.** This gives the Chinese authorities more scope to smooth GDP growth, i.e. by steering resources away from the overheated sectors/areas to deficit sectors/areas, thus potentially reducing the risk of a hard landing.
- **Large FDI and JV presence in China mitigates risks**. China has absorbed massive FDI inflows (cumulative utilised FDI since 1992 totals roughly USD 700 bn), thus foreign direct investors & joint-venture (JV) partners are stakeholders in the Chinese economy, mitigating the risk that they would desert China easily during a downturn. Japan's manufacturing sector was much more closed compared with China's today.

Why China may avoid a Japan-style downturn

Large untapped potential in in the rural sector in China

Urban population, % of total



Source: UN

A valuable lesson learned from Japan is that imbalances cannot be corrected by macroeconomic measures alone. These must be accompanied by microeconomic reforms. In China, the fact that microeconomic reforms are being implemented for some time now gives the country a chance to avoid a Japan-style downturn. At the macroeconomic level, monetary tightening policies will continue in order to reduce money supply growth. This may not be effective, though, if the RMB appreciation pressures continue to be resisted. Furthermore, administrative measures (investment and lending rules, land and tax measures) will be employed to discourage investment in sectors with overcapacity. At the microeconomic level, restructuring has begun in the banking sector and in key state-owned enterprises, with a view to making their business models more commercially-driven and in line with international practice. Greater recognition of the role of private enterprises and their contribution to economic growth as well as a more open environment for foreign competition are likely to increase efficiency and boost productivity.

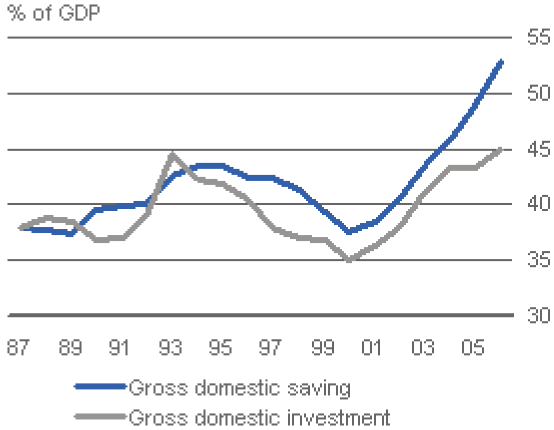
Success depends on a reallocation of resources to revitalise China's heartland. President Hu Jintao's speech at the CCP's Congress in October laid out the game plan to rebalance the economy away from investment toward private consumption. As part of an urbanisation policy, the vision is to develop key cities to function as regional growth engines. Among them are Tianjin (near Beijing), Chengdu and Chongqing (in western China). More spending will be allocated to education, healthcare and public housing, especially to help bridge the rural-urban divide. The specific goal is to quadruple the per capita income level of 2000 by the year 2020.

Beware of the pitfalls

Vulnerabilities in China could be heightened by a combination of unfavourable factors. These hypothetically include sharply slower global demand, policy mistakes with regard to the speed and sequence of reform, and a failure to see through reform implementation at the micro- level.

Strong savings provides cushion to domestic liquidity

% of GDP



Source: IIF

Slower global growth could lead Chinese firms to invest less and consumers to reduce spending. An economic slowdown as a result of slowing global demand and continued tightening policies may be relatively mild at first but lead to a rise in NPLs as firms' revenues slow and financing costs rise. There is a risk of a pull-back in lending activities if banks need to cut down on lending in order to meet the capital adequacy requirement of 8%. If credit lines are pulled, this could potentially aggravate the correction in the asset and real estate markets.

Asset markets, in particular the stock market, will not be immune to correction in the future as investors grow more sophisticated and pay more attention to valuations. The correction in the asset markets could also be triggered by an outflow of domestic savings for overseas investment (if and when the door is opened wider). This is why the Chinese authorities have proceeded very cautiously in liberalising the capital account. They still need the large domestic savings pool to fund domestic investments, recapitalise banks and plug the unfunded pension liabilities gap.

China should still beckon

Nevertheless, a sharp correction in the asset markets will not necessarily lead to a prolonged and deep economic recession as in Japan. The Chinese have been more pro-active than their Japanese counterparts in implementing corporate and banking sector reform, although the process is far from over. Their cautious and gradual reform approach seems appropriate as, on average, risk management capacities are not yet up to speed. Overall, China's attractive long-term potential and its large market size still make a compelling case for investors.

Syetarn Hansakul (+65) 6423 8057

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