ECONOMIC VIEWPOINT

What Would Be the Implications If China Were to Japanify?

By Marc-Antoine Dumont, Economist, Francis Généreux, Principal Economist, and Randall Bartlett, Senior Director of Canadian Economics

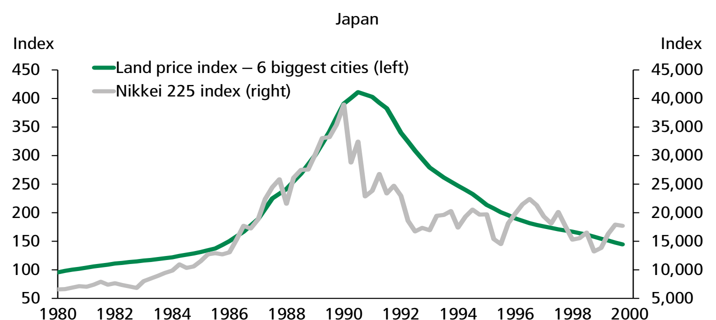
The bursting of Japan's property and financial bubble in the early '90s was major news, and the economic fallout that followed was long-lasting. It's now referred to as Japan's "Lost Decade", characterized by long-term economic stagnation and persistent deflation. From time to time, different countries have demonstrated certain similarities to '90s Japan, like the United States after the 2008–2009 financial crisis. And now it looks like it's China's turn. In this note, we take the comparison a little further and project key economic indicators for China along the same trajectories as they followed in Japan starting 30 years ago. We then determine what the consequences would be for Chinese economic growth and how that would impact the world's—and Canada's—economy.

Japan's Lost Decade

There were many reasons why Japan started running into economic problems in the late '80s and early '90s. But the biggest trigger was undoubtedly when the multi-year bubble in its property and financial sectors finally burst. That bubble had, in turn, been inflated by multiple factors such as overly expansionary monetary and fiscal policies, and financial sector deregulation, which stimulated speculation and risk appetite. The Japanese real estate market skyrocketed, with land values in Japan's six largest cities more than tripling between the start of 1985 and the 1990 peak. The stock market also soared as easy credit drove up the price of the Nikkei index, which jumped 225% from early 1985 to early 1990 (graph 1)

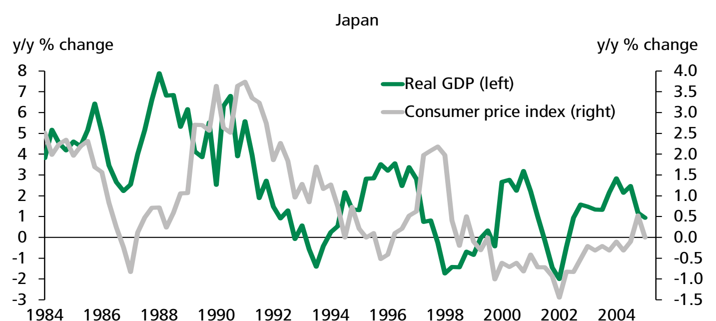
But the euphoria eventually faded. The Bank of Japan belatedly started tightening its monetary policy in the summer of 1989, which sent the stock market spiralling more than 40% in 1990. The value of real estate, and of related loans, tipped into a long slump that destabilized bank balance sheets. Business and consumer confidence, as well as economic activity, followed the same downward trajectory, kickstarting a vicious cycle where the economic slump and slower population growth worsened expectations for future growth. Despite interest rate cuts and government efforts, which were often seen as insufficient, the economic malaise lasted many years. Banks' reluctance to grant credit after suffering heavy losses from non-performing loans, a lack of private investment and the behaviour of consumers who would rather save than spend were largely to blame. This liquidity trap led to a period of disinflation and even deflation (graph 2) known as Japan's "Lost Decade". Following the initial

GRAPH 1
The Bursting of Japan's Financial and Real Estate Bubble Triggered a Lost Decade



Sources: Japan Real Estate Institute, Datastream and Desjardins Economic Studies

GRAPH 2
The Japanese Financial Crisis Led to Much Slower Economic Growth and Deflation



Sources: Datastream and Desjardins Economic Studies

NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.
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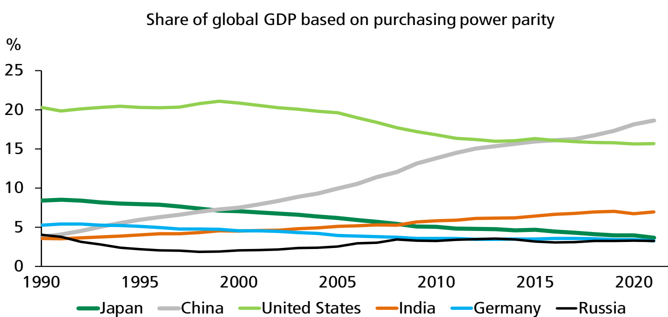
financial and economic crisis, it was characterized by stagnating growth, a long slide in housing starts and home prices, and rising unemployment, which was not the norm for Japanese workers.

Japan's economic funk was exacerbated by unfavourable demographics that dimmed hopes for a housing market recovery. The country's aging population and slowdown in demographic growth, which turned into outright population decline in the 2000s, also resulted in a re-evaluation of the country's long-term economic trajectory.

Parallels with the Japanese Crisis: What Does Economic Japanification Mean?

The hardships of the Lost Decade and emergence of more robust competitors such as China pushed Japan down the ranks of the world's major economies. If we compare GDP based on purchasing power parity, Japan is currently in fourth place, behind China, the United States and India. At the end of the '90s, however, it was in the second spot, behind only the US (graph 3). Since then, Japan's decline has served as a cautionary tale for other economies that offers lessons whenever financial bubbles burst around the world.

GRAPH 3
Japan's Share of Global GDP Fell Sharply



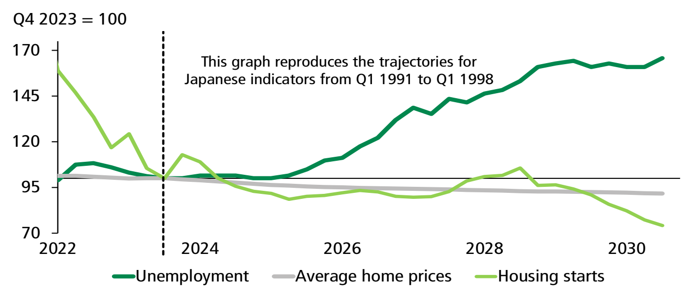
Sources: World Bank and Desjardins Economic Studies

Analogies with other countries have often been drawn. This happened with the United States on more than one occasion—when the dotcom bubble burst in 2000 and again when the 2008–2009 financial crisis hit. In the second case, especially, the parallels were easy to see. First, both crises were caused by the same factors: easy credit after financial deregulation, excessively loose monetary and fiscal policy, a real estate bubble and a big run-up in the price of financial assets. The immediate repercussions were also the same: real estate and stock prices nosedived, confidence plummeted, unemployment and savings rates soared, and the fear of deflation ran rampant. The main difference was the speedier response of the US government and the Federal Reserve. Their quick actions helped prevent, to a certain extent, another lost decade, yet Japan was still frequently cited as an example during the subprime crisis and in subsequent years. The situation in Europe after the 2008–09 recession and the sovereign debt crisis that soon followed also bore certain similarities with 1990s' Japan.

What Would Japanification Do to China?

China's current situation is similar in many ways to Japan in the '90s. The stalling of the Chinese property market after Evergrande defaulted in 2021 could be considered to be the start of Japanification in China. The question then arises as to what would be the consequences and implications of such a scenario would be. To answer this question, our analytical framework uses three Chinese indicators—home prices, housing starts and unemployment—and puts them on the same trajectory as their Japanese equivalents back in the '90s (graph 4). Keep in mind that we've deliberately left the financial sector out of this analysis due to the opacity and lack of reliability of Chinese financial data. But the property crisis is just one part of this scenario. The country's aging population must be also be considered to capture the natural atrophy of demand.

GRAPH 4
In a Japanification Scenario, China's Unemployment Rate Would Rise from 3.4% to 5.7%

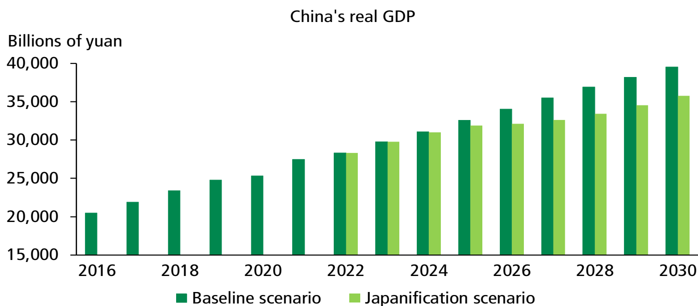


Sources: National Bureau of Statistics of China, Datastream and Desjardins Economic Studies

China's Japanification would reduce the level of real GDP in 2030 by 10% compared to our baseline scenario (graph 5 on page 3). The reason for such a big drop is the size of the construction industry, which represents around 25% of the nation's economic activity once indirect effects are factored in. Consequently, a steep slide in home prices and housing starts would cause the construction sector to contract, taking a big bite out of domestic demand and driving up unemployment. The downturn would spill over into services and consumer spending, amplifying job losses. However, industrial production would avoid some of the repercussions since it mainly depends on foreign demand, which is dictated by the global economic outlook.

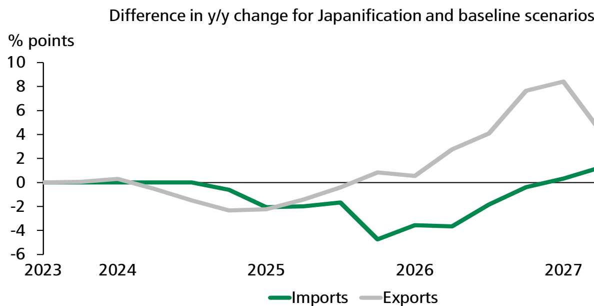
Japanification would affect each side of China's trade balance differently. Chinese imports depend on manufacturing, construction and consumer spending. A pullback in imports would mostly be driven by the correction in the property market. At its most extreme, the year-on-year decline in imports would be 4.9 percentage points below the baseline non-Japanification scenario (graph 6 on page 3). The price of commodities would

GRAPH 5
China's Japanification Would Lower 2030 Real GDP by 10%



Sources: National Bureau of Statistics of China, Datastream and Desjardins Economic Studies

GRAPH 6
A Slowdown in Construction Activity Would Drive Down Imports



Sources: National Bureau of Statistics of China, Datastream and Desjardins Economic Studies

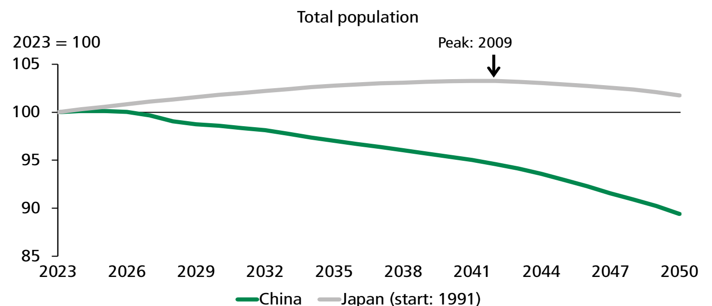
also be impacted, especially oil and metal prices, since the commodities boom has mostly been fuelled by China's breakneck development in recent decades. As for exports, our analytical framework shows that industrial production could quickly bounce back after the initial slump and offset some of the negative repercussions of faltering domestic demand. That's why exports could actually ramp up in a Japanification scenario. This wouldn't necessarily involve higher export volumes. Instead, it might be the result of increasing the added value of exports, just as Japan's manufacturers did when they shifted to high-tech sectors in the '90s. But a rebound in industrial production is a big assumption that will be relaxed in the next section.

China Is in an Even Trickier Situation than Japan

Despite the many similarities between '90s Japan and China today, there are some key differences. First, Japan's crisis hit during a period of global geopolitical stability after the end of the Cold War. This made it possible for the Japanese government to focus its resources on the country's various economic problems. Second, China might be viewed as more of a direct competitor of the United States, rather than an ally. In contrast, the US played a role in helping Japan's economy recover in the '90s. Finally, and this is related to the other two differences, Japan had broad access to the North American market, which helped its economy regain its footing. Even though China is the US's biggest trading partner, its situation is very different. The trade barriers between the world's two biggest economies have multiplied in recent years, and there are even strict controls on sharing certain strategic technologies like microchips and artificial intelligence.

Further, as a share of population, Chinese citizens over 65 are on a similar trajectory as the same age group in Japan once we line up the starting point of their respective property crises (2023 and 1991). However, the total population curves are very different. The Japanese economy enjoyed 19 more years of population growth (graph 7), even though the average age rose from 37.4 in 1991 to 43.9 in 2009. Meanwhile, China is expected to have only two more years of growth, which will inevitably affect consumer spending, the property market, the labour market and public revenues, in addition to limiting the government's ability to intervene.

GRAPH 7
When Its Crisis Began, Japan Still Had 19 More Years of Population Growth



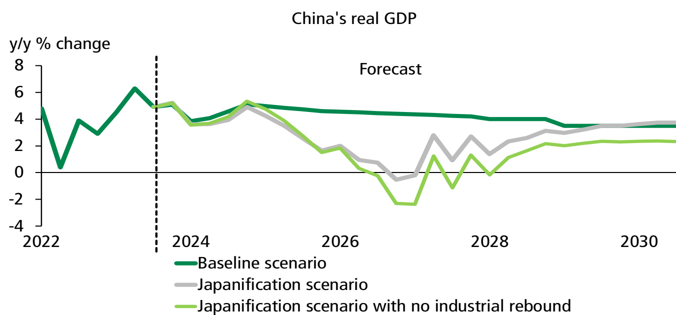
Sources: United Nations and Desjardins Economic Studies

In a Japanification scenario, China would also lose two of its economic engines (construction and consumer spending), which would leave government spending and the manufacturing sector as the main factors fuelling growth. But China doesn't have the same advantages as Japan. In addition to population decline, debt will be another factor limiting the Chinese government's fiscal wiggle room. Even though the central government's debt-to-GDP ratio is only 77%, this figure jumps to 360% once we include local government and private sector debt. Whether or not Japanification occurs, Chinese authorities have to deal with these major structural challenges. But doing so conflicts with short-term growth targets, which sooner or later will have to be set aside to implement the required reforms. This means China may be resistant to the idea of ending its generous stimulus measures. That said, there are some factors that work in its favour. In 1990, Japan's GDP per capita ranked second in the world, right after the United States. But China's GDP per capita is currently ranked 72nd, which means the country is still developing. Consequently, economic modernization may still drive major gains in growth. Another advantage is

that China's authorities have the policy power to make certain unpopular changes like relaxing the system of residence permits to spur consumption. Finally, most of the country's debt is held domestically, which reduces market pressure to tighten its budget.

Moreover, China's formidable manufacturing sector may prove incapable of responding effectively in a crisis. In such a scenario, the year-on-year change in GDP would fall by an additional 1 to 2 percentage points per quarter (graph 8). We should nevertheless keep in mind that our analytical framework doesn't reflect how quickly China's property market could correct. It also overlooks the extent of the volatility that may be observed, especially since the financial sector has been excluded from our analysis. In such a case, China's real GDP could tumble well before 2026, as our Japanification scenario suggests.

GRAPH 8
If Industrial Activity Doesn't Bounce Back, China's Crisis Could Get Even Worse



Sources: National Bureau of Statistics of China, Datastream and Desjardins Economic Studies

Impact on the Global Economy

If China's economy cools considerably as a result of a Japan-style economic crisis, it would definitely have negative repercussions on the global economy. However, as stated in a previous *Economic Viewpoint*, China still has a bigger impact on global supply than it does on demand. Furthermore, the supply chain issues experienced during the pandemic demonstrated how important China is to global output. Even though the impact of changes in Chinese domestic demand aren't negligeable, they aren't as crucial. In fact, a large share of China's imports is used for future exports rather than for domestic consumption or investment. Consequently, assuming that demand in other countries remains relatively unchanged, the Japanification scenario would only have a mildly negative impact on global GDP.

A sharp slowdown in Chinese domestic demand would likely also exert more downward pressure on some prices, especially for commodities. Although energy prices would be weakened, industrial metals would probably fare worst of all since they're closely tied to China's construction industry. Countries that are net importers of commodities would therefore benefit from improved terms of trade, but the revenues of net resource exporters may be harder hit.

Of course, the risks of contagion may turn out to be much more harmful and the repercussions could extend beyond changes in international trade flows in response to a slowing in China's domestic demand. Complex value chains and highly integrated global financial markets have more or less made it impossible to immunize developed countries against economic turmoil in China. That means a major financial crisis in China would create greater uncertainty for the world's economy. This could undermine international financial markets and the net asset values of consumers, businesses and financial institutions. But such effects fall outside the scope of this analysis.

Impact on the Canadian Economy

Canada is likely to feel the impact of a sharp slowdown of China's economy through several channels. The first is its impact on international trade. While 75-80% of Canadian exports go to the US, the impact on the US economy of the potential Japanification of China is expected to be minor. Instead, the roughly 4% of total Canadian exports that goes to China will be more directly affected, primarily through reduced demand for commodities. Indeed, lower commodity prices on falling Chinese demand are expected to hit the Canadian economy more immediately, weighing on profitability, investment and hiring. That's the second channel. The resulting drag on Canadian equity valuations and financial markets is the third channel by which a slowing China will impact Canadians. Together, these channels—trade, commodity prices and financial markets—will lead to slightly lower real GDP and employment growth in Canada (graph 9).

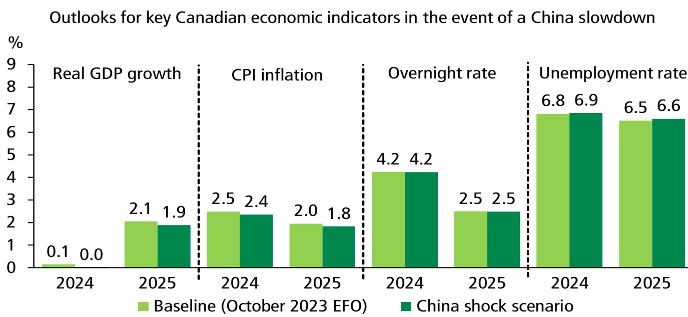
GRAPH 9
Canada's GDP Would Weaken Modestly If China's Economy Slowed Sharply

EFO: Economic and Financial Outlook
Sources: Statistics Canada and Desjardin Economic Studies

Falling commodity prices and lower risk sentiment would also cause the Canadian dollar to depreciate, bringing down export prices but boosting the cost of imports. This will partly but not entirely offset the downward pressure on inflation from more anemic growth and commodity prices (graph 10 on page 5). It will also make the Bank of Canada's job more complicated, as an

external shock with mixed inflationary impacts and only a modest hit to real GDP growth may not be enough to prompt the central bank to cut rates more deeply than currently anticipated. However, if China's predicament were to reveal key vulnerabilities in the global financial system, central banks (including the BoC) may feel the need to respond using a range of policy tools.

GRAPH 10
Economic Weakness in Canada May Not Be Enough to Prompt Addition Rate Cuts



EFO: Economic and Financial Outlook
Sources: Statistics Canada, Bank of Canada and Desjardin Economic Studies

Conclusion

The situation in China today bears many similarities to Japan in the early 1990s. If these persist over the next few years and the country is really starting down the road of Japanification, the impact on its domestic market will be severe. The global—and Canadian—economy would also take a hit, especially when it comes to international trade and commodities. The financial repercussions, which haven't been analyzed here, could also be a major vector of contagion. That said, the Japanification of China is by no means certain. And even though there are striking similarities between the two countries, China could still manage to steer its economy toward a more positive outcome.