Regional Analysis China

China | Will China enter into "Japanization" and "balance sheet recession"?

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The Chinese economy has achieved remarkable growth over the past few decades, often referred to as the "China Miracle." This growth can be attributed to the implementation of the reform-and-opening-up policy in 1978 and China's entry into the World Trade Organization (WTO) in 2001, together with a series of structural reforms.

China's ranking in the global economy has significantly improved, with its GDP rising from the 9th position in 1982 (USD 158.6 billion) to the world's second-largest economy since 2011 (USD 6.43 trillion in 2011). Since then, China has consistently maintained its position as the second-largest economy in the world, following the United States as the largest. As of 2022, China's GDP in USD terms reached USD 18.1 trillion, approximately 70% of the US aggregate GDP of USD 25.47 trillion.

Over the past decades, China has frequently achieved double-digit GDP growth rates, contributing to its impressive economic performance (Figure 1). The consensus among forecasts is that China will surpass the US aggregate GDP and become the world's largest economy before 2035. Additionally, when comparing GDP based on purchasing power parity (PPP), which adjusts for living costs domestically and is widely used to compare economic productivity and standards of living between countries, China already surpassed the US in 2022 (Figure 2).

Despite of the promising aggregate GDP figures, China's GDP per capita remains relatively low. In 2022, China's GDP per capita was USD 12,813, ranking 72nd in the world. Particularly, China's gross national income (GNI) per capita was USD 12,850, which falls slightly below the World Bank's GNI threshold for a "high-income country" (USD 13,845 in 2022). Therefore, a significant challenge for China lies in overcoming the "middle-income trap" and transitioning into a "high-income" economy going forward.

China's economic slowdown in recent years, particularly during the post-pandemic period, has garnered global attention, marking a shift from its previous "Great Miracle" status to "Great Moderation". Following the reopening of its economy after a three-year "zero Covid" policy, China has experienced a real estate crash, a dip in growth rate, and a deflationary environment amidst low interest rates. These developments have raised concerns in the market about the possibility of China entering a phase of "Japanization" and a "balance sheet recession".

Notably, in August 2023, China's economic indicators, both on the demand and supply side, fell below market consensus and previous readings. The declining housing prices and stock market have also had an adverse impact on the balance sheets of enterprises and households.

China's current economic situation during the post-pandemic period prompts a reflection on Japan's experience in the 1990s, following the burst of the stock and housing market bubble, which was followed by the so-called "lost 30 years" of the Japanese economy. The current combination of "low inflation, low growth, and low interest rates" in China bears resemblance to the environment seen in Japan during the 1990s.

In addition to the concerns mentioned earlier, the market has also raised questions about China's long-term growth outlook, including the growth model and the engine that Chinese authorities will adopt to propel the country towards becoming a "high-income" economy and overcome the "mid-income" trap in the future. The Chinese economy faces various long-term challenges, such as the sustainability of its debt, particularly local government and corporate debt, the need for structural reforms across different sectors, and geopolitical risks, with the China-US relationship being a chief concern.

This report aims to address the questions and concerns of global investors by conducting economic analysis on Chinese economy in the short term and long term. Specifically, it seeks to answer the following four important questions:

1. What is the intrinsic meaning of "Japanization" and "balance sheet recession"?

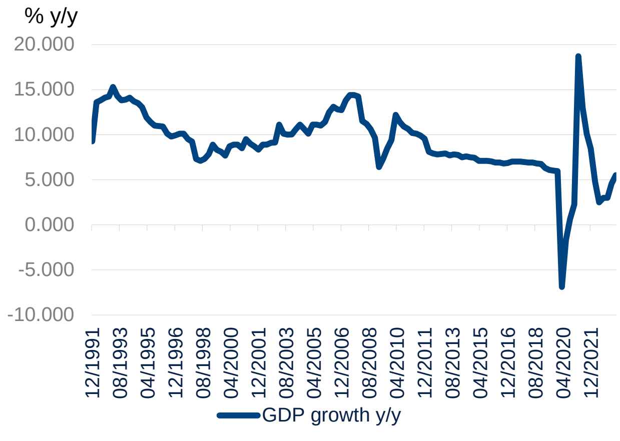
2. Will the theories of "Japanization" and "balance sheet recession" also apply to the Chinese economy?

3. What are the fundamental economic differences between China and Japan?

4. Assuming China is not entering a phase of "Japanization" or "balance sheet recession," what will be China's long-term "new growth model" to tackle the country's long-term challenges and overcome the "mid-income" trap?

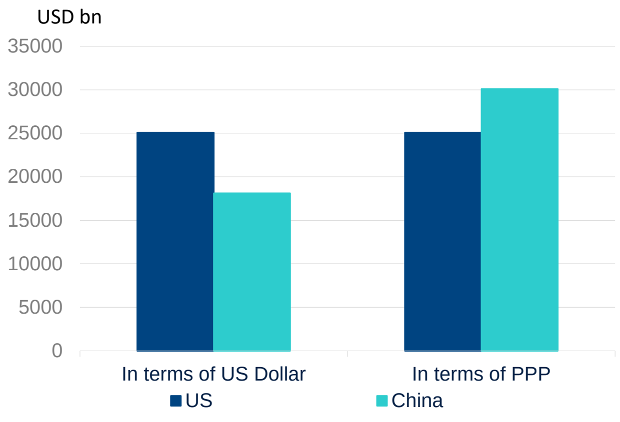
Based on these questions, the report aims to identify the fundamental differences and similarities between China and Japan, highlighting key distinctions to conclude that China will not experience "Japanization" or a "balance sheet recession." Furthermore, it seeks to summarize China's new growth model, which authorities are attempting to adopt for long-term industrial upgrading and structural transformation. The report also provides additional policy suggestions for avoiding the "mid-income trap" in the long term.

Figure 1. **FOR MOST YEARS IN PAST DECADES, CHINA MAINTAINED DOUBLE-DIGIT GROWTH**



Source: CEIC and BBVA Research

Figure 2. **CHINA VS. US GDP IN TERMS OF BOTH USD AND PPP in 2022**



Source: BBVA Research and CEIC

Revisit the definition of “Japanization” and “balance sheet recession”

The term "balance sheet recession," coined by Japanese-American economist Richard C. Koo, refers to an economic recession caused by high levels of private sector debt. During this type of recession, households and businesses prioritize debt reduction over spending or investing, resulting in a decline in economic growth. This phenomenon typically occurs after the bursting of an asset bubble. Japan's recession since the 1990s serves as a prominent example of a balance sheet recession.

In a “balance sheet recession”, the objective of businesses shifts from profit maximization to debt minimization. Monetary policy becomes ineffective in this situation, regardless of how low interest rates may be, as households and businesses are reluctant to take on further debt. This resembles the concept of a "liquidity trap" in Keynesian economics. In such circumstance, fiscal policy, instead of monetary policy, becomes the key tool for stimulating the economy by increasing government expenditure to generate additional demand.

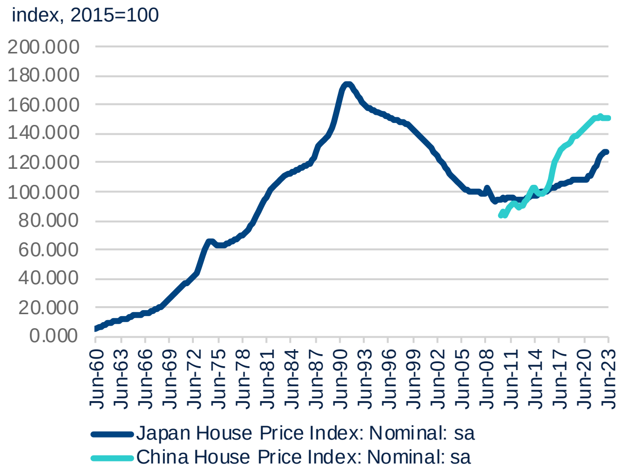
On the other hand, "Japanization" refers to a sustained period of stagnant economic growth and price deflation in an economy, drawing parallels to the challenges that have plagued Japan since the early 1990s.

However, the economic situation in current China and 1990s Japan have many fundamental differences…

First, in "balance sheet recession", a large-scale burst of an asset bubble is typically the trigger that causes enterprises and households with significant exposure to these assets to shift their focus from spending or investing to saving and debt reduction**. Japan experienced such a scenario in the 1990s due to the real estate and stock market crash. However, Chinese authorities have a better chance of containing the adverse impact of a housing bubble burst on the economy and financial system.**

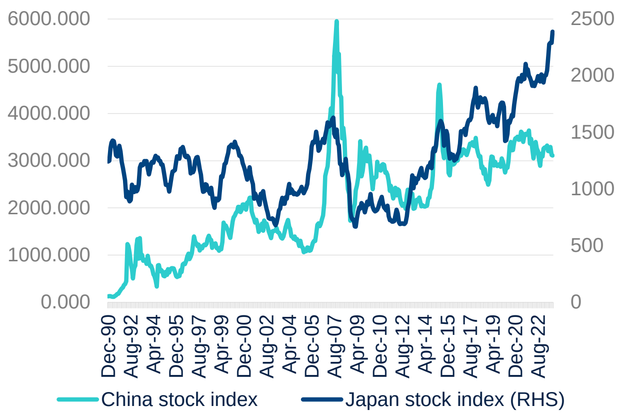
Unlike Japan, Chinese authorities have been proactive in recognizing and preparing for the risks associated with a housing bubble. Drawing lessons from Japan's experience in the 1990s and the United States in the 2000s, they implemented various measures to curb real estate bubbles before they could reach a bursting point. These measures include restrictions on direct purchases, higher minimum down payment requirements, and caps on housing prices for new homes in overheating areas (as depicted in Figure 3 and 4).

Figure 3. **UNLIKE JAPAN IN 1990S, CHINA’S HOUSING PRICE LEVEL (NOT %) NEVER DIPPED**



Source: CEIC and BBVA Research

Figure 4. **CHINA’S STOCK INDEX CURRENTLY NOT EXPERIENCED JAPAN’S DIP BACK TO 1990S**

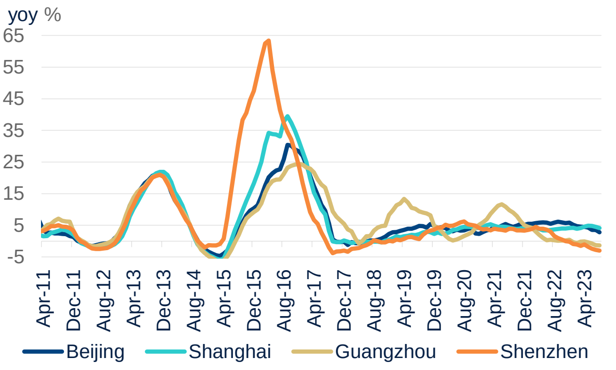


Source: BBVA Research and CEIC

These tightening measures not only helped to mitigate associated risks but also provided policy flexibility when the housing bubbles began to deflate. For instance, setting the minimum down payment requirement for homebuyers at 30% reduced banks' exposure to the housing market through mortgage loans. Moreover, higher down payment ratios allowed households to better withstand shocks resulting from housing price fluctuations.

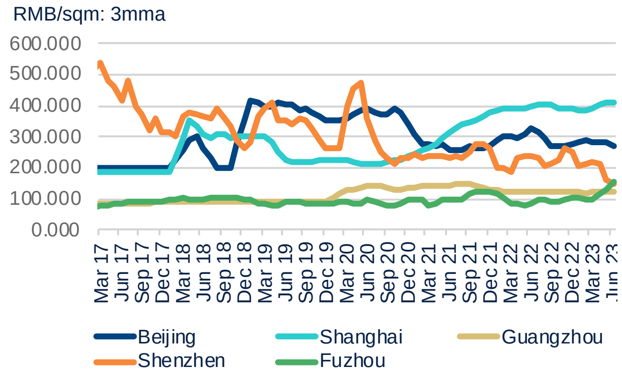
Furthermore, there are notable differences in the structure of housing price drops between China's current situation and Japan in the 1990s. In Japan, the decline in housing prices primarily affected large metropolitan cities, with land and industrial real estate experiencing more significant drops compared to residential housing prices. On the other hand, China's price drop has been concentrated in tier-3 and tier-4 cities, with residential real estate experiencing a more substantial decline than commercial real estate.

Figure 5. **YEAR-ON-YEAR GROWTH OF HOUSING PRICE IN LARGE CITIES DID NOT EXPERIENCE LARGE DROP CURRENTLY**



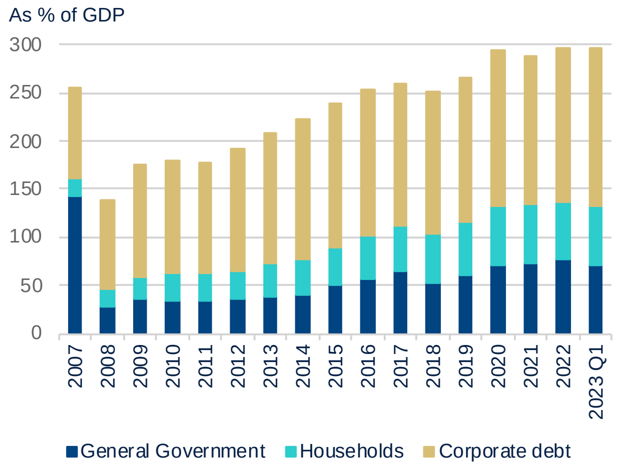
Source: CEIC and BBVA Research

Figure 6. **THE INCREASING RENT PRICE IN TIER 1 AND 2 CITIES ARE QUITE ROBUST, INDICATING RESILIENT DEMAND IN BIG CITIES**



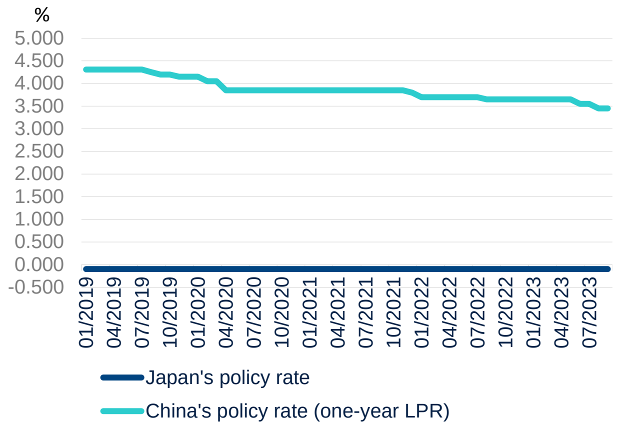
Source: BBVA Research and CEIC

Figure 7. **CHINA'S CORPORATE LEVERAGE RATIO HAS BEEN STEADILY INCREASING WITHOUT "PROACTIVE DELEVERAGING"**



Source: CEIC and BBVA Research

Figure 8. **CHINA HAS NEVER CONDUCTED QE-LIKE (OR ZERO INTEREST RATE) MONETARY EASING POLICY**



Source: BBVA Research and CEIC

Additionally, the overall impact of the real estate sector on the respective economies differs significantly. China's real estate market value currently stands at around 260% of GDP. In contrast, during Japan's 1990s recession, the total market value of housing reached 560% of GDP, indicating a much larger influence of the real estate sector on the Japanese economy at the time. Furthermore, China's stock market's total market value is approximately 67% of its GDP, significantly lower than the 142% seen in Japan during the 1990s. These figures highlight the disparities in the relative importance of the real estate and stock market sectors between the two countries.

Despite concerns in the market regarding China's current property market crash, the primary issue stems from the supply side rather than the demand side. The crash is predominantly driven by the high-leverage business model of housing developers, leading to increased default risks. This situation can be attributed to policy-driven factors, particularly the housing regulatory measures implemented since 2021. (Figure 5)

However, there is still considerable policy space available to facilitate a rebound in the housing market. Chinese authorities have already implemented some measures to address the situation, such as reducing existing housing mortgage rates, cutting interest rates, and easing restrictions on housing purchases. Moving forward, it is advisable for the authorities to further relax housing purchase regulations in mainland China. This is crucial because there is still significant rigid demand and upgrading demand in large cities. (Figure 6) Additionally, allowing foreigners, including residents of Hong Kong, to hold Chinese properties in mainland China could also help stimulate the market. These measures would contribute to the recovery of the housing market by tapping into the existing demand potential.

Second, it is important to note that China has not entered a "liquidity trap" situation like Japan, and its policy rate remains relatively high compared to major economies worldwide.

Since the global financial crisis of 2008-2009, the Bank of Japan has employed Yield Curve Control (YCC) and maintained an ultra-low policy rate. From November 2008 to January 2016, the policy rate stood at 0.1%, and since February 2016, it has even been negative at -0.1%.

In contrast, China's central bank has never implemented a zero or negative policy rate or engaged in quantitative easing (QE)-type monetary measures. China's policy rate has consistently ranged between 3.5% and 4.5% in recent years, remaining higher than Japan's and other major economies such as the United States and Europe.

Since the global financial crisis of 2007-2008, the People's Bank of China (PBoC) has pursued a "prudent" monetary policy approach with a focus on financial stability. It has been cautious about flooding the market with liquidity, having learned from the consequences of the RMB 4 trillion stimulus package during the previous crisis, which contributed to China's debt buildup. In other words, the PBoC has been conservative when it comes to interest rate cuts as a means to stimulate growth.

Consequently, China still has significant policy room for monetary policy easing and has not fallen into a "liquidity trap" scenario, where even extremely low or negative interest rates fail to incentivize borrowing for consumption or investment purposes (as shown in Figure 8).

Third, Chinese enterprises have significantly smaller exposure to the real estate market compared to the situation in Japan during the 1990s.

China has implemented strict regulations on real estate asset holdings for listed firms, discouraging excessive exposure to the volatile real estate market. This approach helps mitigate the risk of significant losses when the real estate market experiences deep corrections. In contrast, many Japanese listed firms held substantial real estate assets during the housing bubble period, which resulted in severe contagion from the real estate market to the equity market and the overall financial system when property prices plummeted in the early 1990s.

For instance, in the 1990s, land value accounted for 19.3% of total assets in Japan, and land value as a percentage of total sales even reached 27.3%. In comparison, as of 2022, China's non-financial non-real estate enterprises had limited land value exposure, with land value accounting for only 2.4% of total assets and land value to total sales ratio standing at 10.8%. These figures suggest that Chinese enterprises have minimal exposure to the real estate sector (as shown in Table 1).

Considering these factors, Chinese authorities have a better chance of containing the adverse impact of a housing bubble burst on the economy and financial system compared to the situation in Japan. Even in the event of a housing bubble burst similar to Japan's experience, the balance sheets of Chinese enterprises would not be as heavily affected as those of Japanese enterprises. Therefore, it is misleading to argue that China will enter into a "balance sheet recession" akin to Japan's situation.

Table 1 **Enterprises' exposure to real estate (All listed firms excluding financial institutions and real estate firms)**

Country	Variable	Period	Mean	Std Dev	10th percentile	Median	90th Percentile
Japan	Land value/Total asset	1985-1990	19.3%	11.9%	6.5%	17%	35%
	Land value/Total Sales	1985-1990	27.30%	28.20%	6.90%	19.90%	53.80%
China	Land value/Total asset	2013-2015	2.60%	5.60%	0.10%	0.80%	6.50%
	Land value/Total Sales	2013-2015	7.30%	26.80%	0.10%	1.50%	13.50%
China	Land value/Total asset	2016	2.40%	6.3%	0.06%	0.6%	5.2%
	Land value/Total Sales	2016	10.4%	73.6%	0.1%	1.2%	12.6%
China	Land value/Total asset	2022	2.44%	6.06%	0.05%	0.6%	5.76%
	Land value/Total Sales	2022	10.8%	61.3%	0.08%	1.15%	15.26%

Source: Serdar Dinc and Patrick M McGuire (2004), WIND, BBVA Research

Finally, compared with Japanese economy in 1990s which was already a full-fledged advanced economy, China is still a developing country to catch up with other advanced economies. This catch-up effect indicates China has more potential room for growth.

For instance, China's current GDP per capita stands at USD 12,700, which is approximately 17% of the US GDP per capita. In comparison, in 1990, Japan's GDP per capita was USD 25,371, surpassing the USD 23,889 figure in the US. This indicates that China currently has more potential room for catching up through improvements in total factor productivity.

Additionally, during the 1990s, Japan had already achieved a high urbanization rate of 77%, with a significant portion of the population residing in metropolitan regions. In contrast, China's urbanization rate is currently at 64%, with only 46% of the population living in large cities. This suggests that China has further potential for urbanization and concentrated economic development.

Moreover, China's labor market is much more flexible and adaptable compared to Japan's permanent employment system. Private enterprises in China have the ability to adjust their balance sheets by easily laying off employees when necessary. This flexibility enables quicker adjustments and responses to changing market conditions.

Furthermore, China's emphasis on technology advancement and high-end manufacturing, under the advocacy of "technology self-sufficiency," provides an advantage and opens up new growth opportunities. This focus on technological development and innovation is expected to contribute to China's long-term economic growth and resilience.

Overall, these factors, including China's potential for catch-up growth, room for urbanization, flexible labor market, and emphasis on technology advancement, position China in a favorable position to navigate challenges and seize new growth opportunities.

The biggest challenge to Chinese economy in long-term is not “Japanization” but “middle income trap”

In the previous analysis, it was concluded that China is not currently experiencing "Japanization" or a "balance sheet recession." However, it is essential to address the long-term challenge of overcoming the "middle-income trap" to achieve a transition into a high-income economy.

While the immediate concern is not a short-term one, Chinese policymakers should not be complacent. Official statistics indicate that China's per capita GDP reached approximately $12,700 in 2022, close to the global median of $12,300. Despite significant progress, China remains a middle-income country facing challenges similar to other emerging markets.

The "middle-income trap" refers to the phenomenon where many middle-income economies struggle to achieve sustained and high-income growth. This trap is often characterized by a fragile financial system, high income inequality, unsustainable growth models, and premature deindustrialization.

China also faces challenges associated with the middle-income trap, in addition to the risks posed by property market bubbles. The country's financial system is vulnerable due to corporate sector indebtedness, local government bond and the presence of shadow banking activities. Income disparity is a significant concern in China, with a substantial portion of the population earning low salaries, as highlighted by former Premier Li Keqiang in 2020. The lack of direct subsidies to households during the Covid-19 pandemic may have further exacerbated this situation.

Moreover, China's previous growth model, which heavily relied on government-led investment and external demand, is no longer sustainable for achieving rapid and inclusive growth. To overcome the middle-income trap and transition to a high-income economy, China needs to focus on structural reforms, promote innovation and technological advancement, foster domestic consumption, address income inequality, and develop a more sustainable and resilient growth model.

It is crucial for Chinese policymakers to tackle these challenges effectively and proactively to ensure sustainable and inclusive economic development in the long run. By addressing these issues, China can enhance its prospects of successfully navigating the middle-income trap and achieving high-income status.

First of all, to overcome “mid-income trap” requires China to maintain a decent growth rate and inflation rate in the next decades, among which, China’s long-term “new growth model” to develop new economic growth opportunities is the key. (See our recent Economic Watch: China | Understanding China’s new growth model)

China's new growth model is built upon three pillars: common prosperity, self-sufficient technology, and carbon neutrality. These pillars are aligned with the current global trends and are interconnected with each other.

While the policy promulgation may sometimes lack subtlety and market communication, these measures and reforms are aimed at addressing a range of challenges faced by countries worldwide. These challenges include market monopolies driven by technology, widening wealth gaps, global climate change, and housing affordability, among others.

China's new growth model and its shift from a "growth-first" approach to social sustainability are expected to lead to a gradual decline in the country's long-term potential growth rate. Currently at around 6%, it is anticipated to decrease to approximately 4% by 2035. However, even with this decline, China's growth rate will still be respectable. The future growth will increasingly depend on progress in total factor productivity rather than relying heavily on capital investment and population expansion.

The new policy framework provides support to sectors such as high-end manufacturing, advancements in "bottleneck" technologies, and the development of new energy and clean energy industries. These policy-supported sectors are likely to become the future drivers of growth in China.

By focusing on common prosperity, self-sufficient technology, and carbon neutrality, China aims to address key challenges, foster sustainable development, and create new opportunities for growth. These pillars reflect China's commitment to a more balanced, inclusive, and environmentally conscious economic trajectory.

Second, to overcome “mid-income trap” also requires China to continue to press ahead a series of structural reforms, particularly SOE and POE reform.

The Chinese authorities should prioritize the revival of the reform agenda announced at the third plenary of the 18th CCP National Congress, which was disrupted by the unexpected US trade war and the Covid-19 pandemic. A crucial aspect of these reforms should be focused on state-owned enterprises (SOEs), aiming to establish a level playing field for all Chinese firms, regardless of their ownership structure. This will rectify resource misallocations and enhance overall productivity, facilitating the transition to a more sustainable growth model.

Furthermore, it is essential for the authorities to strengthen the financial regulatory framework and social security nets. This will ensure that the benefits of economic and social development are shared by the entire population, rather than being concentrated in a few interest groups. By creating a more inclusive system, China can foster social stability and promote equitable growth.

Unlike matured advanced economies, the Chinese economy is currently undergoing a transformation and is at a crossroads of various structural reforms. These reforms include improving the relationship between state-owned enterprises (SOEs) and private-owned enterprises (POEs), enhancing market permissions, protecting property rights, strengthening corporate governance, and constructing a robust legal system. Of particular importance is improving the efficiency of SOEs by addressing the issue of "soft budget constraints" and fostering the confidence of private-owned enterprises.

One of the main challenges to the economic recovery during the post-pandemic period is the weakening confidence of private-owned enterprises, largely influenced by the regulatory storms in 2021, particularly in sectors such as after-school tutoring, technology, and real estate. These regulatory actions significantly dampened private enterprises' confidence. Going forward, maintaining policy consistency and enhancing market communication to avoid large policy shocks will be crucial for success.

To ensure a smooth and successful economic transition, it is imperative for the Chinese authorities to prioritize these reforms, address key issues in the business environment, and provide a stable and supportive policy framework. By doing so, China can boost private sector confidence, promote sustainable growth, and create a conducive environment for economic recovery and development.

Third, to overcome “mid-income trap” needs to prioritize technology advancement.

Deindustrialization concerns in China are largely driven by the impacts of the US trade war and tech embargoes, specifically in critical sectors like advanced chip making, artificial intelligence, cloud computing, and quantum computing. To stay competitive, it is crucial for China's authorities to prioritize the development of key technologies in these areas. By doing so, China can maintain its edge and mitigate the risks associated with deindustrialization.

However, it is equally important for China to continue its policy of opening up and fostering international cooperation across a broader range of sectors. Collaboration with other countries can facilitate knowledge exchange, technological advancements, and market access, which are essential for sustained economic growth. By embracing openness and cooperation, China can leverage the strengths of its domestic industries while benefiting from global innovation and expertise.

Moreover, a cooperative approach can help address concerns and build trust with other nations, potentially reducing trade tensions and promoting a more stable and predictable international economic environment. This can further support China's efforts to navigate deindustrialization challenges and ensure a smooth transition to higher value-added industries.

In summary, while developing key technologies is crucial to combat deindustrialization concerns, China should simultaneously embrace openness and international cooperation. By striking a balance between domestic advancements and global collaboration, China can position itself for long-term success and mitigate the risks associated with deindustrialization.

Finally, to overcome “mid-income trap” in the long term also requires the authorities to continue to concern about financial stability and to avoid large-scale bubble burst.

Drawing lessons from the RMB 4 trillion stimulus package implemented during the 2008-2009 Global Financial Crisis, the People's Bank of China (PBoC) has displayed a conservative approach in recent years regarding monetary easing measures. During various business cycle downturns, the PBoC has refrained from injecting excessive liquidity into the market or directly implementing quantitative easing (QE)-like measures.

Looking ahead, to prevent large-scale asset bubbles from bursting in the housing and stock markets, it is crucial for the central bank to maintain caution regarding extensive monetary stimulus. Striking a balance between stimulating economic growth and preserving financial stability has always been a challenging task, as observed in the experiences of major economies worldwide.

In summary, China's reform and opening-up policy, initiated in 1978, has played a pivotal role in the country's transformation and the significant reduction of poverty for billions of people. As China continues to face challenges associated with the middle-income trap, it will be essential to rely on this policy framework to navigate the path ahead. By embracing reform and opening up, China can foster sustainable economic growth, tackle structural issues, and promote inclusive development.

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