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How similar is the Chinese economy to that of Japan after the bubble burst?

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Summary

Since the burst of China's real estate sector bubble in mid-2021, there is a growing concern that the Chinese economy could end up like that of Japan in the early 1990s. Some patterns are strikingly similar, such as the sharp deceleration in fixed asset investment, especially in the housing market.

Both countries have long suffered from low private consumption, especially when compared with the rest of the world, and an excessively high saving ratio. Their initial policy responses to the growth challenges are also similar since both China and Japan were initially hesitant to ease monetary and fiscal policies after the collapse of the bubble. Instead, they chose to expand supply, in particular manufacturing, with an eye on external demand. The result of such policies is protracted trade surpluses, which did not help mitigate the consequences of the burst of the bubble. On the contrary, they only fed deflationary pressures.

China seems to be following Japan in terms of seeking expansion of its overseas assets although with some differences. For Japan, offshoring or production to China and Southeast Asia, through greenfield foreign direct investment (FDI) was crucial in reducing its production costs and ensuring continued access to Western markets. The strategy also helped Japan circumventing protectionist measures, especially from the US. China has also stepped up its outbound investment, as Japan did in the 1980s although the focus has been a bit different, namely acquiring resources and building infrastructure through the Belt and Road Initiative. Another similarity to maintain supply has been the quest to move up the ladder, with a surge in expenditure in research and development (R&D).

Notwithstanding the similarities, there are also crucial differences in China's and Japan's structural situation. Some should make China's case potentially better off but others push in the opposite direction. Starting with the latter, China's macroeconomic imbalances, in particularly the excess saving and low private consumption, are much larger than that were in Japan and. China's reliance on manufacturing is also significantly larger, which has led to a larger share of global exports.

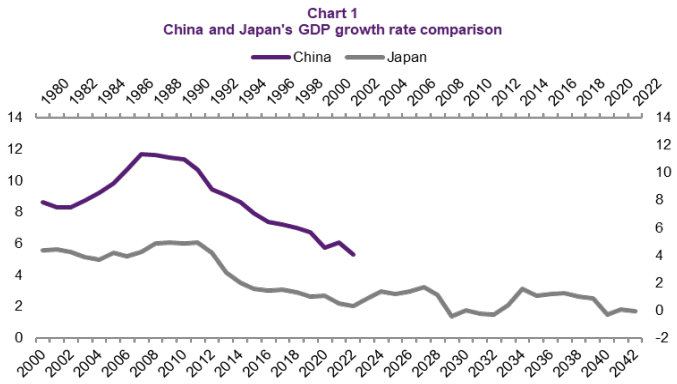
Moreover, the wave of protectionism now is much stronger than it was when Japan was pushing its manufacturing in the 1980s. China will find it harder to protect itself from protectionism by offshoring its manufacturing capacity through greenfield investment than Japan did, especially because its income per capita are lower than those of Japan when it moved its production overseas in the 1980s. The positive angle for China, compared to Japan, is its geopolitical power with the Global South and its ability to become self-reliant technologically. This also offers options for China to create its own ecosystem if the US keeps containing China.

All in all, China seems to be heading to similar growth trajectory as Japan did in the past. However, some differences also exist that could yield different outcomes, making it important to closely monitor the situation.

1. Introduction: Is China replicating Japan's lost decade?

After reaching a remarkable growth rate of 14% in 2007, China's economy experienced significant slowdown and gradually decelerated to 6% in 2019. The outbreak of Covid-19 further impacted its growth rate. After the pandemic, the government was only able to set the GDP growth rate at 5% for 2024. Such a rapid economic slowdown, together with other similar experiences, such as the collapse of the real estate sector, is behind the increasingly frequent comparison with Japan's experience in the 1990s, often referred to as "the lost decade". (Chart 1).

Chart 1. China and Japan's GDP growth rate comparison



Source: Natixis, CEIC

The question is whether the Japanese experience is comparable to that of China today so that it can guide us in understanding the future of the Chinese economy. There have been numerous existing studies on the explanations for Japan's lost decade, including fiscal inadequacy (Kuttner and Posen, 2002), insufficient monetary policy and liquidity trap (Bernanke, 2000; Leigh, 2010), the role of financial intermediation (Kwon, 1998; Ogawa and Suzuki, 1998), and the preceding over-investment that has led to low rate of return on capital (Bayoumi, 2001).

In a seminal paper, Hayashi and Prescot (2002) turned to the long-term perspective of understanding Japan's slowdown, and argued that the transition to a new and lower growth path due to the decline in total factor productivity was the fundamental driving force for the economic slowdown. Griffin and Odaki (2009) further investigated the micro-reallocation mechanisms, showing that the lack of exits by the least productive firms and lack of entries by small productive firms reduced TFP growth during the 1990s, whereas there was no strong evidence of misallocation of resources across incumbent firms. The finding seems to suggest the lack of creative destruction process during Japan's lost decade. Imai et al. (2017)'s econometric analysis further found that the decline in Japan's export industry competitiveness during the 1990s can be attributed to a decrease in the innovation and growth of these industries.

Due to the similarity between China and Japan, China observers carefully compared the experience between the two countries, with most researchers focusing on the role of the real estate (land) market. For example, Garcia Herrero and Iwahara (2024) have delved into the performance of the real estate for the China-Japan comparison.

In this paper we take a broader perspective by focusing on the saving-investment pattern of China and Japan, showing how Japan's macroeconomic imbalances in the 1980s may compare with those of China at the time when the imbalance was built up (in the 1980s for Japan and in the 2000s for China). The framework helps understand the internal and external factors driving the slowdown in both economies, why they are similar but also how they differ.

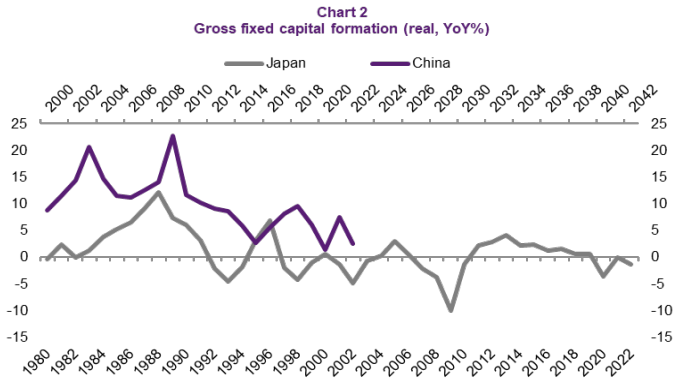
2. The investment-saving story for China and Japan

China and Japan have both exhibited large macroeconomic imbalances with high savings and lower investment. The fact that domestic savings could fully finance such high levels of investment and even with excess savings made it easy for both countries to ride on an investment boom financed by repressed, i.e., artificially low – interest rates. High investment was also accompanied with low private consumption in both countries.

Japan's growth in fixed asset investment (FAI) rate declined sharply from an average of 4.7% in the 1980s to only 0.34% in the 1990. For China, the growth in FAI reached 14.2% after its accession to the World Trade Organization (WTO), fed not only by foreign direct investment setting up manufacturing plants in China but also by infrastructure investment **(Chart 2)**. In the following decade of the 2010s, China's growth rate slowed to 7.7% following the slowdown of the real estate sector.

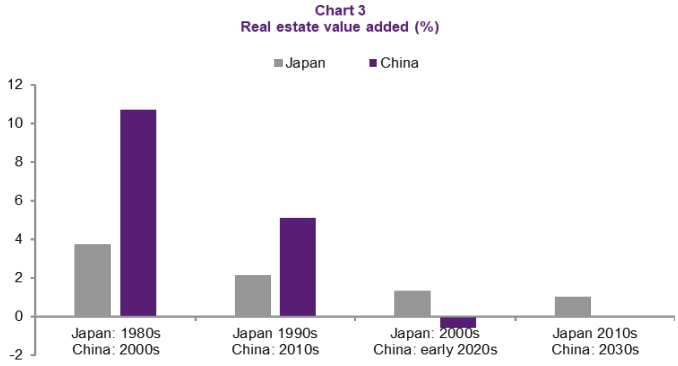
Focusing on the real estate sector, Japan experienced an increase in real estate value-added of 3.7% in the 1980s but slowed considerably to 2.1% in the 1990s. China saw its real estate value-added grow at 10.7% in the 2000s, but this also slowed, reaching 5.11% in the 2010s **(Chart 3)**. While the trend looks similar, China's investment growth was always higher than that of Japan's, which explains why China GDP growth was also always higher than that of Japan. It is also true that China's starting point, in terms of income per capita, was lower than that of Japan, which means that China had more space for growth convergence, starting with a lower level of urbanization. That having said, China's real estate market adjustment has been more rapid comparing to Japan's, causing concerns if any immediate crisis would take place and the possibility of "hard landing" **(Chart 2)**, but China has finally moderated the crisis and avoided the worst scenario.

Chart 2. Gross fixed capital formation (real, YoY%)



Source: Natixis, CEIC

Chart 3. Real estate value added (%)



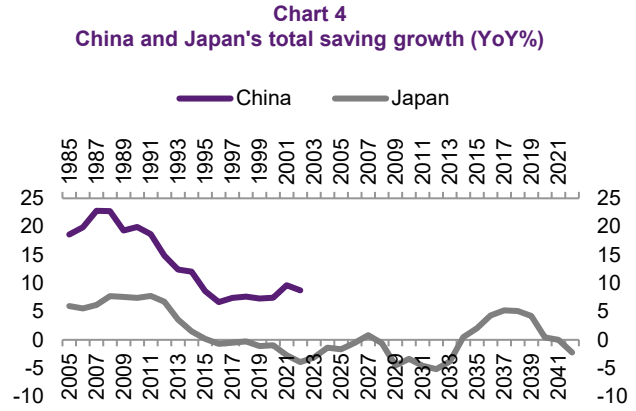
Source: Natixis, CEIC

Generally, a decline in investment typically leads to a higher reliance of the economy on consumption, thereby reducing the incentive for saving. This was what had happened in Japan in the 1990s. Japan's total saving growth dropped from nearly 8 percent to negative levels amidst the economic deceleration of the 1990s (Chart 4). China has undergone a similar trajectory since 2008 but with a softer decline in savings. As of now, China continues to rank significantly higher than other major economies in terms of the saving-to-GDP ratio (Chart 5), even after the slowdown of the

economy which already to some extent corrected the saving-investment imbalance.

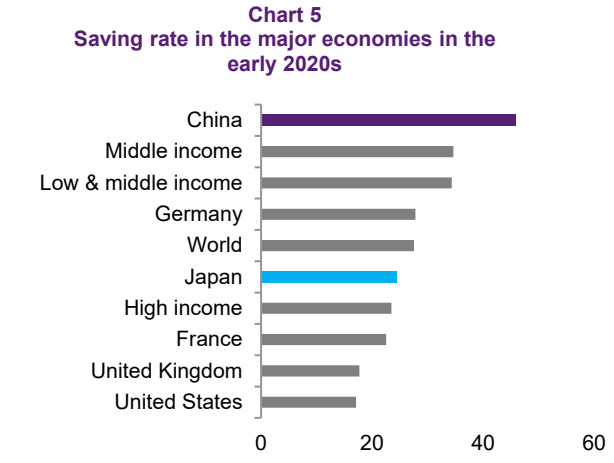
The reasons for China's massively high savings, even surpassing Japan's, are partially related to the lack of welfare state or, in other words, a mechanism of public insurance. Private insurance remains rather limited even after the modernization of China's financial sector. Beyond these factors, the high degree of uncertainty about the geopolitical environment, especially since Trump came to power and started its containment policies on China, as well as the outbreak of the pandemic, also explains why Chinese households still hold a higher level of saving from a precautionary perspective.

Chart 4. China and Japan's total saving growth (YoY%)



Source: Natixis, CEIC

Chart 5. Saving rate in the major economies in the early 2020s

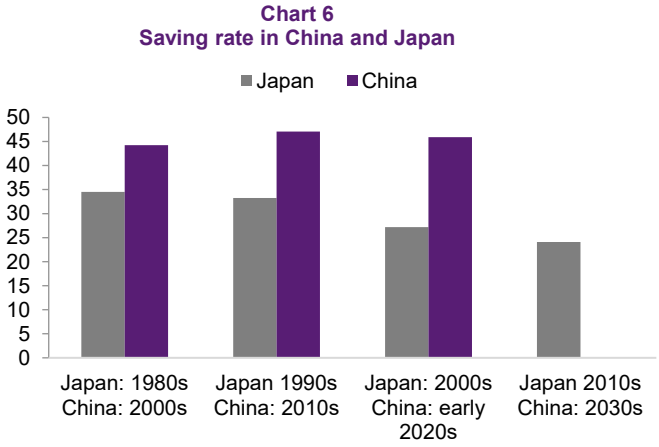


Source: Natixis, CEIC

All in all, both China and Japan have experienced a significant decrease in investment, but Japan achieved a gradual shift from an investment-driven to a consumption-driven growth model while China has barely reduced its imbalances, characterized by high excess savings (Chart 6) and low private consumption.

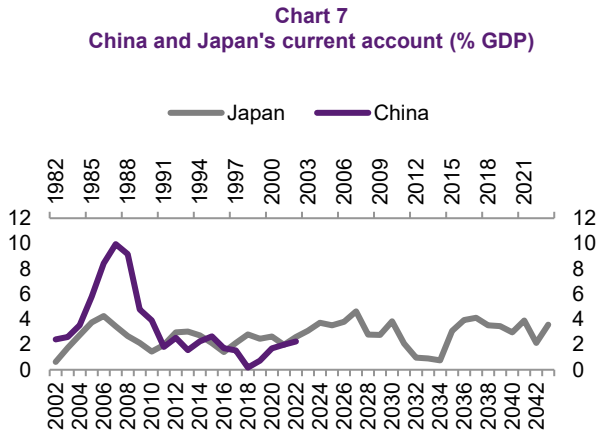
Consequently, China's savings rate continues to exceed its investment rate, leading to a persistent current account surplus. This outcome contrasts with earlier expectations that the surplus would diminish as China's GDP per capita rose and imports increased, driven by a growing middle class seeking high-end consumer goods. China's current account ratio has plateaued at approximately 2%, resembling Japan's situation in the early 2000s (Chart 7).

Chart 6. Saving rate in China and Japan



Source: Natixis, CEIC

Chart 7. China and Japan's current account (% GDP)



Source: Natixis, CEIC

Finally, the containment strategy adopted by various US administrations, from Trump to Biden, towards China mirrors Japan's experience in the late 1980s. In Japan's case, this containment was primarily economic, focusing more on trade than technology, as Japan had not developed military capabilities following its defeat in World War II. The US engaged in trade negotiations that heavily favored American interests, capitalizing on its significant bilateral deficit with Japan, particularly in the automobile and electronics sectors. The US also implemented tariffs and quotas on Japanese imports and pursued voluntary export restraints on specific products. Besides, the US targeted Japan's semiconductor industry, exemplified by the 1986 Semiconductor Trade Agreement, which aimed to boost market share of the American companies. The US also pressured Japan to appreciate the yen through the Plaza Accord.

The US containment strategy toward China, which gained momentum when Trump took office in 2017, has unfolded differently. Unlike Japan, China is perceived as presenting not only an economic threat but also military and security challenges. As a result, economic containment, such as the trade measures that sparked the Trump-led trade war, represents just one facet of a broader strategy. In addition to the economic containments, the US also rapidly expanded to encompass technology, particularly in the realm of dual-use technologies, with stringent export controls on critical sectors like advanced semiconductors. The overarching goal of the US regarding China is much more comprehensive than it was with Japan, as it seeks to maintain its hegemonic position globally.

The US has also struggled to impose the same type of asymmetric official agreements with China, such as pressuring Chinese imports from the US and hindering China's advancements in strategic sectors.

3. China following Japan's trajectory

The follow-up question is whether the parallel saving-investment pattern in China and Japan will lead to a similar growth trajectory, namely that of a rapid deceleration after their respective bubbles burst.

Starting with the Bank of Japan (BoJ), some argue that it went too far hiking rates between 1988 and 1989 to avoid a further growth of asset prices and contributed to the bursting of the bubble (Japan Center for Economic Research, July 2002). In the same vein, one can argue that the PBoC's monetary policy in the run-up and during the pandemic was also too tight, at least when compared to the rest of the world. This, together with additional regulatory tightening such as the so-called three red lines for real estate developers, rapidly cooled investment enthusiasm. For more details on the behavior of the Bank of Japan, see Box 1.

Box 1. Some lessons from the BoJ's role during the bursting of Japan's bubble

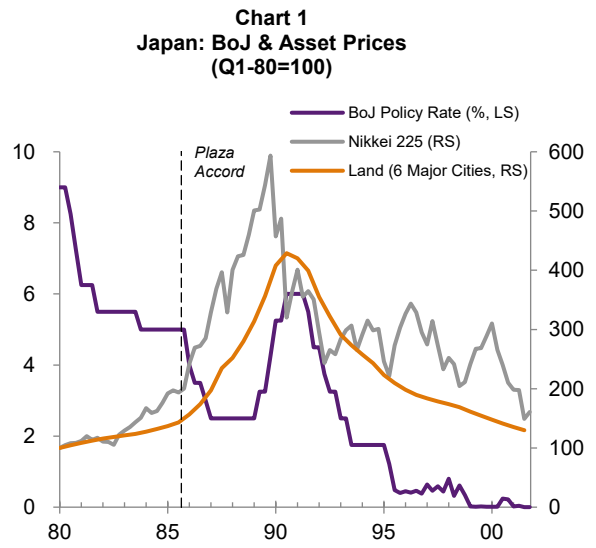
With the benefit of hindsight, the Bank of Japan (BoJ)'s response to the equity and real estate bubbles in the 1980s was too small and too late, and possibly also a bit erratic. After lowering the policy rate from January-1986 to support growth, the Bank finally tightened from May-1989 to cool the overheating economy and stem off pressure from the bubbles (Chart 1). Although headline inflation was stable, bank loans accelerated by about +10% annually and asset prices more than doubled during the same period. As macro-prudential policy was hardly developed at the time, the BoJ delayed responding to increasing macroeconomic imbalances.

The BoJ was also slow to react to the sharp decline in equity prices. After the Nikkei stock index dropped by -38% from the peak in December-1989, the Bank finally responded by lowering the policy rate by 50 bps in July-1991. The BoJ also took more than four years to lower the policy rate to 0.50% in September-1985, because it was concerned that the monetary easing would reignite the real estate bubble. This gradual easing was not enough, as monetary conditions remained tight in the second half of 1990s. The "Japan premium" increased Japanese banks' financing cost in the international market and the Yen steadily appreciated, when banks finally began to clean up their balance sheets.

After the policy rate reached 0.0% in February-1999, the BoJ confronted the zero nominal lower bound, a belief that the policy rate cannot fall below 0.0%. The monetary policy was still considered restrictive, as deflation lifted the real interest rate to about 1% when the neutral rate was generally believed to have fallen below 0.0% (Chart 2).

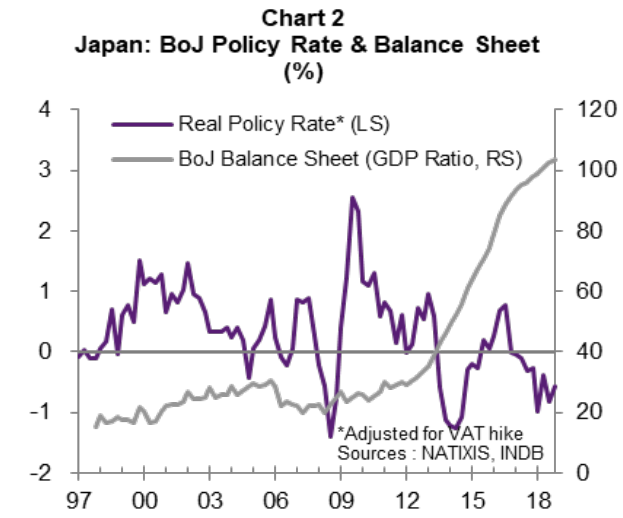
Finally, the BoJ introduced unconventional policy tools to confront the zero nominal lower bound from 1999. At that time, the Bank declared to keep the policy rate at 0.0% until the prospect of ending deflation became clear, which is known today as forward guidance. Subsequently, the BoJ launched quantitative easing in 2001, by massively purchasing short-term government securities to expand banks' reserves on the BoJ's balance sheet. After introducing the Quantitative and Qualitative Monetary Easing (QQE) in April-2013 with the intention to lower the long-term bond yield and to reduce risk premiums in the equity and real estate markets, the BoJ expanded the framework by lowering the policy rate to -0.1% (QQE with a Negative Interest Rate) in January 2016 to encourage banks to expand lending. In September 2016, the policy tool was re-framed by adding the Yield Curve Control (QQE with YCC) with a focus to maintain the 10-year Japanese Government Bond (JGB) yield at around 0%, to lower the bond yield across the yield curve. While these policy responses ended up with a sharp increase in the size of the BoJ's balance sheet above 100% of GDP, the highest among major central bank, the BoJ finally began to see the light at the end of the tunnel on deflation in early 2022.

Chart 1. Japan:BoJ & Asset Prices (Q1-80=100)



Source: INDB, Natixis

Chart 2. Japan:BoJ Policy Rate & Balance Sheet (%)

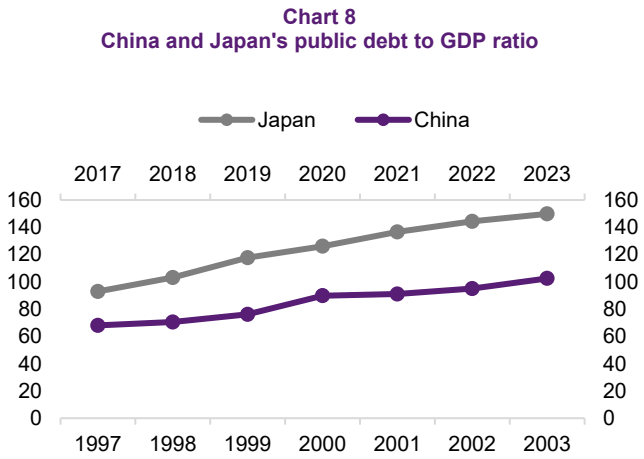


While the BoJ did cut interest rates after the bubble burst, it did it very gradually, reaching zero only in 1999, even if deflationary pressures were persistent, especially for producer prices. In other words, Japan's real interest rates remained stubbornly high after the bubble burst until Governor Kuroda moved to negative interest rates in late 2016 with a huge additional expansion of the BoJ's balance sheet. A similar pattern can be found for China since the PBoC kept interest rates high after the real estate bubble burst in mid-2021. Even if the economy was running below potential with deflationary pressures, especially for producer prices, the change in the PBoC's policy stance has also been very gradual.

On the fiscal front, Japan accumulated public debt very rapidly since the burst of the bubble, reaching levels above 230% of GDP today. China is following the same path of accumulation of fiscal deficits, piling up public debt (Chart 8). But China has then become very careful about the debt problem, especially at the local government level, and started to restrict fiscal spending.

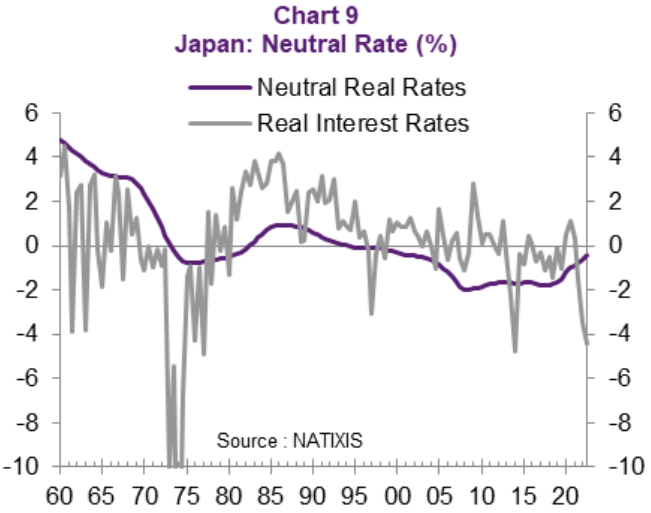
As such, China's fiscal stimulus has also been limited, even though the pile-up of the debt has already become so noticeable that the government continues to implement measures aimed at addressing this issue.

Chart 8. China and Japan's public debt to GDP ratio



Source: Natixis, CEIC

Chart 9. Japan: Neutral Rate (%)



The other similarity is that both Japan and China doubled down on industrial policy as a response to the structural deceleration. In particular, the Japanese government set up a program for financial assistance and tax incentives for specific industries deemed strategically important, such as information technology, biotechnology, and environmental technologies. It also promoted financial support to research and development (R&D) and public-private partnerships. Japan's massive industrial policy did not stop Japan's reduction in the share of manufacturing in the economy and, most importantly, in the innovation rankings (Chart 12). China is following the same route, increasing its R&D expenditure and carry out special projects to support the high-technology sectors.

Stemming from the excessive focus on manufacturing and industrial, both economies have suffered deflationary pressures, especially in the upstream sector (producer prices). Japan endured prolonged deflationary pressures, whereas China has experienced two distinct periods of deflation: first in 2015 and again starting in 2022 (Chart 10 and Chart 11). China managed to mitigate the deflationary pressures in 2015 through a stimulus, but it became more hesitant to follow the same way during the second episode.

Chart 10. China and Japan's CPI Comparison (%YoY)

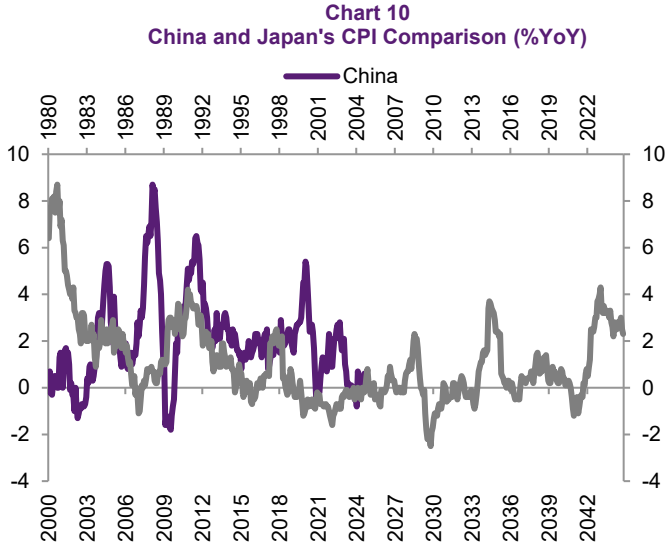
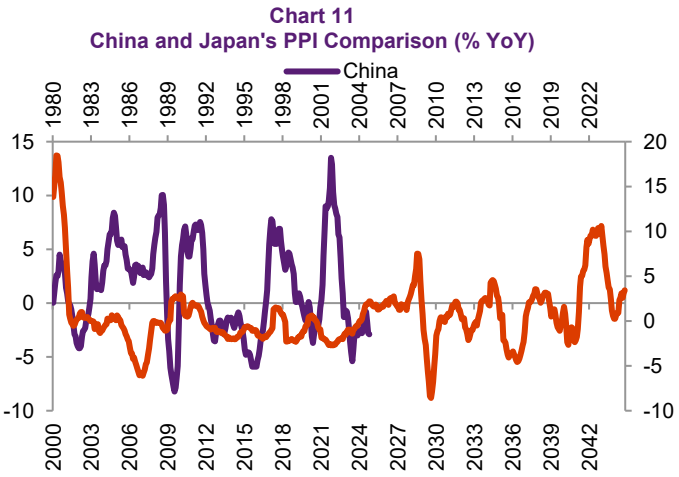


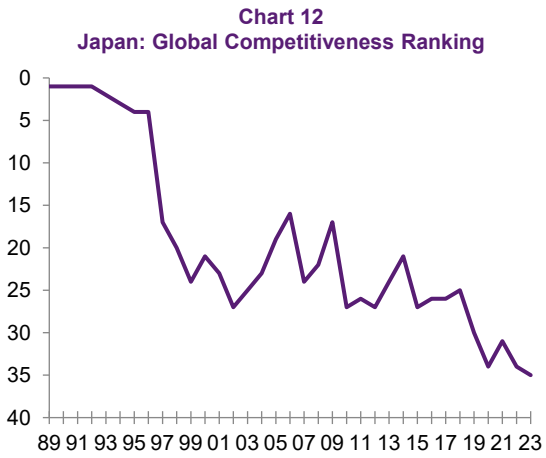
Chart 11. China and Japan's PPI Comparison (%YoY)



N.B. Data as of October 2024.
Source: Natixis, CEIC

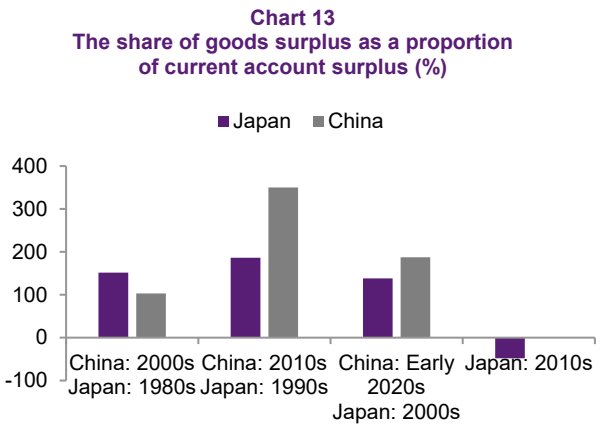
Another relevant similarity is the use of export markets to channel excessive manufacturing capacity. Japan tried to mitigate the structural slowdown by expanding overseas markets, leading to current account surplus (Chart 13), but that effect faded away and even disappeared twenty years later as Japanese became more of a tourist destination than an exporter of manufactured goods. So far, China has still maintained significant current surplus after its slowdown, with particular improvement in the higher-end technology exports.

Chart 12. Japan: Global Competitiveness Ranking



Sources: IMD, NATIXIS

Chart 13. The share of goods surplus as a proportion of current account surplus (%)

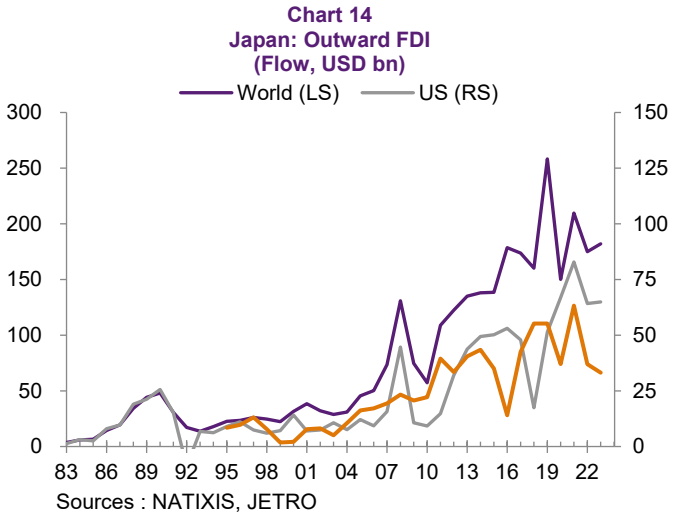


Source: Natixis, CEIC

Japan and China both decided to expand investment overseas with foreign direct investment or lending. For Japan, foreign direct investment (FDI) emerged as the primary channel for expansion, with Southeast Asia and China serving as key destinations under the "flying geese" strategy. In addition to greenfield investments in manufacturing, Japan also pursued mergers and acquisitions (M&A), which became particularly feasible, and not expensive, when the yen appreciated following the Plaza Accord. The collapse of Japan's economic bubble further accelerated its shift toward acquiring overseas assets, driven by a steep decline in domestic growth and persistently high labor costs within its manufacturing sector. (Chart 14). When it comes to lending, Japanese banks emerged as significant global overseas lenders, including in Latin America before its major sovereign crisis in the 1980s.

China has also significantly expanded its overseas presence primarily through lending, with a particular emphasis on infrastructure financing. Its cross-border lending efforts have predominantly targeted emerging economies, especially those involved in China's flagship initiative, the Belt and Road Initiative. Comparing to Japan, China's greenfield investments in manufacturing are a relatively recent development, with the developed world being selected as a key destination not only to expand markets but also to acquire technology assets.

Chart 14. Japan: Outward FDI (Flow, USD bn)



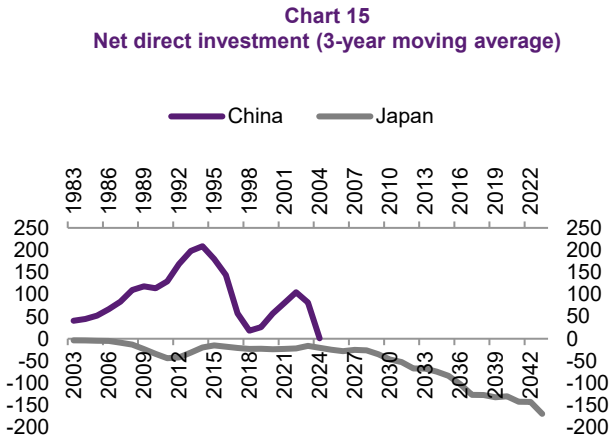
4. What might make China different from Japan?

While there are many similarities between Japan in the 1980s and 1990s and China today, there are also important differences. Some are in China's favor, but others make China's situation even more challenging than that of Japan then.

A potentially significant difference between Japan and China lies in the level of outbound investment. Japan became the largest net external creditor decades ago and, despite the shrinking size of its economy, it continues to hold this status. The country maintains substantial overseas investments, both in terms of foreign direct investment (FDI) and portfolio flows. In contrast, while China ramped up outbound FDI from 2013 to 2016, this flow has significantly slowed since then (Chart 15). On the portfolio side, China has never fully opened its markets to capital outflows, resulting in much more limited overall overseas portfolio investment (Chart 16).

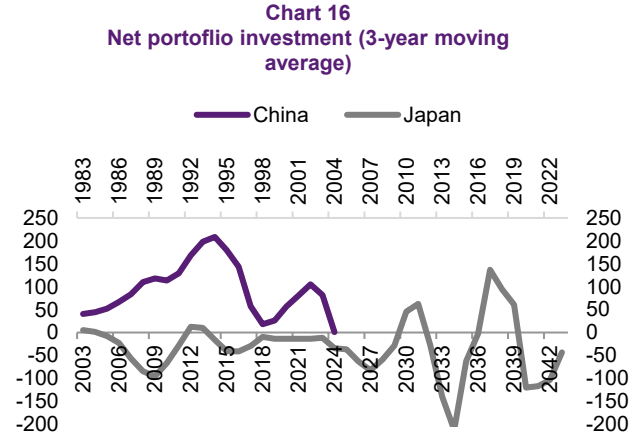
Japan's income from overseas investments has played a crucial role in sustaining its current account surplus. However, China's situation differs, as its trade surplus is more prominent, accompanied by minimal net income from overseas investments (Chart 17). Consequently, China is more vulnerable to protectionist measures than Japan ever was. China faces heightened scrutiny from international markets, particularly from the US and increasingly from the EU. China's wages are also currently lower than those in Japan at that time, making it less straightforward to relocate production overseas, as the wage differentials are not as pronounced.

Chart 15. Net direct investment (3-year moving average)



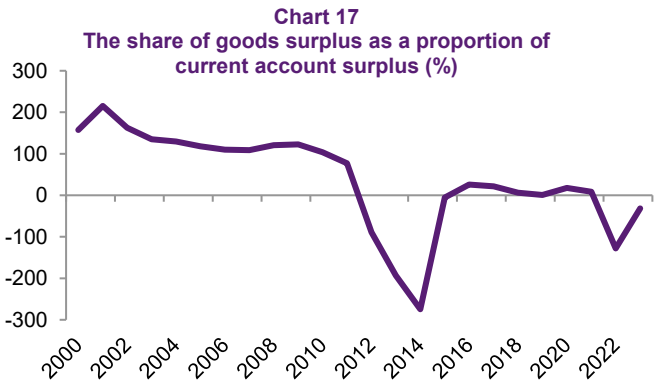
Source: Natixis, CEIC

Chart 16. Net portoflio investment (3-year moving average)



Source: Natixis, CEIC

Chart 17. The share of goods surplus as a proportion of current account surplus



Source: Natixis, CEIC

Japan's exchange rate policy was also different than that of China, at least so far, since Japan accepted a sudden rapid appreciation of the yen after concerted intervention pushed by the US in the mid-1980s under the Plaza Accord. The consequences of the strong yen are analyzed in the box below (Box 2). China has so far avoided any push from the US Treasury to appreciate its currency and has generally kept the RMB relatively weak to foster external competitiveness. Capital control is still an important tool for China to achieve this goal, while Japan abandoned it long time ago.

Box 2. Yen appreciation: a structural factor behind Japan's lost two decades

The Plaza Accord in 1985 was arguably an important turning point of the Japanese economy. From the early 1980s, high interest rate and large fiscal deficits under the Reagan administration resulted into an appreciation of the US Dollar. It was also widely argued out that tight regulations in Japan prevented capital inflow, which undervalued the Japanese Yen. As a consequence, the US Dollar real effective exchange rate (REER) appreciated by about 25% from 1981 to 1985, which in turn expanded Japan's current account surplus and US's deficit (Chart 1).

To alleviate the macroeconomic imbalances, Japan signed in September-1985 the Plaza Accord to devalue the US Dollar along with the G-5 nations. As the central banks coordinated interventions in the foreign exchange market, the Yen rapidly appreciated from USDJPY=237.1 in August-1985 to 139.7 in April-1987 (Chart 2). To counterbalance the severe headwinds on exports and to support growth, the Bank of Japan (BoJ) slashed the policy rate from 5.00% in 1985 to 2.50% in February-1987. The monetary stimulus ended up fueling optimism on the Japanese economy which ultimately resulted into the twin bubbles in the real estate and equity markets.

After the bubble burst around 1990, the strong Yen weighed on the economic recovery through different channels, characterizing Japan's lost two decades. The appreciation of the Yen not only reduced exports but also increased competition with cheaper import products from Asia. As domestic demand also stagnated during the post-bubble period, corporate profitability further deteriorated reducing nominal wages, which in turn led to falling inflation. As deflation became embedded in expectations, manufacturing companies reduced investments due to higher real interest rate, while expanding foreign direct investment in Asia, which resulted into hollowing out of the Japanese economy. These developments complicated the BoJ's policy decisions after lowering the policy rate to 0.0% in 1999.

The trend in the Yen finally reversed after the BoJ raised the inflation target to 2% from 1% in January-2013. While the monetary policy with the Quantitative and Qualitative Monetary Easing (QQE) under Abenomics depreciated the Yen to around USDJPY=115, the momentum accelerated from early 2022 on the back of widening monetary policy differential between the US Federal Reserve (Fed) and the BoJ. While the Fed tightened to contain surging inflation, the BoJ kept its monetary policy accommodative to meet the 2% inflation target in the medium term.

Chart 1. Japan: REER & Current Account (GDP Ratio %)

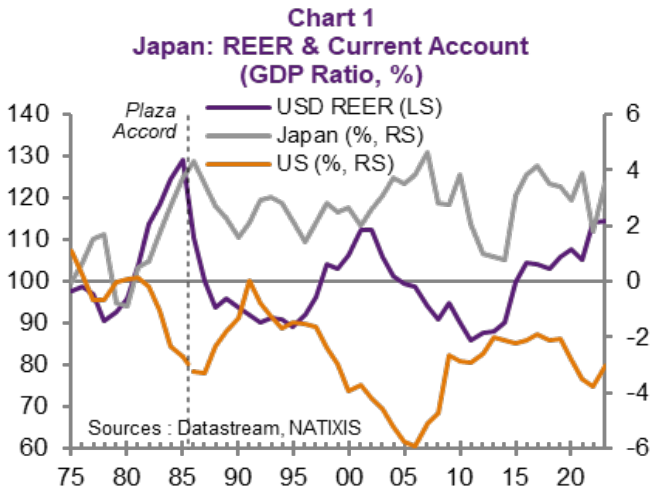
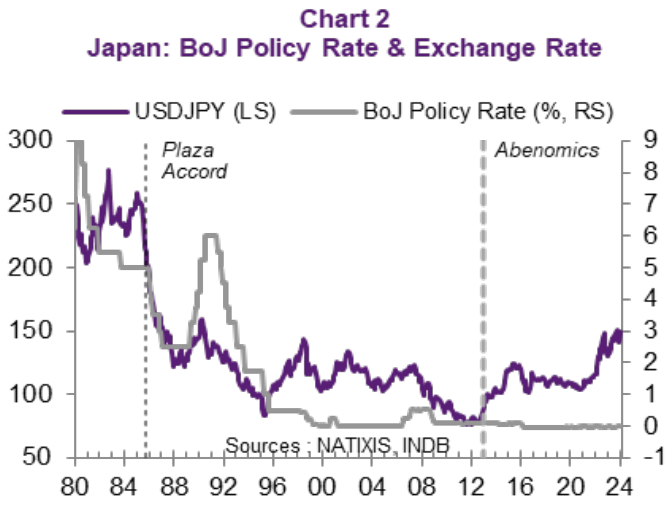


Chart 2. Japan: BoJ Policy Rate & Exchange Rate



Another key difference lies in the impact of the real estate crisis on the banking sectors of Japan and China. Japanese banks were significantly more exposed to real estate developers compared to their Chinese counterparts, as regulations in China have limited banks' ability to finance real estate ventures. Box 3 examines the extent to which Japanese banks suffered from this exposure and its broader implications for the economy. While Chinese banks have less direct exposure to developers, they are heavily exposed to the local government financial vehicles (LGFVs), which have been instrumental in funding real estate and infrastructure projects but are currently facing serious financial difficulties. Similar to Japan, Chinese banks are experiencing a shrinking interest rate margin, which is impacting their profitability (Garcia-Herrero and Ng, 2024).

In summary, while China has thus far managed to mitigate the effects of its economic deceleration and real estate market adjustments on its banking sector, it remains uncertain whether it will ultimately follow in Japan's footsteps. The ongoing decline in bank profitability and the emerging risks to asset quality could pose significant challenges in the future.

Box 3. Japanese banks: Decade long trial and error to heal from housing market crisis

Before the asset bubble emerged in the 1980s (both in the equity and real estate market), Japanese banking policies became increasingly misaligned. On the back of financial deregulations, large companies were permitted to raise money from financial markets, reducing their dependency on banks. Because banks needed to develop a new customer base, they ended up lending aggressively to the real estate sector. At the same time, the Ministry of Finance (MoF) employed the “convoy system” where banks would not go bankrupt but rather would be merged with solvent institutions even if this came as a loss for them. Such policy increased moral hazard and reckless behavior by banks, which contributed to the twin bubbles.

The real estate sector played a critical role during the bubble period. Because real estate prices hardly declined after the Second World War, the “myth of land” (an old belief that land value will never fall) was the breeding ground of the frenzy. From a relatively moderate increase in real estate prices in the early 1980s tripled after the Bank of Japan (BoJ) expanded the monetary policy to alleviate the headwind from the strong Yen following the Plaza agreement in 1985, banks aggressively expanded loans to the real estate sector by using land as collateral **(Chart 1)**.

In the early 1990s, Japanese banks were slow to respond to the collapse of the real estate bubble. With a confidence on the “myth of land” they expected that the decline in land prices would be only temporary. By anticipating that land prices would eventually recover, banks made inadequate provisions and refrained from writing off non-performing loans (NPLs). Possibly, they didn’t sufficiently acknowledge

deteriorating creditworthiness, because accounting rules allowed a large room for discretion and disclosure was limited by then. Furthermore, banks largely believed that the Ministry of Finance would eventually bailout under the convoy system, which increased moral hazard. Hence, while continuing to lend to zombies in the real estate and construction sectors, banks became reluctant to lend to other segments such as startups, as the economy stagnated. These lending behaviors hurt Japan's economic productivity down the road.

From the second half of 1990s, Japanese banks finally began to write off NPLs. One of the important turning point was the financial crisis in 1997, where a major bank, brokerage firm and life insurance company went bankrupt. Banks were finally convinced that the MoF was unable to bailout while liberalizing the financial markets. At the same time, the government established legal frameworks for bank resolution under the Financial Revitalization Law in 1998 and disposals of NPLs under the Financial Revitalization Program in 2002. These initiatives have changed Japan's banking policy from a discretionary policy to an "objective" law based one, which effectively ended the convoy system. Consequently, after Japanese banks made major progress to re-assess creditworthiness and to write-off non-performing loans, banks loans finally bottomed out around the mid-2000s, a decade after the bubble burst **(Chart 2)**.

Chart 1. Japan: REER & Current Account

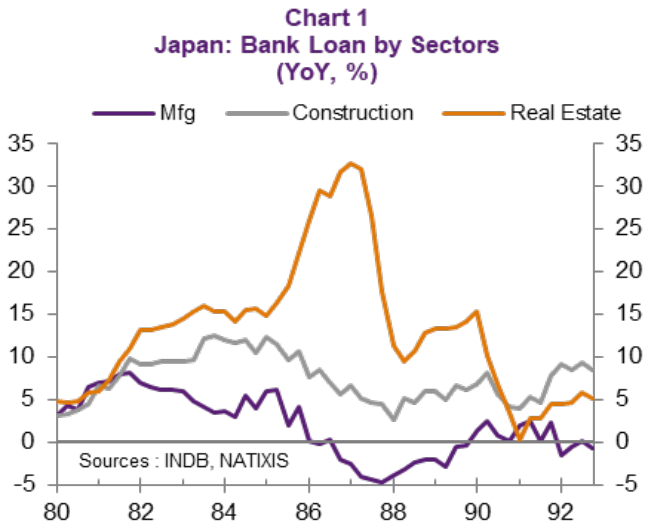
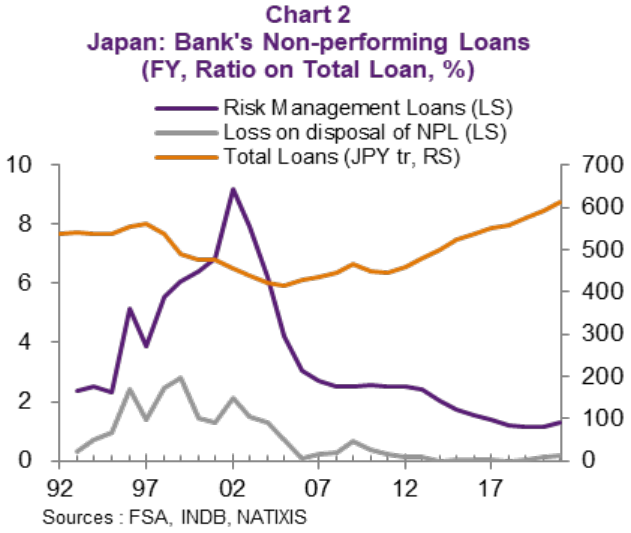
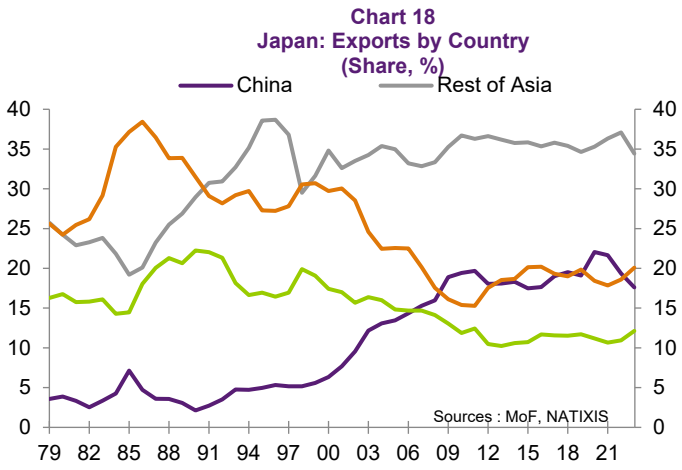


Chart 2. Japan:Bank's Non-performing Loans (FY, Ratio on Total Loan, %)



Internationally, Japan's more subdued role in global governance, resulting from its diminished political status after World War II, stands in stark contrast to China's increasingly assertive posture. Japan historically aligned itself with US policies without forging an alternative path (Chart 18), whereas China has taken a different approach. Beginning with the Belt and Road Initiative, China has expanded its economic influence as well as its soft and, in some cases, hard power on the global stage. This strategy could work to China's advantage if it successfully rallies support from the Global South. However, it also faces the challenge of containment from the US. Furthermore, Japan's approach to self-reliance is more measured compared to China's. Learning from Japan's experiences, China has adopted a more proactive strategy to ensure its independence from Western influence, particularly in critical sectors like semiconductors, while striving to maintain its competitive edge.

Chart 18. Japan: Exports by Country (Share, %)



Finally, China's technological trajectory may diverge significantly from Japan's, as China has achieved more breakthroughs in critical technologies, positioning itself much closer to the global frontier than Japan was at a similar stage. This advancement is bolstering China's efforts toward technological self-reliance, especially as the US intensifies its containment measures in this area. However, it remains uncertain how these innovations will help mitigate the structural deceleration of China's economy. Current evidence suggests that China's total factor productivity is declining alongside the economic slowdown, offering uncertain optimism for a turnaround (IMF, February 2022).

5. Conclusions

Japan provides valuable lessons for the world as an economy that once appeared poised to surpass the US, only to subsequently experience structural deceleration characterized by a declining population and low potential growth.

As China enters its own "new normal" of structural deceleration, some trends bear a resemblance to Japan's experience, particularly in terms of the collapse of the real estate bubble and increased reliance on the manufacturing sector and industrial policy. These similarities are exacerbated by the macroeconomic imbalances both countries have grappled with for decades, including excessively high savings rates that have led to over-investment and a persistent current account surplus.

There are two significant consequences of this investment-heavy economic model: the rapid accumulation of public debt and deflationary pressures resulting from overcapacity. However, important differences also exist. For instance, China's economy features an even lower share of private consumption relative to GDP and a relatively small volume of overseas investment. Besides, China's substantial advancements in innovation, particularly in critical technologies, have bolstered its technological self-reliance. That said, the tangible impact of this innovation on growth, specifically through increased productivity, remains to be seen, even for China.

Japan's experience does not provide a definitive answer as to whether a focus on technological progress alone can reverse the decline in growth, especially if increases in industrial capacity are not accompanied by greater domestic consumption. The external market ultimately served as only a temporary solution for Japan, as rising protectionist measures from the West limited its ability to export its way out of economic stagnation. Similarly, China faces the challenge of an oversupply relative to demand, which had perpetuated the specter of deflation that led to two lost decades for Japan.

One of the key difficulties in moving away from supply-side policies, both for Japan in the 1990s and for China today, is that policymakers have vivid memories of past successes. The macroeconomic imbalances (excessive savings and insufficient consumption) that once fueled growth for both Japan and China have since become liabilities. While China risks following a similar trajectory, it may be too early for policymakers to fully pivot away from its current growth model.

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7. About the author

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