7 March 2024

Macro Picture

THE DE-JAPANIZATION OF THE WORLD (& JAPAN?)

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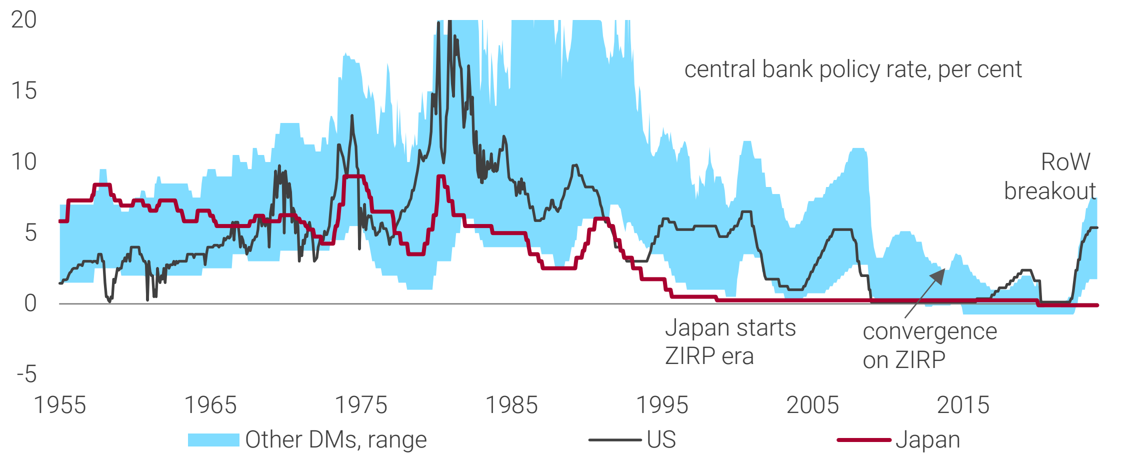
The Japanization narrative died during the pandemic, when global inflation hit its highest levels in half a century. Now, instead, we have "de-Japanization", the prospect of the world economy turning *structurally inflationary* and even dragging Japan out of its multi-decade liquidity trap. How valid is this new thesis – both for Japan and the rest of the world?

Chart 1: The world isn't turning Japanese anymore



Source: BIS, TS Lombard

NARRATIVE REVERSAL

In the 2010s, many investors became obsessed with the idea that the world was "turning Japanese" – a supposedly inevitable endgame for an era of ageing demographics, excessive debts and deflationary psychology. But it seems the Japanization narrative died during COVID-19. In fact, we now have the reverse: de-Japanization, which may even apply to Japan itself.

DEPANIZATION OF JAPAN

The Japanese authorities believe the country can break free of its multi-decade deflationary trap. They cite structural forces that will produce a more inflationary global backdrop, together with the emergence of favourable wage-price dynamics at home. While we agree with the BoJ's prognosis for the world, it remains to be seen whether de-Japanization will also take root in Japan.

CHINA EXCEPTION

There is one part of the world that is likely to buck the de-Japanization theme (and complicate life for Japan) – China. Indeed, across various dimensions, China's economy looks vulnerable to the same sorts of dynamics Japan faced after its property bubble burst in the early 1990s. But we think the authorities can manage their structural downturn, delivering "Sinification" instead.

THE DE-JAPANIZATION OF THE WORLD

When the IMF declared the start of a "global liquidity trap" in November 2020, it seemed as if a decade (or more) of chatter about the "Japanization" of the world economy had finally been vindicated. Perhaps we would be stuck with ZIRP and QE for decades, if not forever. As it turned out, the appropriate response – consistent with the IMF's track record – was to fade the whole thesis and the Fund's declaration duly marked a historical inflection point in inflation and interest rates. Indeed, since then, the whole Japanization narrative has been flipped on its head. Not only is the world now facing the possibility of structurally higher inflation, but there is even talk of "de-Japanization", where Japan eventually follows the rest of the world into *structural reflation*, leaving the era of zero interest rates behind. But to assess the true validity of the de-Japanization thesis, we must understand what was driving Japanization in the first place. Was there something special about Japan after the 1990s or did it share certain characteristics with other developed nations in the 2010s? Was Japan's liquidity trap structural, a symptom of "too much debt" or the result of policy mistakes? And to what degree do these conditions still matter?

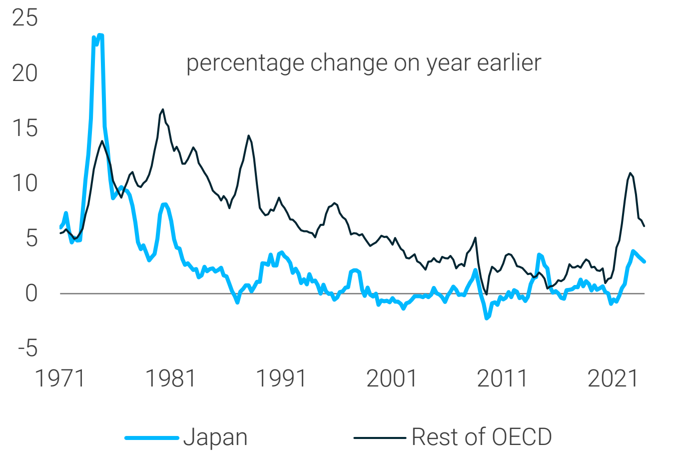
In an influential speech, Kazuo Ueda, the new(ish) governor of the BoJ, recently argued that there is a realistic possibility of Japan escaping the country's long deflationary trap. His thesis has three main tenets: (i) the structural forces that were previously pushing Japanese consumer prices lower, such as demographics and globalization, have started to reverse: (ii) the psychology of Japanese citizens has begun to shift, with deflation losing its grip, and (iii) Japanese macro policy – both fiscal and monetary – is set to remain more expansionary than in the past (when premature tightening often halted reflation in its tracks). As a description of broader global trends, we have a lot of sympathy for Ueda's analysis. We always felt that the Japanization thesis of the 2010s was overstated and that structural forces would eventually deliver a more inflationary global backdrop. Even ageing demographics was never as deflationary as investors assumed, something the pandemic has confirmed. But while "de-Japanization" is a plausible theme for the world as a whole, there are questions about the extent to which Japan itself will share these dynamics. Much will depend on policymakers' success in permanently shifting wage and price-setting dynamics, which will not be easy after decades of accumulated deflationary experience.

While, overall, the global economy has a realistic prospect of escaping so-called Japanization, there is one part of the world where the threat of a deflationary trap is still alive – China. Indeed, according to some of the most important macroprudential metrics, such as the level of private indebtedness and the economy's exposure to a domestic property bubble, China now looks susceptible to a pernicious "balance-sheet recession", similar to what happened in Japan 30 years ago. The question is whether the Chinese authorities can manage their post-bubble transition better than the Japanese did, rebalancing their economy without triggering a nasty crash. We see reasons for optimism, particularly with regard to the willingness and capacity of the Chinese state to provide additional fiscal support, at least when it comes to sectors that are consistent with wider social objectives (such as delivering the green transition and securing geostrategic resources). If we are correct, China is facing a grinding deceleration in activity (we call it "Sinification") rather than a genuine economic collapse. Somewhat ironically, China's structural weakness will also shift its role in the global economy, flipping on its head the country's interaction with the rest of the world. While China was a source of balance-sheet expansion and (intermittent) reflation for a world struggling with secular stagflation in the 2010s, China could now become a persistent source of disinflation for a world that is structurally more inflationary.

1. NARRATIVE REVERSAL

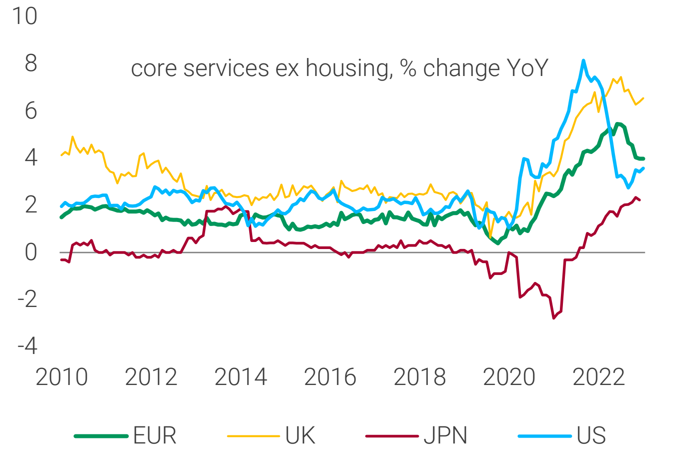
Investors and policymakers spent much of the 2010s worrying about the "Japanization" of the global economy (remember secular stagnation – an idea that had not been so popular since the 1930s?) For many, Japanese-style deflation was the inevitable endgame for a world with ageing demographics and "too much debt". Today, those worries seem totally misplaced. Not only do we have interest rates at multi-decade highs, but we must now consider the prospect of "de-Japanization", with policymakers in Japan arguing that the more inflationary global backdrop will eventually help them win their long battle with deflation. What should we make of this narrative reversal? Were the worries about Japanization always misplaced? What can the experience of the last three years teach us about the longer-term path of global inflation and interest rates? And is there really a genuine prospect of Japan escaping its ZIRP/QE era?

Chart 2: Can the world pull Japan out of deflation?



Source: OECD, TS Lombard

Chart 3: Japan's core CPI follows the rest

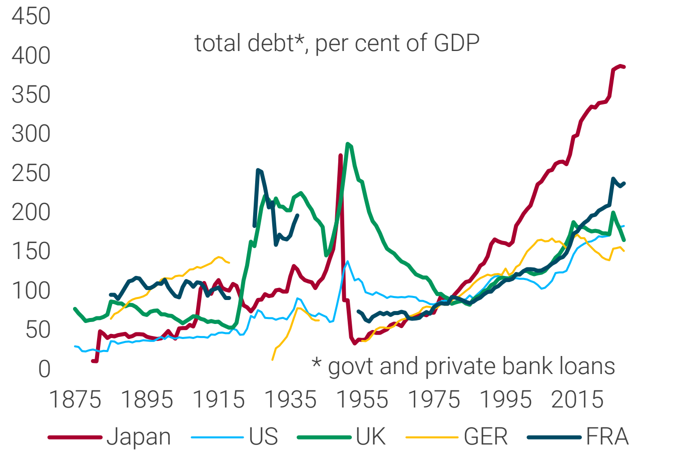


Source: OECD, TS Lombard

The curse of the IMF

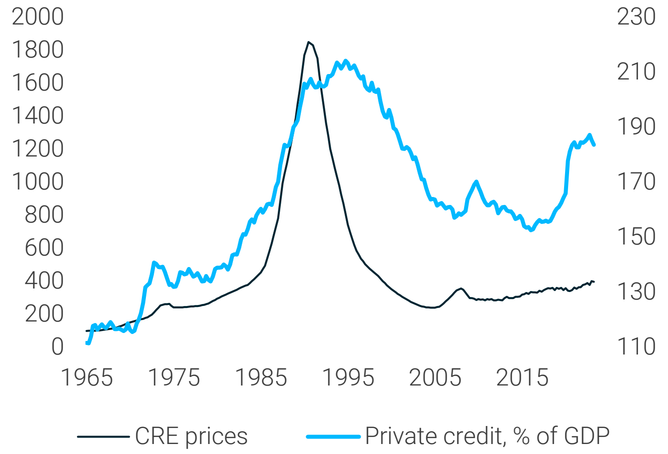
Worries about Japanization first emerged in the early 2000s. By then, deflation was already firmly entrenched in Japan and there were some economists – including various officials in Japan – who believed it would eventually spread *everywhere*. (I attended a top-level OECD meeting in 2002, where Haruhiko Kuroda, then a special adviser to the Japanese prime minister, gave a passionate speech cautioning central bankers in the US and Europe that they would eventually find themselves in a deflationary trap.) At first, it was easy to dismiss these warnings: Japan was a "special case"; Japanese policymakers had made a series of avoidable blunders. But after the global financial crisis in 2008, the Japanization narrative started to gain traction, both among policymakers and as an investment thesis. Perhaps Japan was not so unique after all. And if Japanization was a genuine threat, central banks needed to do everything they could to guard against this possibility. A decade or ZIRP, NIRP and large-scale QE programmes followed, as the authorities panicked about a persistent inflation undershoot, which – in retrospect – looks like little more than a rounding error. As it turns out, "peak Japanization" was in November 2020, when the IMF's Gita Gopinath proclaimed the onset of a "global liquidity trap". (Cue inflation surging to its highest levels in half a century and the fastest monetary tightening in history.)

Chart 4: Japan led the world's debt surge



Source: MacroHistory, TS Lombard

Chart 5: Japan's boom-bust in the 80s and 90s



Source: BIS, TS Lombard

Causes of Japanization

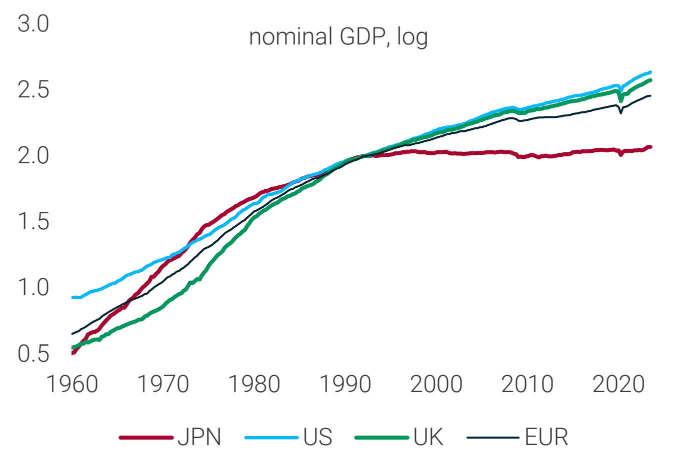
Understandably, mainstream economics devoted a huge amount of time and energy to comprehending what had gone wrong in Japan since the early 1990s, which is when the economy collapsed and deflationary dynamics first started to take hold. While there was no agreement on how to weight the various explanations, most people blamed a combination of:

1 **Balance sheets:** Japan had experienced a spectacular credit-fuelled property bubble throughout the 1980s, which had burst at the start of the 1990s. As asset prices plunged, debt levels (fixed in nominal terms) suddenly became unsustainably high, which triggered a lengthy period of deleveraging. This dynamic is now known as a classic "balance-sheet recession", but it took economists a while to understand the significance of this process. The big thing about a balance-sheet recession is that it is dangerously reflexive. As the private sector tries to rebuild its net worth, it curbs its spending, which reduces economy-wide income and thereby further rounds of balance-sheet destruction. Back in the 2000s, the consensus believed Japanese policymakers had been too slow to arrest these dynamics. Rather than recapitalizing the banking sector, they used various forbearance schemes to conceal the true scale of the problem, which only undermined the long-term health of the financial system.

2 **Insufficient policy support:** Most economists now believe that policy stimulus – both monetary and fiscal – is the only way to deal with a severe balance-sheet recession: the government must use its own balance sheet to support private-sector incomes and halt the deleveraging process. Japan generally failed to do this in the 1990s. Not only was the BoJ slow to cut interest rates and launch QE on a meaningful scale, but Japanese fiscal policy was too conservative. If we look at the fiscal impulse – the annual change in the structural fiscal balance (Chart 8) – it is clear that the Japanese provided only a relatively modest stimulus and were always too quick to reverse budgetary support. The classic example of this is when the government hiked the consumption tax (similar to VAT) in 1997, just as the economy seemed to be emerging from its deflationary slump. Note, however, that there is a popular misconception about Japanese fiscal policy: pundits tend to point to the country's rapid increase in public debt as evidence that fiscal stimulus "didn't work", but this was largely

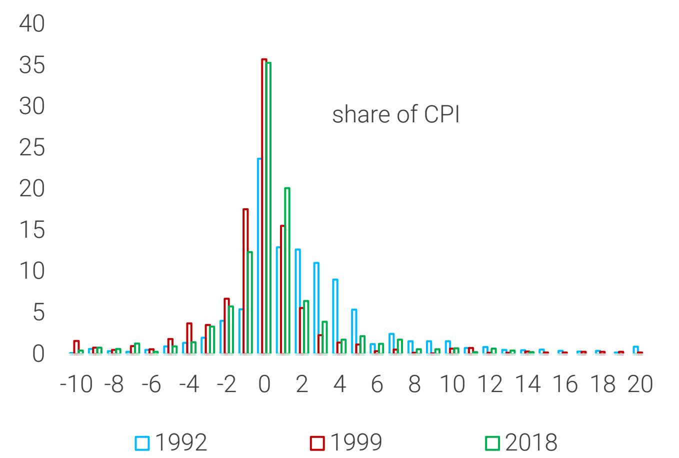
a passive response to weak economic activity (lower tax revenues) rather than the result of a deliberate attempt at reflation.

Chart 6: Japan's nominal inertia



Source: OECD, TS Lombard

Chart 7: Signs of deflationary psychology?

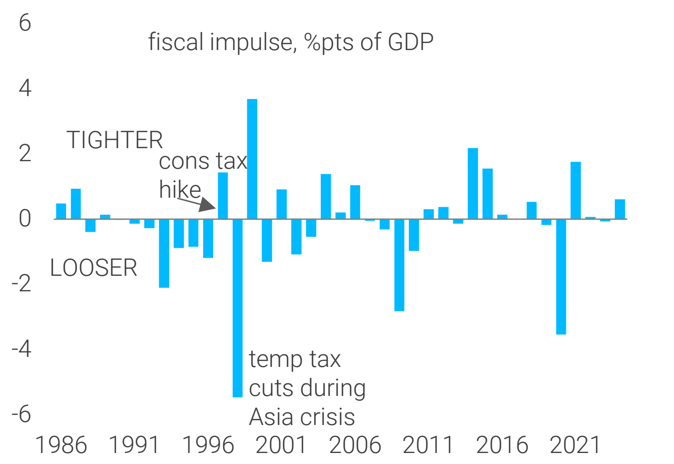


Source: BoJ

3 **Expectations trap:** After a lengthy period of balance-sheet adjustment and years of inadequate policy support, deflation in Japan took on a life of its own. Once businesses and households saw falling prices as the "new normal", the expectation that this trend would continue influenced their behaviour in ways that ensured prices continued to fall. There are two examples of how this can happen. The first is where companies think their competitors will reduce their prices, so they lower their own prices to protect their market share. The second example is where households' expectations for falling prices taper their wage demands, which reduces economy-wide cost pressures, killing any incentive to raise prices. While it is difficult to gauge the magnitude of these effects – since deflation is both the cause and the effect of a deeper malaise – it is clear that deflationary psychology has been a problem in Japan since at least the early 2000s. We can see both in the feedback loop between nominal wages and prices and in the media's reaction to high-profile corporate price increases – companies that hiked their prices were often lambasted in the press.

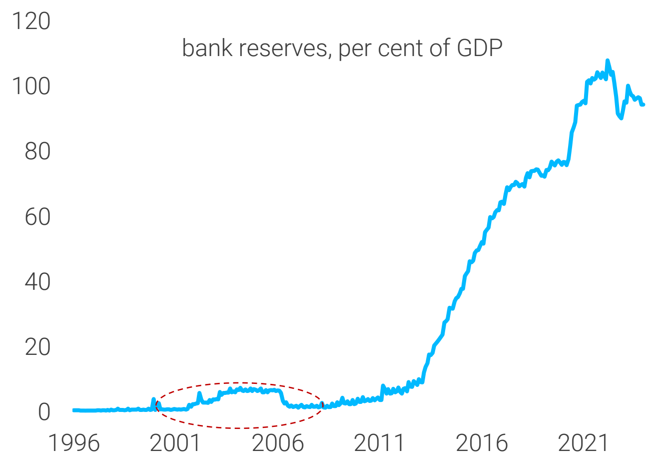
4 **Structural forces:** As always in discussions about inflation, there has been a lively debate about whether Japan's deflation was the result of "monetary" or "non-monetary" forces. Owing to the persistence of Japan's problems, attention eventually shifted to structural causes, particularly demographics and poor corporate governance (see Section 2, below). Japan's population is older than that of other developed nations, and the country passed a crucial demographic inflection point in the mid-1990s, when the population started to shrink – around the same time the economy entered deflation. Naturally, this fuelled a lot of speculation about whether other parts of the world would eventually experience similar dynamics – whether demographics was destiny and whether the arc of history was one that would always settle on falling prices. While we have been sceptical of this idea (for reasons we explain in Section 2), there were many pundits who simply assumed ageing demographics were inherently deflationary. They focused only on some of the effects of an ageing population, such as weaker investment and slower GDP growth. But as we explained in a previous report, demographics is a complicated process.

Chart 8: Japanese fiscal policy was too timid



Source: OECD, TS Lombard

Chart 9: BoJ didn't get serious until 2013

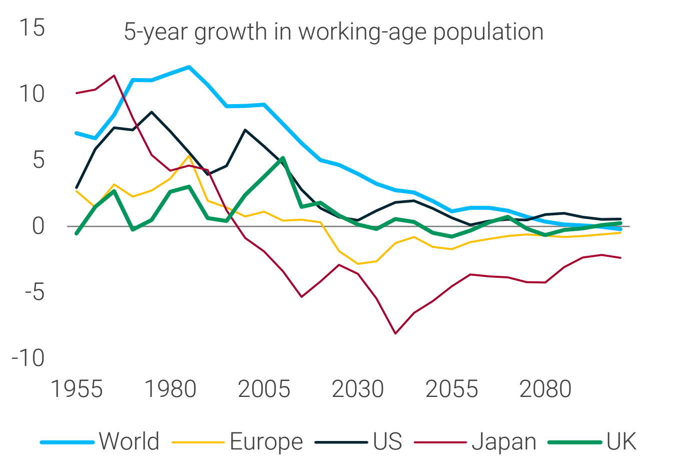


Source: BoJ, TS Lombard

The Japanization of the world

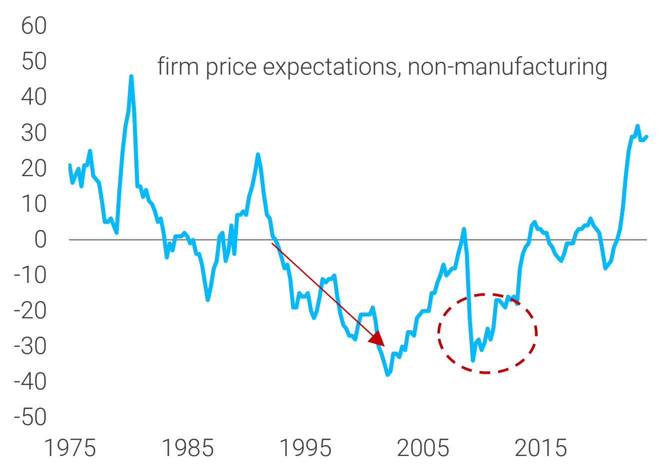
Given these popular explanations for what was happening in Japan, it is not surprising that many investors believed the entire global economy was converging on a "Japanese-style endgame" through the 2010s. Debt levels (both private and public) were close to historical highs after the global financial crisis, and many parts of the world suffered balance-sheet recessions as a result. The global policy mix was generally unhelpful, especially in the first half of the 2010s, which is when governments were pursuing austerity. Ageing demographics was everywhere, and the trends were particularly advanced in Europe (which, for long periods in the 2010s seemed to be closest to following Japan into outright deflation). And persistent "lowflation" seemed to threaten a dangerous expectations trap, where central banks would never be able to arrest persistent CPI shortfalls. It is no coincidence that secular stagflation, a term coined during the Great Depression, dominated macro commentary and featured so heavily in every investment outlook. Yet the events of the last three years have largely killed the Japanization narrative. Now, nobody is talking about secular stagnation anymore. So, what have we learned about inflation during this period? How has the post-COVID period recast the outlook for Japan – and the wider global economy?

Chart 10: Japan led DM ageing in the 90s



Source: UN, TS Lombard

Chart 11: A revival in inflation expectations

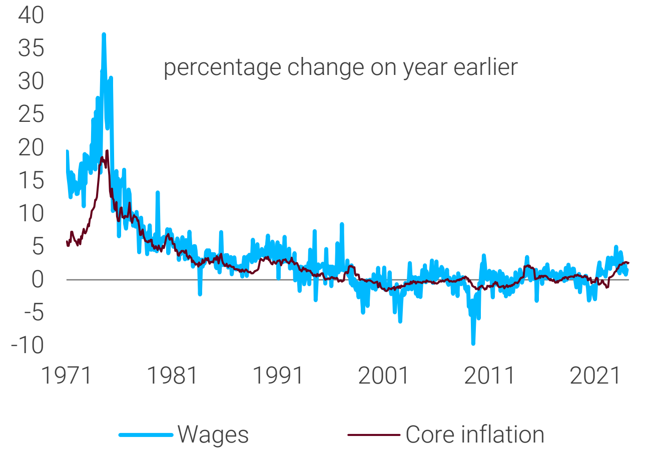


Source: Datastream, TS Lombard

2. DE-JAPANIZATION OF JAPAN

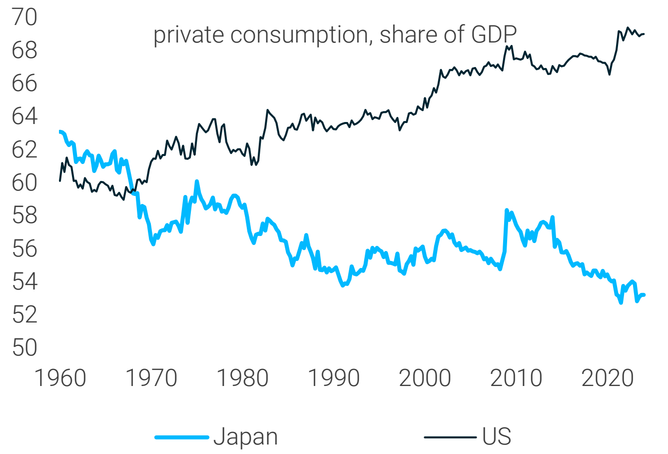
Kazuo Ueda caused a stir in January when he claimed that there is now a realistic possibility of Japan escaping its deflationary funk. He argued that the global backdrop was not only becoming more inflationary from a structural point of view but that some of the domestic forces that had contributed to falling prices in Japan – including demographics, poor corporate governance, and depressed expectations – had started to shift. This is significant because it shows just how far the Japanization narrative has changed in the last few years. In fact, we now have the prospect of de-Japanization, in which an inflationary world pulls Japan out of deflation. This would obviously turn the thesis of the last two decades on its head. But is Ueda correct? As a view about how the global inflation backdrop is shifting, we agree with his analysis. We think inflation will be structurally higher in the 2020s, for many of the reasons Kazuo identifies. The more difficult question is whether these trends will meaningfully shift the dial on Japanese inflation and allow the BoJ to escape large-scale QE and permazero interest rates. Success here will depend on the extent to which Japanese policymakers can transform domestic price expectations and generate sustained nominal wage growth. The authorities will need to proceed carefully (which seems to be their intention), because this is an area where Japan has had false dawns in the past.

Chart 12: Start of a virtuous cycle?



Source: Datastream, TS Lombard

Chart 13: Japan's deflationary imbalance



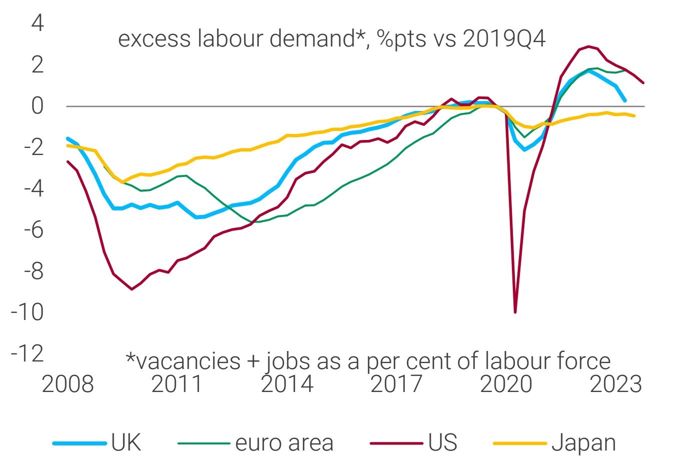
Source: OECD, TS Lombard

This time is different?

Ueda's speech starts with an assessment of what went wrong in Japan in the 1990s. On the whole, his analysis is consistent with the consensus interpretation we outlined in Section 1 – albeit with a little less emphasis on bad policy and a little more focus on bad luck. Ueda agrees that Japan suffered a balance-sheet recession in the early 1990s and that, over time, structural forces and the onset of deflationary psychology served to keep Japan in a liquidity trap. But Ueda also makes the case that Japan's escape from this situation was not helped by a series of nasty external shocks, including the Asia crisis in the late 1990s, the global financial crash in 2008, the major East Japan Earthquake in 2011, and eventually COVID-19. Does that mean Japan would have exited deflation earlier, had it not been for these events? Perhaps. There were certainly occasions in the past where the consensus thought Japan would escape ZIRP, only to have those hopes dashed by subsequent events (and a strong yen!). But Ueda outlines a structural case for reflation – reasons to think that, after various false dawns, this time will be different for Japan.

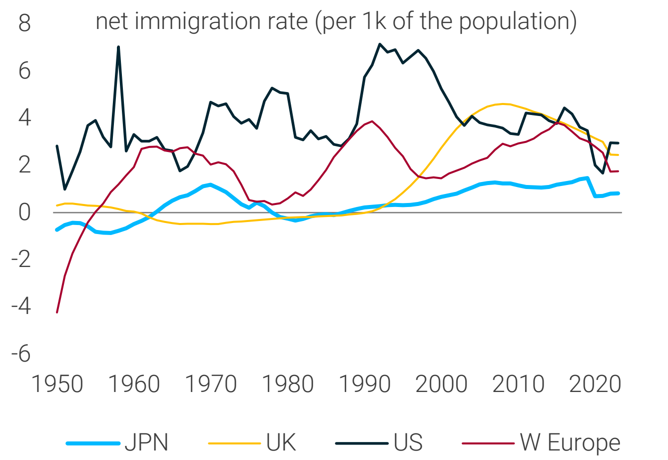
Ueda's assessment that Japan can escape deflation rests on three tenets. The first two are domestic and focus on the interaction between private-sector psychology and macro policy. The BoJ governor points out that the authorities in Japan – like in other parts of the world – have learned the lessons of the last 30 years and engineered a much more reflationary policy mix. Not only has the central bank been engaged in massive QE since the late 2010s, but the government has been using fiscal stimulus on a much larger scale than in the past. Ueda believes this is helping to shift expectations in Japan, which have become a lot more reflationary since COVID-19. Firms are now inclined to increase their prices, and they are doing so much more frequently – which suggests the obstacle of "high menu costs" has been overcome. Ueda's hope is that expansionary macro policy will establish a "virtuous cycle" between nominal wages and prices, breaking the deflationary dynamics of the past 30 years. Naturally, this thesis places a lot of emphasis on wage bargaining, where workers do seem more willing to demand – and secure – higher pay. Japanese wages tend to be set annually as part of the Shunto process, and last year saw the largest wage gains for three decades.

Chart 14: Japan's labour market hasn't changed?



Source: national sources, OECD, TS Lombard estimates

Chart 15: Japan's low immigration rate



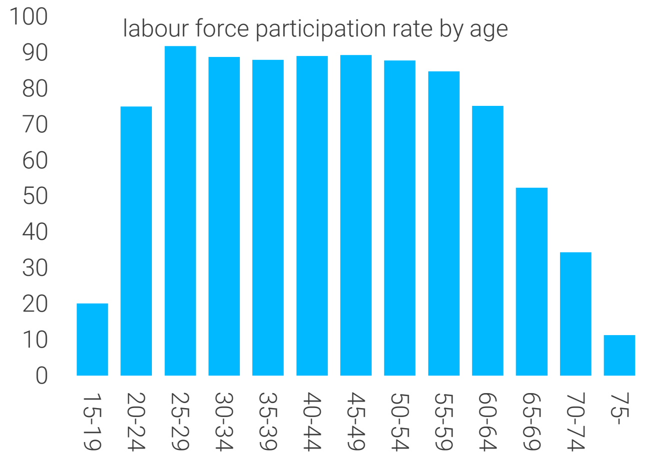
Source: UN, TS Lombard

Whether Ueda is correct in his assessment of a "virtuous" feedback loop between nominal wages and prices remains to be seen. In this regard, the next wage round – which will take place in the spring – will be particularly important. We will learn whether post-COVID wage gains were just a one-off response to the pandemic (as has been the case in other developed economies) or the start of a trend acceleration. But it is important to remember that Japan's labour market does not look so very different from how it looked in 2019. With both the demand for and supply of Japanese labour declining during the pandemic, there is less evidence of "domestic overheating" than we have seen in some other parts of the world. From a cyclical view, this makes us a little sceptical about the prospects of sustained domestic reflation in Japan. But we do think Ueda is right when it comes to structural forces, particularly the interplay of ageing demographics and deglobalization. And the stock market is certainly reacting well to recent corporate reforms.

A structural break

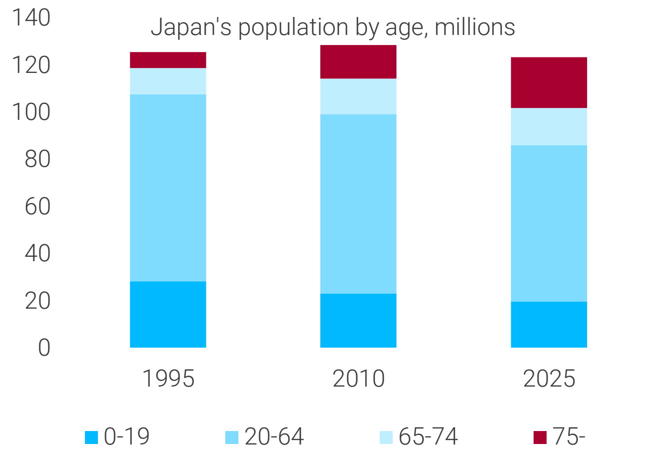
The BoJ's governor's most controversial thesis is that demographics is no longer deflationary in Japan. To be precise, he argues that demographics *was* deflationary – when older Japanese citizens were saving for retirement – but that this dynamic has reversed because older people are dropping out of the labour force. Chart 16, which he used in his speech, shows that participation rates typically plunge at the age of 75, which is the threshold many Japanese babyboomers have now reached. Once the elderly stop working, this has two inflationary effects. First, it causes savings rates to decline, which boosts the equilibrium interest rate (because people are no longer in paid employment, so they spend from their accumulated earnings). Second, lower participation among the old can lead to labour shortages, which boost the wage bargaining of younger workers (a dynamic that played out across much of the DM world during the pandemic, when a surge in early retirements triggered a sudden burst of wage inflation). Though controversial, Ueda's analysis is consistent with academic studies, including an excellent (2019) paper from the BIS, which showed that demographics is not as deflationary as everyone has been assuming.

Chart 16: Participation rates about to plunge?



Source: BoJ, TS Lombard

Chart 17: Japan facing structural labour shortages



Source: BoJ, TS Lombard

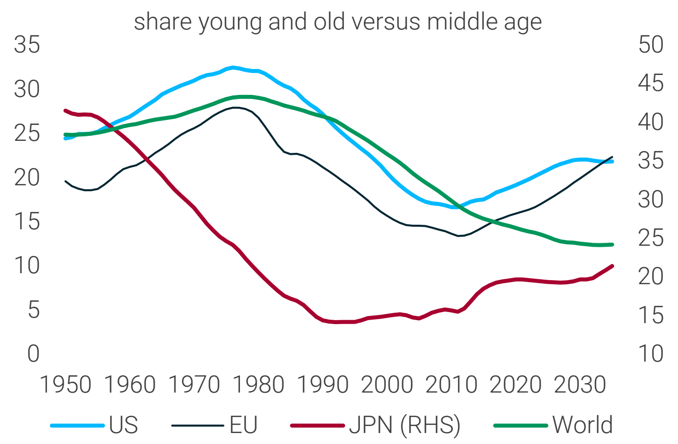
Demographics no longer deflationary

Estimating the effects of the demographic structure — not just ageing — on inflation based on data from 22 advanced economies from between 1955 and 2014, the BIS found a robust relationship. In particular, the researchers identified a stable U-shaped pattern: the young (aged 5-29) and the old (65+) are inflationary, whereas the prime working-age cohorts are disinflationary. This U-shaped pattern is robust and did not disappear when other variables often associated with inflation — such as output gaps, oil prices, real interest rates, population growth and fiscal policy – were included. Moreover, the relationship survives different periods and alternative country samples. The BIS believes age structure explains the bulk of "trend inflation" and about a third of the overall variation in OECD CPIs. Looking ahead, they predict a sustained inflationary impulse over the next 20 years – as the share of middle-aged people continues to dwindle. If this analysis is correct, recent developments in Japan could be part of a much wider global theme.

Other structural forces

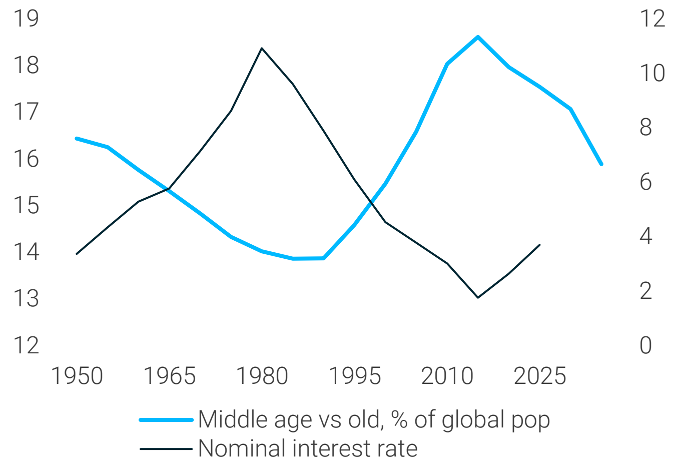
Demographics is not the only structural force that could ease deflationary pressures in Japan. Ueda also points to deglobalization. Again, we have a lot of sympathy for this idea: we think deglobalization is real and has gathered pace since the pandemic, in response to shifting geopolitics and the incentive to boost supply-chain resilience through reshoring and friendshoring. Whereas our focus has been on the potential for deglobalization to interact with demographics to produce structural labour shortages, Ueda focuses on the role of product markets and international competition. From a Japanese perspective, this makes sense, especially as Japan has never experienced rapid immigration (in contrast with the US and much of Europe). Ueda argues that Japan's geographic position (i.e., its proximity to China) and its large industrial base meant the country was particularly exposed to imported disinflation. Worse, Japanese companies resorted to wage suppression in an effort to restore their competitiveness. But if globalization is now in retreat and global competition eases, these pressures will fade.

Chart 18: Japan less inflationary than elsewhere?



Source: UN, TS Lombard

Chart 19: Demographics to raise r*?

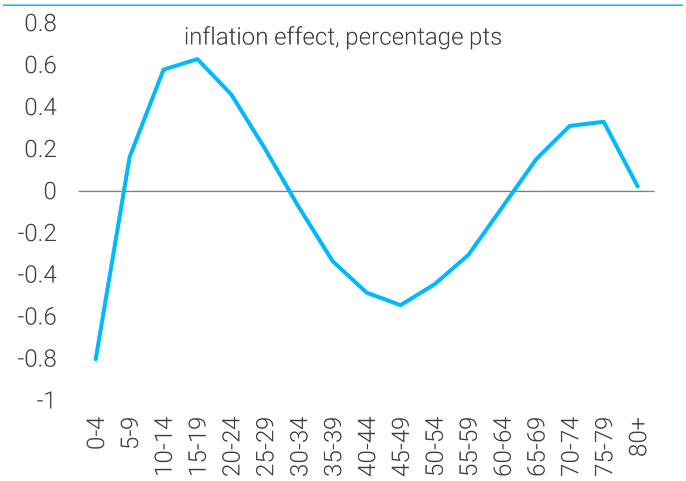


Source: UN, TS Lombard

Cautious optimism

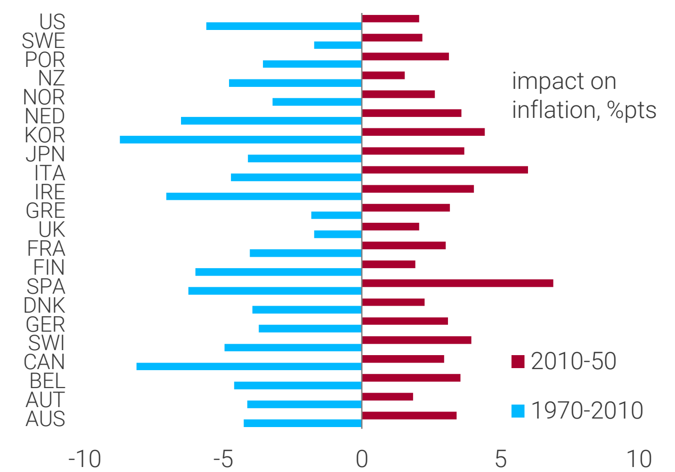
We think Ueda is right in his analysis about the structural inflationary trends in the global economy and that his analysis of Japanese demographics is particularly important to this wider discussion. We think the 2020s will produce a mild reflationary trend, as the balance of power between labour and capital tilts back towards workers for the first time since the early 1980s. Over time, this reflationary impulse should also reach Japan. But we are not yet convinced that what we are seeing in Japan is the start of a genuine escape from ZIRP, rather than an echo from the artificial inflation breakout of the past two years (imported into Japan via an extremely weak currency). The good news is that the BoJ clearly understands the risks and wants to proceed cautiously. Given previous false dawns, the authorities will be desperate not to repeat past mistakes – particularly premature policy tightening, which could trigger a surge in the yen.

Chart 20: Inflationary impact by age group



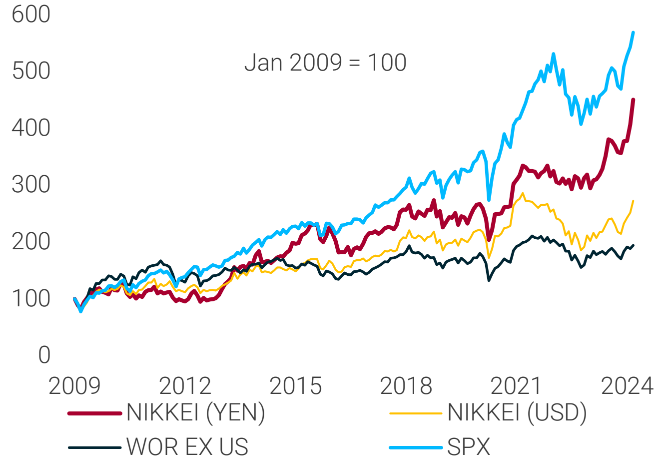
Source: BIS study (see text)

Chart 21: Demographics is becoming inflationary



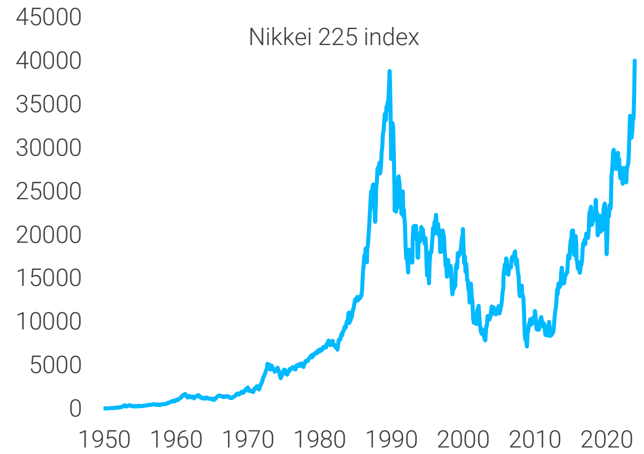
Source: BIS study (see text)

Chart 22: Weak Yen boosted Japanese stocks



Source: Datastream

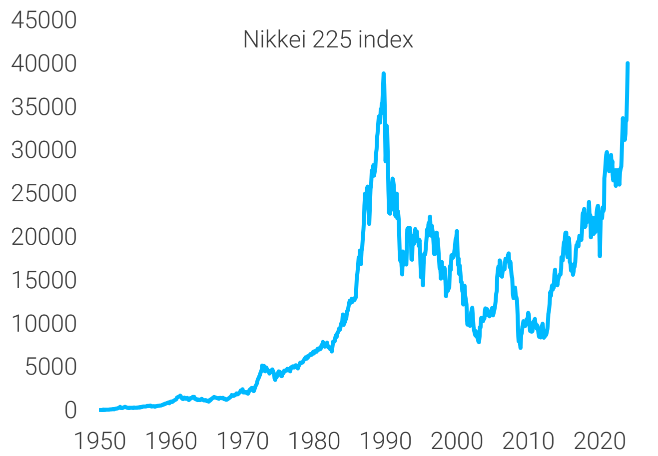
Chart 23: Japan is so back!



Source: Datastream

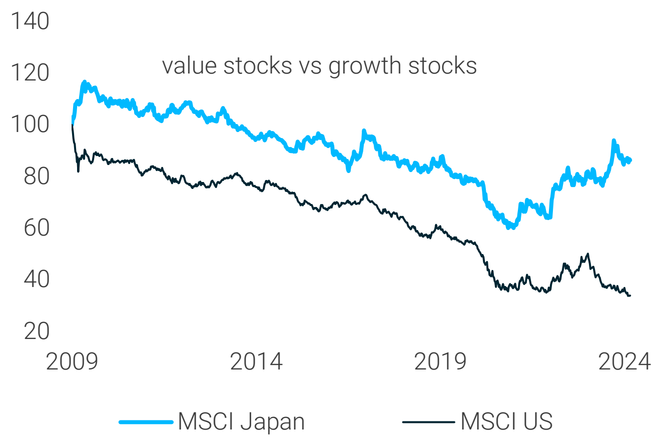
There are several risks associated with Japan's currency, especially if the world is one in which where other central banks are cutting interest rates. One is the "wealth effect" for Japanese investors, who were previously engaged in a powerful carry trade (purchasing foreign assets to take advantage of rate differentials and a weak yen). If Japan's currency started to appreciate, investors could repatriate those funds, which would accelerate the currency move and create a nasty feedback loop. And a surging exchange rate is obviously unhelpful for a central bank hoping for sustained reflation. The second problem with higher interest rates and a stronger currency is that there could be significant fiscal implications. According to a recent NBER research paper, the Japanese government now has a material exposure to tighter monetary policy – thanks to its large unhedged position in foreign assets. This is because, in the QE era, Japan's public sector was, in effect, borrowing overnight from households and investing longer-term in foreign assets. Finally, a big currency appreciation could also have serious implications for Japanese equities.

Chart 24: Japanese stocks are still cheap!



Source: Datastream

Chart 25: Value investing works (in Japan at least)



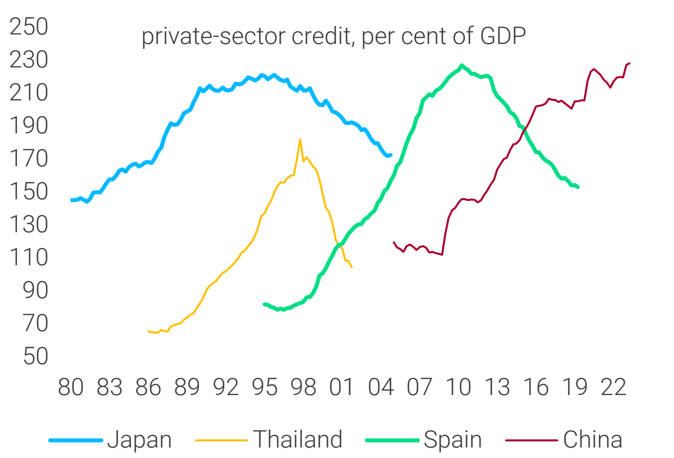
Source: Datastream, TS Lombard

Japan is SO back

Japan's stock market has been rallying hard, with the Nikkei 225 setting a new record high for the first time since the country's property bubble burst in December 1989. In recent years, much of this surge in Japanese equities has been related to currency weakness, since yen depreciation boosts the earnings of the country's large industrial base. But now there are signs that the rally is broadening out, presumably because investors are starting to buy into the view that the country can escape its long secular funk. Reforms to corporate governance have certainly helped. For decades, Japan's corporate sector has been sitting on large surpluses, rather than reinvesting these in their businesses (through wages or capex). By keeping the consumption share down, these surpluses have also contributed to Japan's weak growth performance versus other DMs.

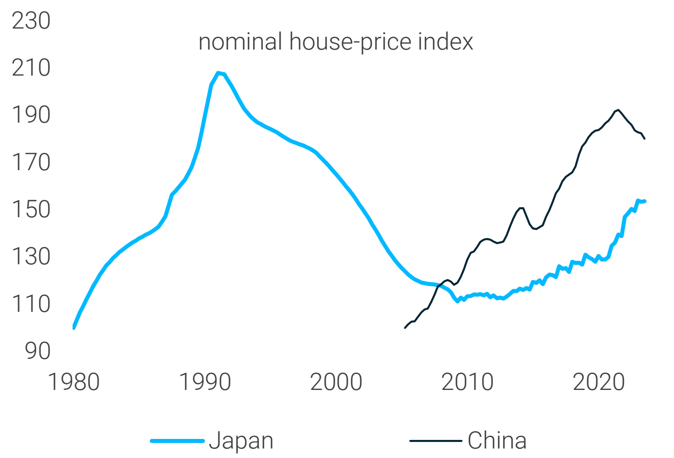
Various features of Japan's corporate landscape have allowed the country's largest companies to resist competitive pressures and behave in ways that were detrimental to shareholder value. The classic example of this is the country's cat's cradle of clubby equity crossholdings, whereby listed companies took strategic stakes in each other to fend off hostile takeovers and maximize their control over corporate decisions, often to the detriment of smaller shareholders. There are signs, however, that this corporate culture is beginning to change. A key moment happened last year, when the CEO of the Tokyo stock exchange publicly shamed listed companies with price-to-book ratios of less than 1.0, forcing them to explain how they would improve their return on equity (or face the prospect of de-listing). So, it is perhaps no surprise that it is the "value" sectors of the market (and earnings) that have been leading the recent rally. While it remains to be seen whether the current reform programme will be truly transformative for Japan's stock market – and the broader economy – our strategy team thinks the rally has further to run. But when it comes to the outlook for sustained reflation in Japan, there is one factor that complicates the outlook – the country's exposure to China. While, in the short term, China's problems have made Japan's stock market even more attractive to foreign investors, they also threaten Japan's longer-term revival.

Chart 26: World's biggest credit bubble



Source: BIS, TS Lombard

Chart 27: Echoes of Japan?

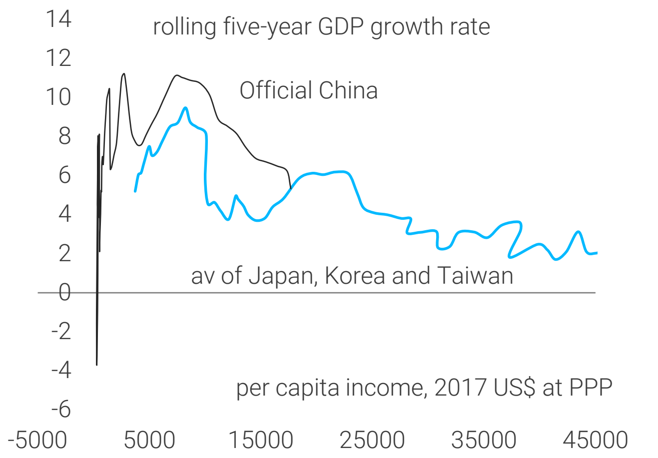


Source: BIS, TS Lombard

3. CHINA EXCEPTION

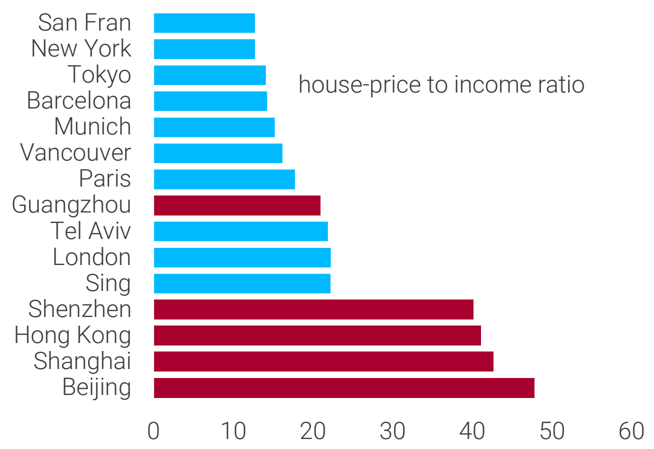
The Japanization theme seems to be dead and, as explained above, there is even a realistic chance of de-Japanization. But there is one part of the world that is likely to buck this trend: China. In China, the threat of Japanization is still very much alive, not least because of some similarities it shares with Japan of the early 1990s (notably, the country's enormous credit-fuelled property bubble). Ultimately, however, we think Chinese authorities will make a better stab at rebalancing their economy without triggering an economic crisis. While a structural slowdown (which we call "Sinification") seems inevitable, there will be no precipitous crash. The key to this is the state's willingness (and capacity) to use its fiscal firepower, particularly when directed at wider social objectives – such as the green transition and securing a geostrategic advantage. But the way China interacts with the wider global economy is likely to shift. Whereas China was a source of "balance sheet" demand and reflation in the disinflationary world of the 2010s, it will become a source of disinflation for a world that is otherwise facing structural reflation.

Chart 28: China facing structural slowdown



Source: Conference Board, TS Lombard

Chart 29: Chinese property is pricey



Source: The Economist

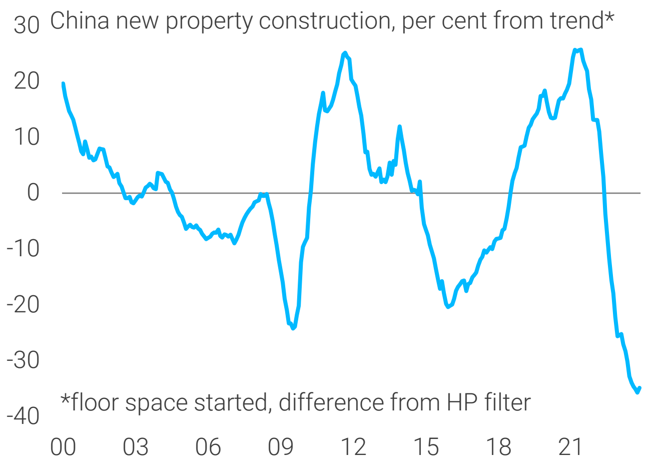
China's Minsky moment – all over again

Over the past decade, there have always been attempts to fit various parts of the world to the "Japan of the 1990s" template. First, there were fears that the US was "turning Japanese", then it was Ireland and the Mediterranean economies following the euro crisis and eventually the entire euro area in the late 2010s. But the comparison with China seems more compelling. Like Japan during the 1980s, China has seen the creation of an enormous credit-fuelled property bubble, which appears to have burst. And like Japan in the 1990s, China's economy is now dangerously exposed to that property sector. According to a study by Ken Rogoff and Yuanchen Yang, Chinese real estate has been responsible for around a third of the country's GDP. So, a sustained slump would be a serious problem, not just for China but potentially the entire world. These worries are not exactly new, however. Doubts about the sustainability of China's credit splurge first emerged in the early 2000s and have been a reoccurring theme ever since. China has a "potential Lehman crisis" roughly every 18 months. But Minsky is still waiting for his moment.

Structural slump

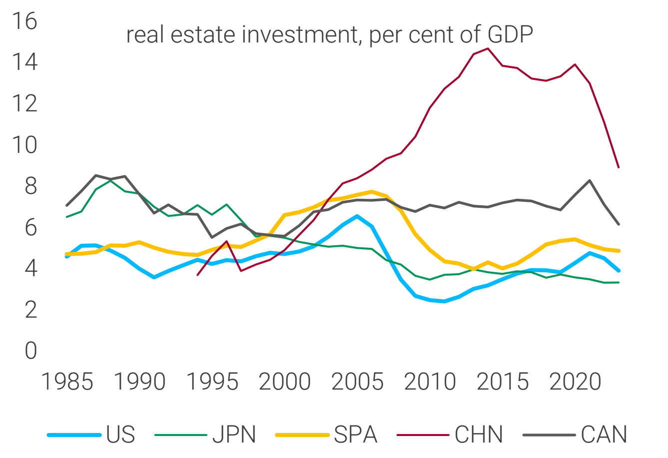
There have been two major changes that suddenly make China's economic outlook a lot more challenging. First (and again like Japan in the 1990s), the country has just passed a demographic inflection point. China's population has started to contract; and that makes it harder to argue that continued growth in the property sector is justified by "fundamentals", particularly when – on some metrics – China is already over-invested in real estate). Urbanization has slowed, and house prices are dangerously high by international standards. Second, it is increasingly clear that the authorities do not want the property boom to continue – a boom that, let's not forget, was essentially created by their policies. Over the past several years, Xi Jinping has shown he is serious about wanting to create a new growth model for China – "Common Prosperity" – with the aim of pivoting the economy away from market capitalism and curbing the "excesses" of the past decade. To deliver this, the authorities must halt China's rapid accumulation of debt and instead allow the economy to settle onto a more sustainable trend. The focus is now on high-quality (and equal) growth, not just high levels of growth. China's policymakers are aware of the danger of repeating what happened in Japan in the 1990s and are desperate to avoid it.

Chart 30: Property crash continues



Source: CEIC, TS Lombard

Chart 31: Over-invested in real estate

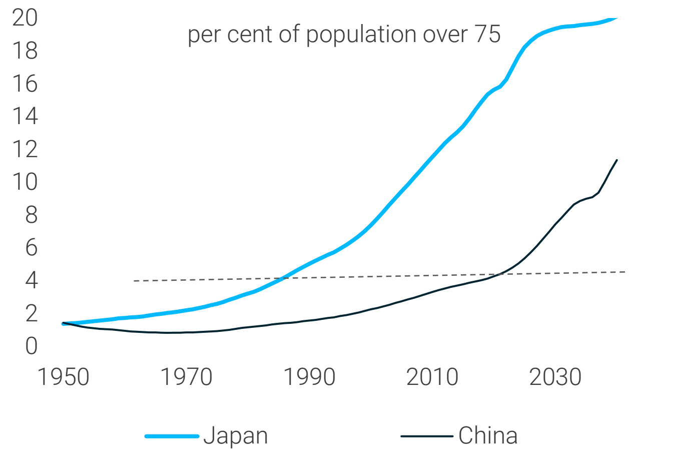


Source: IMF, TS Lombard

No margin call

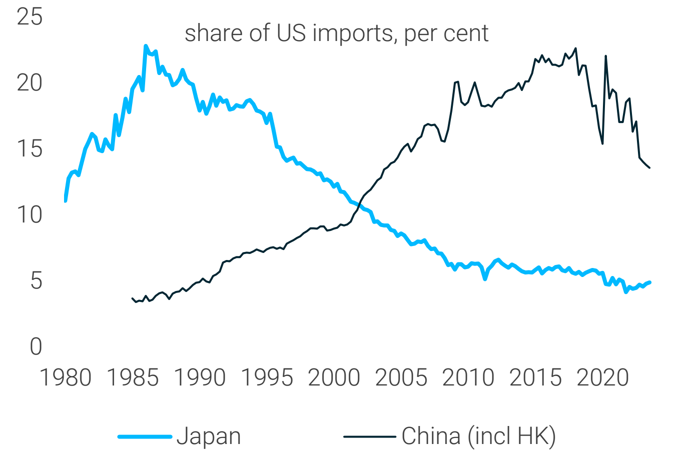
After a decade of vigorous stop-go policy in China, which generated a succession of potential "hard landings" and "Minsky moment" scares, it seems trite to point out that China is not facing a Lehman-style crisis. Financial pundits should have realized by now that there can be no "margin call" when the credit bubble has been largely about state-owned banks lending to state-owned (or quasi state-owned) enterprises. That is not to say, of course, that China's situation will not deteriorate further (or that the authorities will not need to provide more short-term policy stimulus to avert that deterioration). But, overall, we have always believed that China has the capacity to rebalance its economy, without triggering a serious economic or financial calamity. While China cannot cheat the laws of economics entirely – which is why there will certainly be a structural slowdown in GDP – the authorities do have the tools to prevent a Japan-style hard landing.

Chart 32: Demographic inflection points



Source: UN, TS Lombard

Chart 33: Another parallel with Japan



Source: IMF, TS Lombard

Sinification not Japanization

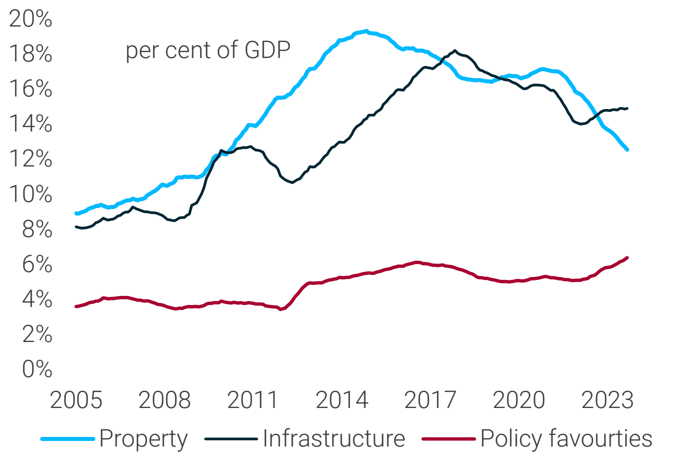
Our China analysts published a detailed report in October that examined in detail the comparison between China today and Japan of the 1990s. Their conclusion was that China is facing "Sinification" not Japanization, which they define as a "grinding deceleration in activity led by falling property investment and weak consumption, only partially counteracted by rising government debt, fiscal spending on tech and welfare, and resilient exports, putting potential growth at 3-4% in the next 3–5 years." The important point here is that the authorities will continue to use their state balance sheet to support the economy but in a more measured and targeted way than what we saw in the decade after the global financial crisis. The authorities have already shown they can come up with unorthodox ways to support the economy, such as their recent shantytown renovation scheme. Local governments destroyed millions of dilapidated homes and compensated the homeowners with cash provided by the PBoC. (The new homeless took that money and leveraged it up to buy property developers' excess inventory.) We are likely to see similar schemes, which will help to shore up the cyclical position of the economy. But the broad focus will shift to sectors squarely aligned with China's long-term social objectives. From a sectoral perspective, the policy favourites are clear: tech hardware and clean energy, including EVs, batteries, semiconductors, robotics, AI, biotech, and 5G. China will try to shift its allocation of resources to these areas, a transition that has been under way for several years now. And we should also expect fiscal spending in other areas – such as welfare – to creep higher.

What this means for the world

China's domestic policy swings had an outsized impact on the global industrial cycle over the past decade, a dominance that puzzled many institutional investors. Episodes of policy tightening in China foreshadowed global growth/deflation scares, typically with a lead of around 8-10 months. Conversely, when the Chinese authorities were trying to stimulate the economy, a period of "global reflation" usually followed. If we are entering an era in which China will run its economy "cooler", dodging the temptation for large credit splurges, the rest of the world could have a problem. Remember, China has added more than US$30 trillion to global debt since 2008, a period during which there was a distinct scarcity of growth catalysts elsewhere. In effect, the Chinese state was an important source of new "balance sheet" for the global economy. The good news, however, is the world economy no longer needs China-led reflation. In fact, with the global economy looking structurally inflationary, China could serve as a helpful counterweight – a deflationary draught that will chill some of the price pressures that are emerging elsewhere. This is interesting because it would flip the role of China, offering another example of a macro theme in which the 2020s is shaping up to be the exact inverse of the 2010s. Other examples include:

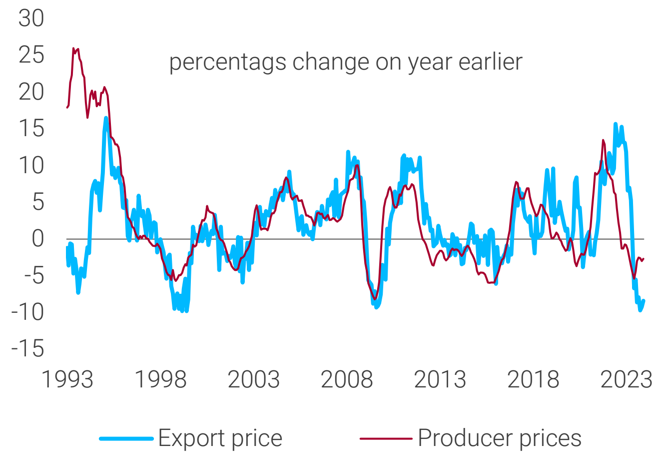
- Tight monetary policy, loose fiscal policy
- High pressure labour markets
- De-Japanization (potentially even for Japan itself)
- A global productivity revival
- Faster technological diffusion

Chart 34: China's new policy favourites



Source: CEIC, TS Lombard

Chart 35: China to export deflation again



Source: Datastream, CPB, TS Lombard

Bottom line

Throughout the 2010s, many investors believed the entire global economy was facing Japanization. Ageing demographics, deflationary expectations, and elevated debt levels would "inevitably" produce an endgame of permazero interest rates. This narrative peaked in November 2020, when the IMF declared a "global liquidity trap". Since then, the thesis has started to lose its grip (the curse of the IMF forecast…). In fact, we now have a hint of "de-Japanization", where a more reflationary global economy has convinced Japanese policymakers that they may soon be able to escape their multi-decade secular funk. De-Japanization, even for Japan! We always felt the Japanization theme was overdone, not least because it was never a politically sustainable endgame for most Western democracies. And we agree with the BoJ Governor Kazuo Ueda that the global economy is facing structurally higher inflation in the 2020s. Not only is fiscal policy likely to remain more expansionary, but ageing demographics and deglobalization will combine to create persistent labour shortages and less intense global competition. The only real question is about the degree to which these international trends can drive a genuine secular shift in Japan itself, which will depend on whether the authorities can transform private-sector expectations, deliver genuine corporate restructuring, and avoid premature policy tightening. In this respect, Japan also has another disadvantage – its outsized exposure to China's structural slump. China is the one part of the global economy where the Japanization risk is still very much alive.

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