The Big Read **China**

Is China's economy turning Japanese?

Three decades after Tokyo's property bubble burst causing severe damage there are fears that Beijing faces a similar fate

MAY 28, 2017 by: Leo Lewis in Tokyo, Tom Mitchell and Yuan Yang in Beijing

There are few things studied as closely by the Chinese Communist party as how to avoid the fate of its Soviet counterpart. In an internal meeting after he assumed power in 2012, President Xi Jinping said no one in the Soviet Union had been "man enough" to stand up to Mikhail Gorbachev and glasnost.

But for Mr Xi another historical event from the same era may warrant more immediate attention. It is just over 30 years since Japan began inflating a property and stock market bubble whose implosion ravaged public confidence, cowed corporations and scarred an economy for decades. China's priority today is to avoid that fate.

It is not a new concern for Beijing. In 2010, as China's overall indebtedness was approaching 200 per cent of gross domestic product, Mr Xi, then the country's vice-president, asked scholars at the Central Party School to research the subject, according to two Chinese academics familiar with his request. A subsequent paper outlined some of the lessons of the Japanese bubble, including the need for Beijing to raise awareness of financial risks, safeguard "economic sovereignty" and not give in to pressure to change its currency policy.

Seven years on, China's total debt is 250 per cent of GDP and climbing, officials are trying to rein in sky-high real estate prices and the government is still grappling with the aftermath of a stock market bubble that burst in 2015. Mr Xi last month warned the country's leaders of the need to "safeguard financial security".

But how great is the risk of China turning Japanese? Does China, the world's second-biggest economy in 2017, run the risk of repeating the fate of what was the world's second-biggest economy in 1989 — Japanese-style "lost decades?". If Japan's fate were to befall its giant neighbour, the consequences would be devastating for the global economy. China provides 40 per cent of its annual growth. China also supplies just over 20 per cent of US imports, the same percentage as Japan in the mid-1980s.

Goldman Sachs' Naohiko Baba and other analysts suggest that there are lessons for Beijing to learn from Japan's bubble experience, when laid out against spookily similar reference points ranging from corporate debt levels to average white-collar commuting times in China. Yet others, including Andy Rothman, an investment strategist at Matthews Asia, insist that there are far more differences than similarities. He says the only real value of the comparisons "is to calm people down".

A short answer — and one often favoured by both foreign investors with billions of dollars at stake and the Chinese state with 1.4bn people — is that there is more to be gained from taking the bubble risk seriously than from assuming that this time it is different. China has already hit various milestones that recall Japan in its late 1980s pomp. Some, such as the non-financial corporate debt-to-GDP ratio reaching similar levels of about 155 per cent, are technical. Others are more frivolous: Yasuda Kasai, the Japanese insurance company, paying $40m for Van Gogh's "Sunflowers" in 1987; and Chinese billionaire Liu Yiqian's 2015 purchase of a Modigliani painting for $170m.

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To many observers, comparisons of bubble-like economic behaviour have always seemed within easy reach. Both countries have shown themselves capable of spasms of asset inflation with similarly boom-and-bust shaped price charts. And both have paid handsomely for overseas assets — Mitsubishi Estate paid $900m for 51 per cent of New York's Rockefeller Center in 1989 and CC Land shelled out a record £1.15bn for London's Cheesegrater building earlier this year, just one of the deals that has featured in record overseas spending by Chinese groups.

Japan 1980s v China now

1. Most prominent overseas corporate purchase

Japan *Sony paid $3.4bn for Columbia Pictures in 1989*

China *ChemChina's pending purchase of Syngenta for $43bn*

Analysts are particularly intrigued by the similarities between "*zaitech*", the financial engineering techniques used to boost non-operating profits that fuelled Japanese non-financial corporations' speculative financial investment, and the Chinese equivalents that include wealth management products and trusts.

And if the mark of a real bubble is that it spills into unusual assets, look no further than the spring crop price of Old Banzhang — generally regarded as the finest of Pu'er teas. It has soared almost 90 per cent over the past year to Rmb15,000 ($2,174) a kilo, making it four times more expensive, by weight, than silver. In 1987, a similar cocktail of ostentation and speculative money propelled the membership fee of Japan's Koganei Country Club golf course to $3.5m.

The comparisons have felt more compelling as the warnings of a China bubble — or a concoction of inter-related bubbles — have intensified over the past four years. "China has halved its growth rate and doubled its debt over the past eight years," says Fraser Howie, an expert on the country's financial system. "It's not a great correlation."

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Yet there are some very specific points where the comparisons fail. Economic historians date the start of Japan’s bubble economy to September 1985 and the Plaza Accord agreement in New York that gave a green light to the depreciation of the dollar, paving the way for the market to take control. The yen strengthened from ¥240 against the dollar to ¥120 three years later. China, in contrast, carefully manages its currency and regularly cracks down on speculative behaviour. As it demonstrated in July 2015 when it controversially stepped in to arrest declines on the stock market, the Chinese state has a formidable arsenal of weaponry. That is unlikely to change.

2. Land buying overseas

© Getty Images; AP

Japan *Mitsubishi Estate bought Rockefeller Center in October 1989 for $900m*
China *Anbang’s purchase of New York’s Waldorf Astoria for almost $2bn in 2014*

Another striking difference is the respective capacity to rebound from a big crash in property prices. When that hit Japan in the early 1990s, it was catastrophic because it lacked the engines to grow its way out of trouble, but China may have them. In terms of top-down economic planning, says CLSA equity strategist Christopher Wood, China is also attempting something that Japan never consciously signed up to — the move from an export-driven model to a consumption-driven model.

A third distinction between China's present and Japan's past is the unique nature of the Chinese party-state. Two-thirds of corporate debt is owed by state-owned enterprises to state-owned banks. As Macquarie analysts Larry Hu and Jerry Peng noted last year: "China's debt is overwhelmingly owed by one government entity to another. Normal credit analysis fails in this context, given the government's capability in reshuffling debt within the system."

But its expansion has also been much faster. In Japan it took a quarter of a century for private sector debt to almost double from 125 per cent of economic output in 1970 to more than 220 per cent in 1995, according to figures compiled by Steve Keen, professor at Kingston University in the UK. China's private sector debt burden soared from 115 per cent of GDP to more than 210 per cent in just the past nine years.

"China cannot escape all the laws of economics but it is unique in many respects," says Eswar Prasad, a China finance expert at Cornell University.

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3. Eye-catching overseas art purchase

Japan *"Portrait of Dr Gachet" by Vincent van Gogh bought by Daishowa Paper's Ryoei Saito for $82.5m in May 1990*

China *Liu Yiqian's 2015 purchase of Amedeo Modigliani's painting "Nu Couché" for $170m*

What makes Chinese officials nervous, however, is when asset classes from ginseng to copper start to look frothy. The same is true of investors drawn to the market by sustained Chinese growth, who are constantly looking out for similar red flags — particularly because Japan's late-1980s boom of property and stock speculation so clearly marked the end of the country's high-growth era. Japan's bubble did not just end badly, says Martin Schulz, senior economist at the Fujitsu Research Institute, it left scars that are still visible a quarter of a century later and show up in the form of a budget deficit maintained to "keep the economy together".

The clean-up of Japan's post-bubble financial crisis — painfully delayed until the mid-2000s because of a stubborn reluctance to trigger corporate failures and mass lay-offs — represents a masterclass for China in what not to do should it face a similar crisis in its banking system.

Hiromichi Shirakawa, Credit Suisse's chief Japan economist, argues that the authorities' reaction in the aftermath of any China bubble is ultimately more important than whether one is inflating. That is where China has the most to learn from Japan. "The biggest post-bubble challenge is to restore confidence in the banks. If you don't kick a few out, it doesn't work," he says.

At a psychological level, the Japanese experience of watching the stock market triple in value between 1985 and 1989 corresponds with its modern Chinese counterpart: the ascent of assets has knotted itself around a deepening sense of national ascendancy.

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4. Number of outbound tourists (as % of population)

© Getty Images

Japan *7.85 per cent, 9.66m tourists in 1989*
China *8.56 per cent, 122m tourists in 2016*

"A bubble is a euphoric ending to a long period of prosperity," says Peter Tasker, a fund manager and author on Japanese economic history. "It starts with sensible optimism and morphs into a sense that there are no limits . . . every class of investor wants to participate. People become euphoric about their country. And Japan was a total bubble — with stocks and real estate inflating at the same time. The euphoria was social and political as well as economic and financial."

Mr Shirakawa argues that in both China and Japan the sense of confidence comes from having overcome a threat that initially appeared devastating — in Japan's case the "oil shock" of rising prices in the early 1980s, and in China's the fallout from the 2008 global financial crisis.

"But there are differences too. In Japan, the Plaza Accord [and a strong yen] allowed the Bank of Japan to maintain an easy policy for a long time. The banks were under pressure and they took significant risk. In China, the confidence comes from thinking 'we have attracted huge money flows from outside the country and this will continue forever'," says Mr Shirakawa.

Despite that, Beijing is well aware that financial risk, as one government adviser puts it, "is the one thing that can sink the ship".

5. Economy — What the experts say

Japan *'Japan was a total bubble — with stocks and real estate inflating at the same time. The euphoria was social and political as well as economic and financial' — Peter Tasker*
China *'China has halved its growth rate and doubled its debt over the past eight years. It's not a great correlation' — Fraser Howie, author on China*

It is also worried about disturbing demographic trends that, as in Japan, could depress Chinese savings and growth. Both countries have passed from a phase of demographic bonus to demographic burden as the working-age population aged 15 to 54 has begun to decline. For Japan, that crossover was in 1990. In China, it happened in 2012, marking the end of its "demographic dividend".

"The Chinese are looking at demographics because they know now what Japan was not aware of at the time — nobody was. We learnt from Japan how quickly growth can stop when demography changes," says Mr Schulz.

In Japan and China equity valuations both peaked at about the same time as their demographic bonus. This may suggest, says Mr Baba at Goldman, "that in the run-up to the peak of the bubble, the equity market has a tendency to excessively extrapolate the good times of the bonus period in later years".

To the extent that some see compelling similarities between the inflation of the Japanese bubble and China's present situation, the focus has shifted to whether China is close to the same turning points faced by Japan at the start of the 1990s. Moody's last week downgraded China's sovereign rating to A1, the same level as Japan, citing a large and growing debt burden. But the rating agency also upgraded its outlook for the Chinese economy and predicted that its growth potential would slow to 5 per cent by 2022, a far better outcome than the sudden crash and years of stagnation experienced by Japan.

6. Per capita GDP

Japan *$23,472 in 1989*

China *$8,069, 2015*

Sources: World Bank; Japan National Tourism Organisation; China's tourism bureau

In both countries, bubble-like behaviour has produced profound changes in the lives of millions of people. As the Japanese property and stock bubble neared its peak, the price of living in the cities skeetered out of the reach of ordinary "salarymen". By 1989, a modest, 75 sq metre apartment a 90-minute commute from central Tokyo cost 8.5 times the average white-collar salary. Three decades later China is witnessing an even more dramatic dynamic at play in its capital. The average cost of a 100 sq metre apartment in Beijing is Rmb5m — or more than 50 times the average annual income of local residents.

This comparison is especially important, say analysts, because of the respective government approaches to the problem. On becoming governor of the BoJ in 1989 — two weeks before the all-time peak of the Nikkei 225 Stock Average at 38,915 points — Yasushi Mieno condemned rising property prices and long commutes and in doing so triggered, many now believe, the subsequent market collapse.

At some level, China appears to have taken the Mieno experience to heart, and cautiously speaks in terms of "containing" increases rather than deflating a bubble that has transformed tens of millions of urban residents into dollar millionaires. But it is a finely balanced thing. Beijing's awareness of that fragility is clear, as Mr Xi recently warned that "houses are for living in, not speculating on".

This article has been amended since publication to clarify the reference to China's supply of US imports.

Letter in response to this article:

Beijing is changing course to avert headwinds / From Richard Cragg, Kingston upon Thames, Surrey, UK