FOR PROFESSIONAL INVESTORS – 27 March 2024

Chi Time

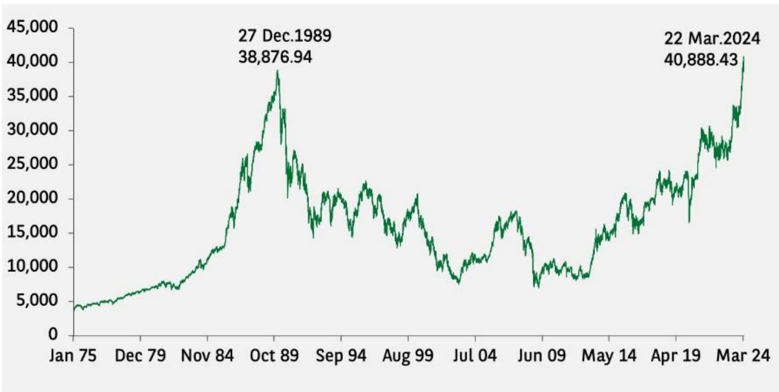
Optimism on Japan, lessons for China

It is during our darkest moments that we must focus to see the light.

Aristotle Onassis

Investor optimism that Japan is finally moving from a long-running debt-deflation spiral into a wage-price 'virtuous' inflation cycle has pushed its stock market to record highs (Exhibit 1). In contrast, there is still significant pessimism about the outlook for China. Some observers have compared Japan's economic and policy experience between the late 1980s and the 1990s with China's post-Covid situation and wonder if China is sleepwalking into a Japan-style economic quagmire.

Exhibit 1
Nikkei 225 index rose to record high in March 2024



sources: CEIC, BNP Paribas Asset Management 22 March 2024

Despite some parallels, notably insufficient policy easing, ageing population and a persistent high debt-to-GDP ratio (at more than 250% in 2023), China's economic backdrop today is different from Japan's 30 years ago, making it unlikely that it will fall into a Japan-style balance sheet recession (see [Chi on China – Is China Falling into a Balance Sheet Recession", 16 August 2023]).

Why has the world turned optimistic on Japan but remained bearish on China? The answers also contain lessons for China to minimise the risk of falling into a debt-deflation spiral.

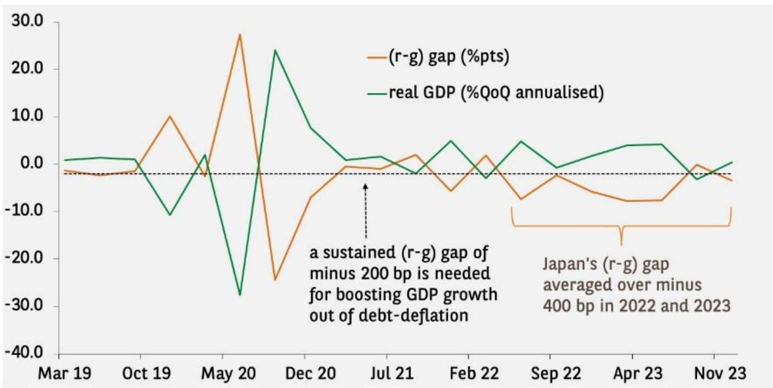
Japan turnaround

An expected macroeconomic regime shift from deflation to inflation, improvement in corporate earnings and corporate governance reforms (such as increasing the number of external or independent board members and shareholder advocacy) have fuelled optimism in Japan's outlook since late 2023. The yen's sharp depreciation due to the monetary policy divergence between Japan and the US and pessimism on China's outlook have encouraged investors to refocused on Japan. Monetary policy divergence has opened a large negative interest rate differential between Japan and the US, causing the yen to fall sharply and adding to imported inflation in Japan since 2022.

Japan had been mired in deflation for three decades. This saw nominal GDP growth fall from an annual average rate of 5.4% in the 1980s to 1.9% in the 1990s and then to -0.4% in the 2000s. However, nominal growth started to rise after 2012 (except 2020 when Covid hit), averaging 1.4% a year between 2012 and 2019 and rising to 3.1% between 2021 and 2023.

This turnaround in nominal GDP growth reflects the Bank of Japan's (BoJ) persistent accommodative monetary stance that kept its negative interest rate policy (NIRP) throughout the US tightening cycle in 2022 and 2023. The policy divergence created a large gap between Japan's real interest rate (r) and real GDP growth (g), averaging over -400bp in 2022 and 2023. That (r – g) gap is significantly wider than the -200bp gap that experience suggests is needed to sustain economic growth in a debt-deflation environment (Exhibit 2).[1]

Exhibit 2
Japan's (r-g) gap is conducive to boosting growth



sources: CEIC, BNP Paribas Asset Management 15 March 2024

The (r-g) gap matters

A large and sustained (r-g) gap is crucial to rekindle 'animal spirits' and revive private-sector spending to help reflate the economy. BoJ research shows that Japanese companies and households are starting to respond to the stimulative effects of its persistent ultra-easy economic policy by changing their pricing habits. Companies are abandoning their reluctance to change prices and lift wages while unions and workers are starting to ask for, and actually getting, pay increases. Notably, Japan's biggest labour union group Rengo successfully negotiated a pay increase of 5.3% in March 2024 (up from 3.8% in March 2023). The increase was significantly above market expectation of 4.0% and had not been seen for over 30 years.

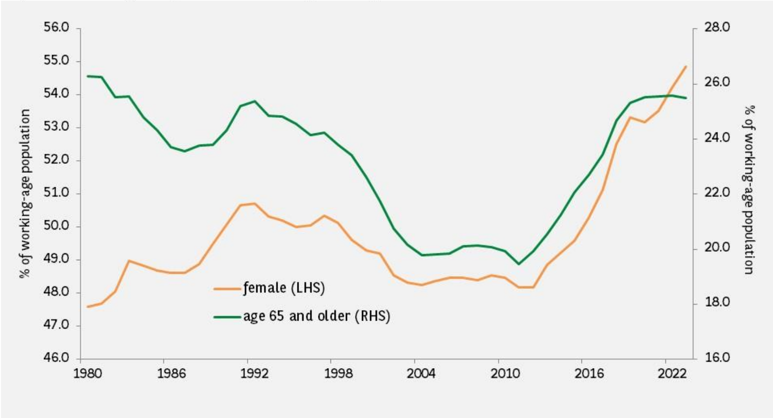
[1] For example, see "*Debt Sustainability: r-g Is Key*", Global and US Economics, Morgan Stanley, July 14, 2021.

The market expects the ‘Shunto’ annual wage negotiation process between workers and employers to set into motion a cycle of rising wages, which should stimulate consumer spending, lift prices sustainably and help pull Japan out of a decades-long economic morass.

Structural factors boosting Japan’s wages

Recent research has refocused attention on Japan’s labour shortage, which is putting upward pressure on wage growth. While Japan’s prime working age population has continued to rise, mainly due to the increase in participation by female and older workers, the limits are in sight. More than half of the female labour force is already working and, crucially, the old age participation rate, which rose from 20% in 2010 to 26% in 2021, is stagnating (Exhibit 3).

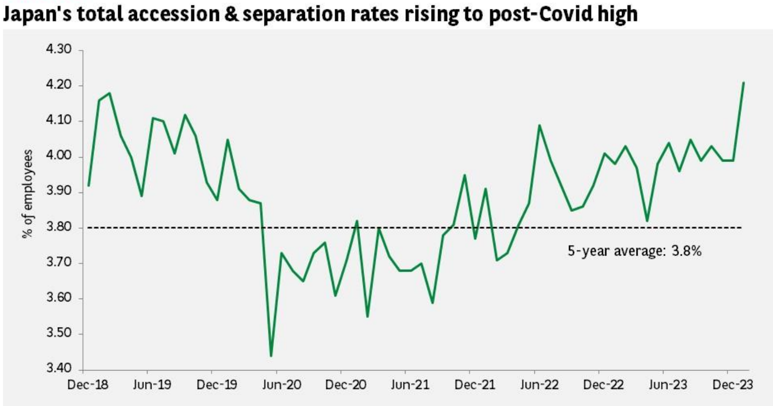
Exhibit 3
Japan's old-age & female labour participantion rate



Souces: CEIC, BNP Paribas Asset Management 15 March 2024

There is also evidence that occupational mobility is rising. As approximated by the combined rate of workers joining and leaving their companies, labour mobility rose to a post-Covid high of 4.21% in January 2024, above the 5-year average of 3.8% (Exhibit 4). This should facilitate wage negotiations for higher pay.

Exhibit 4
Japan's total accession & separation rates rising to post-Covid high



sources: CEIC, BNP Paribas Asset Management 15 March 2024

Japan’s demographic problem of shrinking labour supply limiting GDP growth has been well-known. However, financial markets have recently taken this long-term negative structural factor as a short-term positive bet on the revival of a wage-price spiral. Players expect Japanese firms to pass on the increase in labour cost to selling prices, thus improving the earnings outlook.

What will sustain Japan's turnaround?

For Japan to get out of debt-deflation, the rise in wages would need to be translated into more consumption rather than higher household saving or debt-reduction. Firms would need to pass on the higher labour costs to selling prices. This would prompt workers to negotiate for more pay increases, setting off a wage-price spiral to generate sustainable economic reflation.

BoJ policy would also need to remain accommodative to keep the (r - g) gap large at -200 bp or more to prevent economic growth momentum from faltering. Despite the BoJ's exit from its ultra-easy monetary policy in March 2024, it would need to keep real interest rates negative to revive corporate sector dynamism and boost capex to lift productivity and sustain nominal GDP growth.

The prospect of these developments helps explain the markets' optimism on Japan. Time will tell if they unfold as expected.

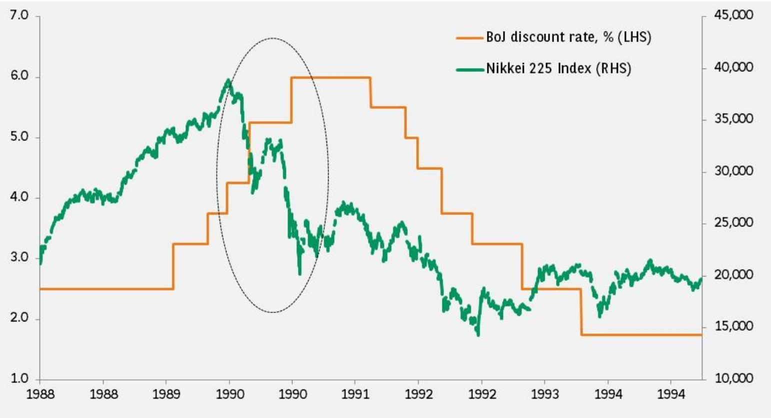
A policy lesson for China

Insufficient policy easing after the Covid-19 health crisis has been a key factor behind China's sluggish economy (see "Chi Flash: PBOC Needs to Ease More Aggressively and for Longer", 2 January 2024"), as policymakers have continued to avoid aggressive easing amid concerns over the negative impact on structural reform and debt-reduction efforts. This policy stance is like Japan's in the early 1990s when similar concerns prevented it from acting in a timely and forceful manner after the country's epic bubble burst. The resulting financial damage was followed by three decades of lost growth.

Japan's policy misstep should serve as a wakeup call for China, as it lays bare the consequences of a policy failure to deal proactively with the destruction of wealth and confidence. Notably, the BoJ did not cut interest rates until more than a year after stock prices collapsed (Exhibit 5).

Exhibit 5

The BoJ only cut interest rate more than a year after the stock market crash



sources: CEIC, BNP Paribas Asset Management 15 March 2024

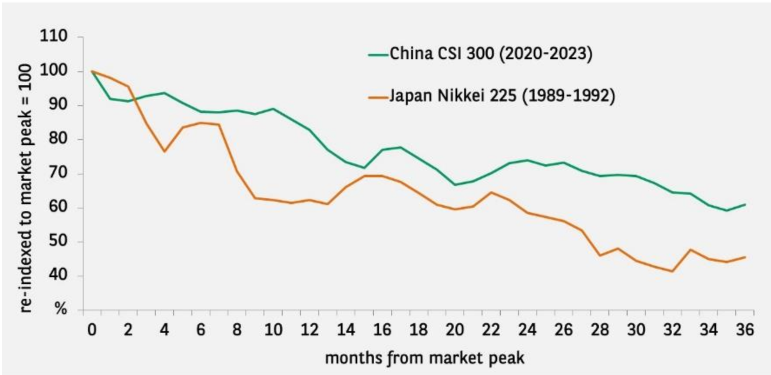
Even when the economy was struggling with price deflation after the asset bubble burst, Japanese policymakers still focused predominately on debt reduction and fiscal austerity. Research has found that the Japan's net fiscal stance in the 1990s was barely expansionary, aggravating the economic stagnation amid insufficient monetary stimulus.

Beijing's self-imposed policy constraints risk similar consequences. Without any forceful countercyclical policy help, the economy must go through a prolonged cleaning process at an enormous economic and social cost.

However, there is a key difference between Japan then and China today that could keep China's picture from becoming as dire as many observers fear.

China has not suffered from the devastating collapse of asset bubbles as Japan did (Exhibit 6). Hence, Chinese households, companies, and banks are unlikely to suffer a massive 'balance sheet recession' (see "Chi on China – Is China Falling into a Balance Sheet Recession", 16 August 2023). Rather, China's economic problems are primarily self-inflicted by insufficient cyclical policy support to counteract the deflationary forces from the country's structural 'creative destruction' process as it strives to develop new industries to drive economic growth. This was aggravated by the now-ended Zero-Covid Policy.

Exhibit 6
China did not suffer from the devastating asset bubble collapse as Japan did

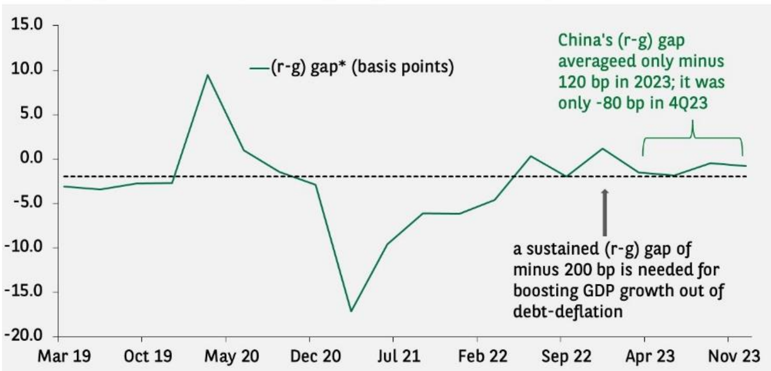


sources: CEIC, BNP Paribas Asset Management 15 March 2024

The (r-g) gap matters, again

The lesson for China's monetary policy is clear – it needs to pursue aggressive monetary easing to create a wide (r – g) gap to revive 'animal spirits', private investment, and consumer spending, all of which are still stuck in the doldrums despite two years of 'incremental easing' policy between 2022 and 2023 (see "Chi Time: Still Bearish on China? Indicators for gauging Changes", 6 February 2024). Unlike Japan, China's (r - g) gap is too narrow, averaging only -120 bp in 2023 (Exhibit 7). This reflects Beijing's conservative easing stance in the post-Covid recovery period on the back of its deleveraging and structural reforms directives that have deprived the economy of growth impetus.

Exhibit 7
China's (r - g) gap is too small for boosting GDP growth under debt-deflation



* 1-year real Loan Prime Rate (LPR) minus real GDP growth rate
sources: CEIC, BNP Paribas Asset Management 15 March 2024

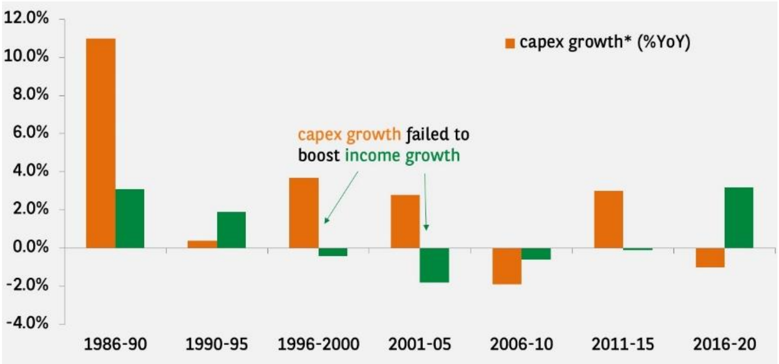
Supply-side expansion alone won't work

At the National People's Congress this year, Beijing doubled down on its emphasis on self-sufficiency and manufacturing upgrades, pledging to increase fiscal support for technology development and upgrading equipment. Support for the consumer sector remained limited. The government expects a rise in manufacturing capex to create more jobs and boost income growth and consumption.

However, Japan's experience between 1996 and 2005 showed that while increasing capital expenditure helped lift productivity in tradeable sectors and boost manufacturing, the uplift for consumption was limited. Insufficient demand led to decline in wage and disposable income growth (Exhibit 8). Such outcome was mostly due to the loss of confidence resulted from massive wealth destruction after the asset bubble burst.

Supply-expansion policy alone – the focus in China – is not enough to reflate the economy without expansionary demand management policy support when there is a loss of confidence, which China is suffering.

Exhibit 8
Japan: Increase in manufacturing capex failed to reflate income growth



* capex in manufacturing & equipmnt, and intellectual property
sources: Morgan Stanley, BNP Paribas Asset Management

China needs to sustain aggressive policy easing to boost both demand and supply and turn around investor sentiment on the Chinese markets. Such policy is especially important given that China's monetary transmission mechanism looks impaired after Covid (See White Paper "Chi on China: Implications of China's impaired Monetary Transmission Mechanism",5 January 2024). If Beijing can pursue such policy with conviction, there is a fair chance that the economy and the asset markets will recover. Amid intensifying deflationary pressures, the key risk is an overly cautious policy, much like the government did in the past two years.

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