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Japanification: a Risk for China's Economy?

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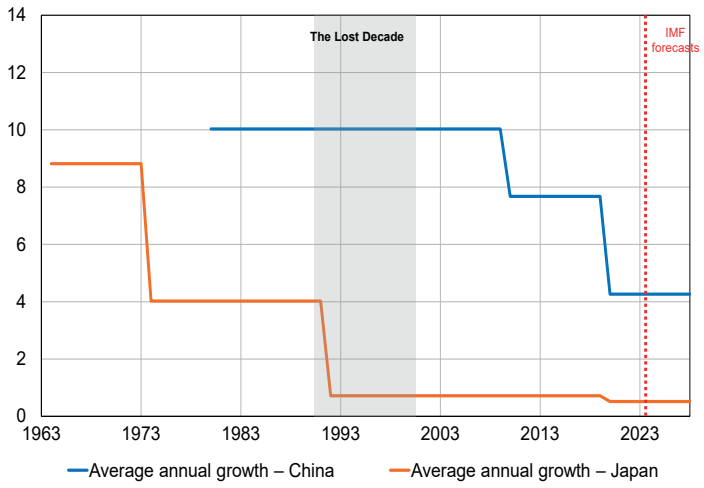
- The "Japanification" of a country alludes to Japan's economic situation starting from the early 1990s following decades of rapid growth. It is characterised by weak growth and inflation rates, and extremely low interest rates.
- China currently bears many similarities to early-1990s Japan – its growth model is centred on industry and investment, and is reliant on buoyant exports. China is also laden with debt, and suffers from a population decline, a downward trend in growth (see Chart) and inflation, as well as a property sector crisis since 2021.
- However, the extent of the decline in growth may be less considerable than in Japan given some of the Chinese economy's strengths and its ability to learn from Japan's difficulties. While China has reached the technological frontier in an increasing number of sectors, it is also looking to switch to a new growth model more focused on new technologies and on ramping up productivity.
- The implementation of this new model could be hindered by China's debt-laden local governments, and more generally there are lingering doubts over this model's ability to sustain high levels of growth.
- A similar fate to that suffered by Japan would mean a severe slowdown in the catch-up process, but not necessarily smaller productivity gains than in other countries: when adjusted for demographics, Japan's growth had been indeed similar to that of other major advanced countries since 1990.

Real annual growth in Japan and China (%)



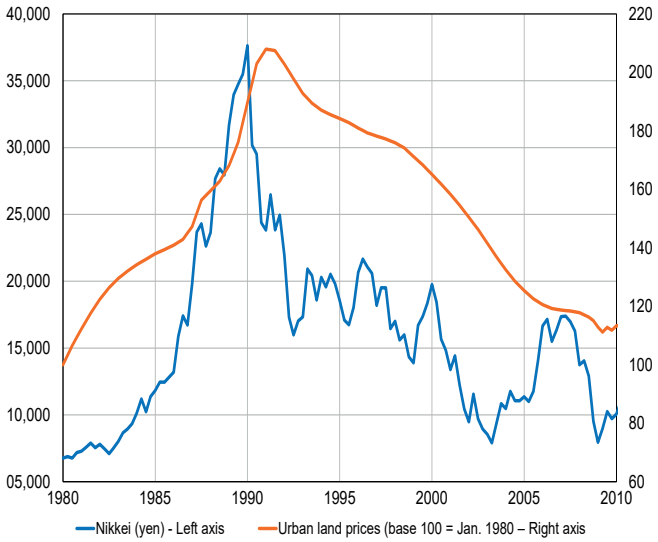
Source: World Bank; IMF for forecasts between 2024 and 2028.
NB: Japan's Lost Decade lasted from 1991 to 2001.

1. Similarities and differences between 1990s Japan and modern-day China

1.1 The Lost Decade in Japan

The defining characteristic of the Japanese crisis in the 1990s – and by extension the concept of a country undergoing Japanification – is a long period of weak growth (less than 1%) and low inflation[1] (close to 0%) in spite of extremely low interest rates, preceded by several decades of rapid expansion. The Lost Decade started in the early 1990s in Japan and was the result of: (i) the collapse of a growth model reliant on exports and investment in unproductive publicly-owned companies; (ii) structural vulnerabilities (population decline, high debt levels in the private sector, a fragile financial sector); and (iii) the bursting of the speculative stock market and property bubbles (see Chart 1 and Box 1).

Chart 1: Change in the Nikkei index and urban land prices in Japan



Source: MSCI, Japan Real Estate Institute (JREI).

Box 1: 1991-2000 – Japan's Lost Decade

The Lost Decade was triggered by imbalances that emerged in the 1980s. The appreciation of the dollar (a 40% increase in the real effective exchange rate between January 1981 and March 1984), caused by US monetary tightening in response to the second oil crisis, prompted finance ministers and central bank governors in G5 nations to sign an agreement to act on the foreign exchange markets (the Plaza Accord in 1985). Japan signed up in full to the agreement, which was intended to depreciate the US dollar relative to the Japanese yen and German Deutschmark. Although the amount employed to manipulate the exchange rates was less than initially set out, the overreaction of the markets was such that the yen's appreciation relative to the US dollar was much faster and sharper than expected.[a]

This appreciation adversely affected exports,[b] and the Japanese economy's growth became even more reliant on domestic demand.[c] The Bank of Japan (BoJ) was forced to keep its interest rates very low in an attempt to curb the appreciation of the yen.[d] This move led to excess liquidity which, combined with financial deregulation in the early 1980s, caused a speculative bubble to form in the equity and property markets.

The bursting of the bubble in 1991 and the resulting recession scuppered Japan's rapid narrowing of the productivity gap and marked the beginning of a period of weak growth dubbed the "Lost Decade". Japan's GDP rose on average by 1.2% between 1991 and 2000, versus a 4.4% increase in the 1980s.[e] Weak domestic demand triggered a slowdown in inflation, followed by deflation (see Chart 2). Structural factors such as close ties between banks and businesses, and an incomplete economic policy response undoubtedly protracted the difficulties faced by the Japanese economy.

a. T. Ito (2015), "The Plaza Agreement and Japan: Reflection on the 30th year Anniversary", Rice University's Baker Institute for Public Policy, *Working Paper.*
b. Over the course of three years (1985-1988), the value of the yen relative to the US dollar doubled, from 260 yen per one dollar in early 1985 to 130 yen per one dollar in early 1988, while exports as a share of GDP dropped from 13.6% in 1985 to 9.4% in 1988.
c. H. Yoshikawa (2000), "La politique économique face à la stagnation de l'économie", *Économie internationale,* (84), 4 (in French only).
d. T. Ito (2015), op. cit.
e. As a result, potential growth fell from roughly 4.0% in 1990 to less than 1.0% in 1999 (see G. Blin-Vialart et al. (2023), "Japan's Growth Drivers", *Trésor Économics*, No. 326).

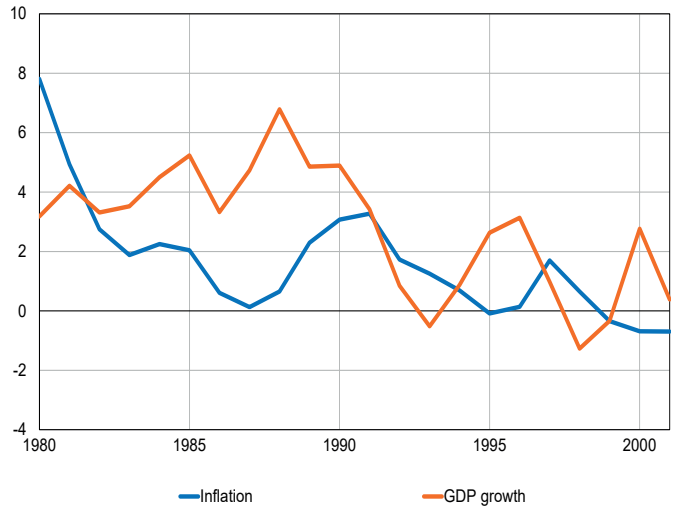
(1) See V. Ciornohuz (2016), "Japan's Response to Deflation: an Assessment of Abenomics", *Trésor Economics*, No. 184.

Japan's banks, having developed a cross-shareholding arrangement with their clients, continued to grant loans to insolvent and bankrupt businesses (i.e. zombies), which in turn further deteriorated their balance sheets.[f] This poor allocation of resources, that worked against profitable sectors, played a part in limiting Japan's growth potential.[g]

The Japanese crisis was also drawn out as a result of the economic policies in place. The Japanese government was slow to restructure the financial sector for fear of worsening unemployment. The close ties between political leaders, the government and industrial and financial circles in Japan may have also played its part in this regard.[h] The monetary policy was most definitely expansionary, but was hindered by the zero lower bound, with low inflation unable to sufficiently reduce the real rates.

As real interest rates could not be effectively leveraged due to very low inflation, it was expected that fiscal policy and government expenditure would support growth. However, this recovery policy proved to be far from effective, particularly because the infrastructure investment targeted rural and agricultural areas and had a weak multiplier effect,[i] resulting in sluggish domestic demand[j] despite government debt more than doubling over the course of a decade.[k]

Chart 2: Inflation and GDP growth in Japan (as a %)



Source: IMF.

f. Ricardo J. Caballero, Takeo Hoshi and Anil K. Kashyap (2008), "Zombie Lending and Depressed Restructuring in Japan", *American Economic Review*, 98 (5), 1943-77.
g. Yoshikawa (2000), op. cit.
h. Japon : crise et douloureuses mutations, report from the inter-parliamentary friendship group no. 28, 01/10/1999 (in French only).
i. S.-H. Heng (2009), ''Insights from Japan's «Lost Decade»', *EAI Working Paper*, No. 154.
j. According to data collected on e-Stat – the website for Japanese government statistics – average domestic demand stood at 1.1% between 1995 and 2001.
k. According to the IMF, government debt rose from 62.2% of GDP in 1991 to 145.1% in 2001.

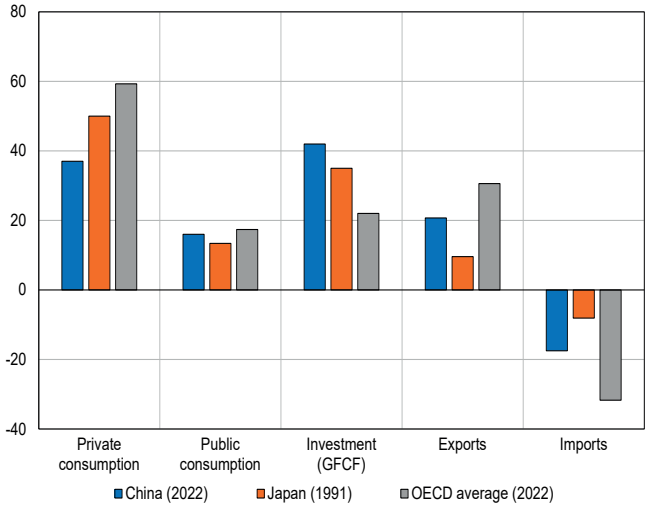
The burst bubbles triggered an extended period of private-sector debt reduction, low consumption and private investment, and price reductions. This crisis weighed on expectations amid a deflationary spiral and more unfavourable employment and wage prospects (see Box 1). The slowdown in economic activity and falling inflation subsequently affected the repayment capacity of businesses. Japanese banks continued to finance "zombie companies",[2] depriving a number of healthy businesses of capital and thereby hampering Japan's growth.

1.2 China's weaknesses in 2024

As well as its growth model which is based on exports and investment (see Chart 3), China is currently displaying many similarities to 1990s Japan: these include a struggling property sector[3] accounting for a large share of GDP, low inflation for several years, an ageing and shrinking population, and high debt levels among households and businesses (see Table 1).

(2) A zombie company is one that is unprofitable and would not exist without assistance from creditors (which may be zombie companies themselves) or the government. Support is provided to these companies so that they can continue servicing their debt or to protect jobs. Zombie companies have a lower productivity than other businesses and result in a sub-optimal allocation of labour and capital.
(3) See T. Carré, L. Chalmel, E. Villani and J. Yang (2022), "China's Dependence on the Property Sector as an Engine of Growth", *Trésor Economics*, No. 311.

Chart 3: The share of various components of demand in GDP for China in 2022 and Japan in 1991 (%)



Source: World Bank.

Following several decades of strong economic growth in China (10.0% of growth per year on average between 1980 and 2009 and 7.7% between 2010 and 2019), the IMF forecasts a medium-term slowdown (4.0% between 2024 and 2029 based on August 2024 forecasts). The slowdown trend was also observed in Japan, with growth falling from an average of 8.8% between 1964 and 1973 to 4.0% between 1974 and 1991 and then dropping further to 0.7% between 1992 and 2019 (see Chart on cover page).

Table 1: Similarities between China and Japan

	China (2022)	Japan (1991)
Fertility rate (births per woman)	1.2	1.5
Percentage of the total population that is over 65	14	13
Active population (15-64 years old) (as a % of the total population)	69	70
Non-financial business debt (% of GDP)	158	138
Household debt (% of GDP)	61	67
Total non-financial sector debt incl. government debt (% of GDP)	293	296*
Share of the property sector in the broadest sense (% of GDP)**	28	20
Property investment (% of GDP)***	11	21.7
Value added of the property sector (% of GDP)****	7.2	10.3
Housing vacancy rate (%)*****	22	9
Investment (% of GDP)	42	35
Average annual inflation (%)******	1.8	0.8

Sources: World Bank, Goldman Sachs, IIF, BIS, IMF, national statistics institutes (National Bureau of Statistics of China – NBS, Private Office).

* BIS data from 1997 (no data available prior to this year).

** NBER data including upstream and downstream sectors for 2016 in China and 1997 in Japan.

*** Data provided by national statistics institutes (2022 in China and 1994 in Japan, including investment in housing and other constructions).

**** Data provided by national statistics institutes (2020 in China, 1994 in Japan). The value added of China's property sector has fallen since 2020 and stood at 5.8% of GDP in 2023.

***** Vacant or unoccupied housing units.

****** Average annual inflation over the 1991-2000 period in Japan and the 2014-2023 period in China based on IMF data.

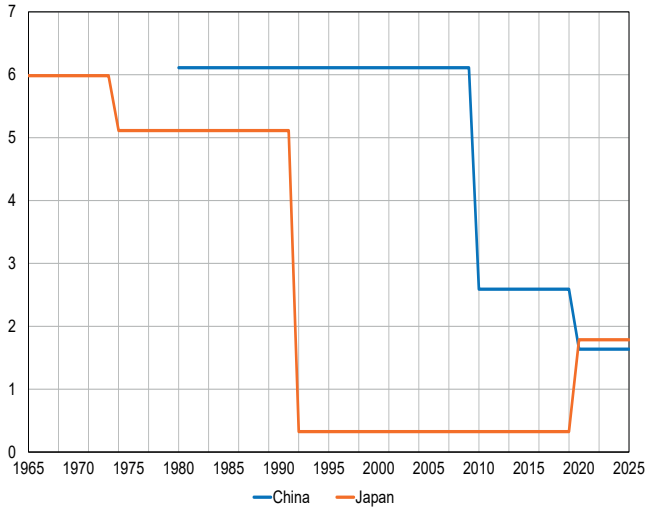
Note: By way of comparison, annual inflation was 8.2% in OECD countries in 2022, the contribution of investment to growth was 22% of GDP and the fertility rate 1.6 births per woman.

A downward inflation trend is also apparent in China: inflation, which stood at an average of 6.1% per year between 1980 and 2009, fell to 2.6% between 2010 and 2019 (see Chart 4), and hit its lowest point since 2010 in January 2024 at –0.8% year on year. Inflation however should remain structurally low in China[4] for reasons that differ from those behind Japan's situation (in which a deflationary spiral developed starting in the 1990s). These reasons are: (i) excess supply that is increasing relative to demand, while the share of household consumption in GDP is low (37% in 2022, versus nearly 60% on average for OECD countries)[5] (see below); (ii) a continuing urbanisation process, resulting in wage restraint given the entry of new urban residents onto the labour market who are willing to accept lower salaries; (iii) food and energy prices that continue to be regulated;[6] and (iv) strong competition, with businesses lowering their prices so as to gain market shares, even at the expense of their profit margins.

1.3 China's growth drivers

China is facing economic conditions similar to those affecting Japan in the early 1990s (in China, a 38% fall in stock market prices between the peak in February 2021 and May 2024, compared with Japan's 56% drop between January 1990 and January 1994, and fall in property prices), but the correction of imbalances affecting the financial and property sectors is expected to have a less severe impact on China. As the Chinese state controls the stock market stakeholders, a systemic crisis originating on the stock market of the same magnitude as that in Japan is unlikely to occur. In addition, China's capital markets are still relatively small compared to the rest of the economy: in 2019, 72% of China's non-financial businesses secured their financing through banks, 30% through bond issues (banks being the main players in this market) and 6% through the equity market (compared to 26%, 5% and 53% respectively for Japan in the same year).[7] The risk of a financial crisis spilling over to the economy is therefore limited.

Chart 4: Change in inflation in China and Japan (average annual rate as a %)



Source: World Bank, IMF (2023 and 2024).

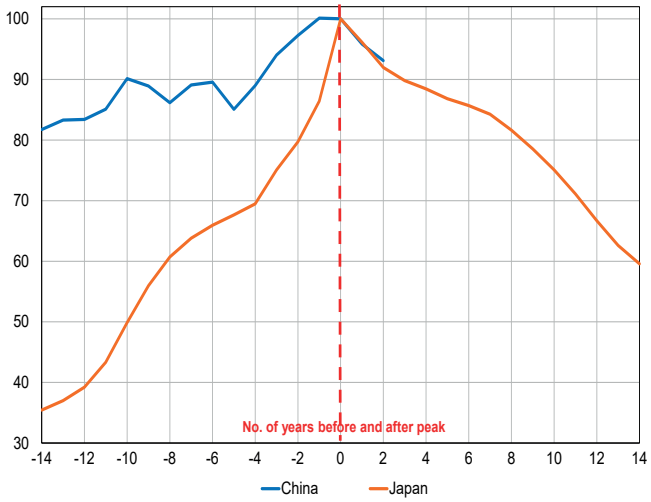
Note: For Japan, the periods covered comprise: (i) the strong growth period in the 1960s; (ii) the slowdown in growth in the 1970-1980 period; (iii) the "Lost Decade", with low growth and inflation lasting until 2019; and (iv) the post-COVID 19 period which saw an upsurge in inflation. For China, the periods presented are: (i) from 1980 to 2007, marked by a catch-up process and reforms (opening up of the country, accession to the World Trade Organisation) with growth of nearly 10% per year, (ii) from 2008 to 2019, when the limitations of China's model became evident with the subprime mortgage crisis (increase in debt, emergence of overcapacity, particularly in the industrial and production sectors, and reduced productivity and return on investment), and (iii) from 2020 onwards, which saw a structural slowdown in China's growth and a deflation risk.

As for the property sector crisis, the rise in urban property prices appears to have been better contained in China than in Japan before the peak (see Chart 5) – provided that property prices were not underreported in China at the height of the bubble. China's property crisis also emerged when the authorities implemented measures to limit the debt levels of developers, and more broadly, to shrink the bubble. In addition, for the past several months marked by this ongoing property crisis, the authorities have put support measures in place to mitigate falling prices and stimulate demand (lowering the minimum down payment rate, more favourable mortgage rates, more flexible purchasing terms etc.). So far these measures have hampered the pace of the correction process, but it is still not complete and its future course continues to be difficult to estimate. At the same time, the risk of spillovers to the banking system seems to be reined in for the time

(4) See "World Economic Outlook in Spring 2024: Moderate and Uneven Growth", *Trésor Economics*, No. 339, March 2024.
(5) The savings rate stood at 37% in Q3 2023, slightly down from its peak of 42% in Q4 2020. By way of comparison, the average savings rate stood at 14% in Q3 2023 in the euro area.
(6) Particularly through strategic reserves of agricultural products and regulated energy prices. The IMF believes that the differences observed in energy and food prices explain the 3-to-4-point gap between China's inflation and the rates recorded in OECD countries in 2022 and 2023.
(7) See T. Carré, Z. Huang and F. Surre (2022), "The Development of Chinese Financial Markets", *Trésor Economics*, No. 319.

being. China's banks estimate their direct exposure to property developers to be 6% of total loans, but to our knowledge no data or publicly available studies have been released on the share of the property sector in collateral for loans.

Chart 5: Change in urban property prices in China and Japan



Source: Federal Reserve Bank of Saint Louis, latest data point: Q3 2023 for China.

How to read this chart: Year 0 is the year 1991 for Japan and 2021 for China (i.e. the year when respective property prices peaked).

Lastly, China has room of manoeuvre to support its long-term growth. Firstly, a portion of the Chinese population is expected to continue to prosper given ongoing economic catch-up in a number of rural provinces and urbanisation, which together could result in an automatic increase in the share of domestic consumption in GDP (see Table 1). Meanwhile, private consumption provided a contribution to growth of one third in China in 2023, compared to a contribution of over one half in Japan in the 1990s (see Chart 3), with GDP per capita in purchasing power parity (PPP) of 17,600 international dollars in China in 2021 versus 33,800 international dollars in Japan in 1991. China's middle class is still small (400 million in 2017[8] – 28% of the population – compared to 67% in Japan in 1994),[9] but is expected to continue expanding and may account for 40% of the population by 2030.[10] The growth in real wages is expected to be rather sharp in China (based on official data, which can be put into perspective with data published on job boards)[11] whereas it plateaued in Japan from the early 1990s. China may also be able to limit pressure on currency through its screening of capital flows and its well-managed external position. Japan on the other hand was unable to do so, with the yen appreciating by nearly 70% relative to the US dollar between 1985 and 1995. In this light, exports are expected to continue to be another source for growth (at the very least in the short term), thanks to supportive supply-side policies (see section 3.1) and a real effective exchange rate for the yuan which returned to its early-2014 level in summer 2023 (with an index of around 90, compared to over 100 in 2022), bolstering the competitiveness of China's exports.

Table 2: Main differences between 2021 China and 1991

	China (2021)	Japan (1991)
Real GDP per capita (in PPP, international dollar in 2017)	17,591	33,791
Urbanisation rate (%)	62.5	77.5
Opening of the capital account[a]	Not open	Open
Private consumption's contribution to GDP growth (% of GDP)	37	50

a. With the Qualified Foreign Institutional Investor (QFII) programme, which has been gradually extended and relaxed since it was introduced in 2002, China has opened up foreigners' access to its markets. However, under the programme international investments cannot be made in businesses that are deemed strategic and restrictions are imposed on joint ventures. More broadly, China refuses to open its financial account, concerned that major capital outflows will compromise the stability of the yuan. See T. Carré, Z. Huang and F. Surre (2022), op. cit.

Sources: IMF, World Bank, NBS, NBER, Our World in Data.

(8) According to the National Bureau of Statistics of China (NBS), people belonging to the middle class have an income of between roughly $15,000 and $75,000 per year. The authorities released a figure of 500 million middle-class people in 2024 but did not provide any methodological explanations for this figure. A consensus has yet to be reached by economists on the number of Chinese people that are middle class.

(9) According to the Institute for Economic Studies, Keio University, with the figure being based on the number of individuals with an income of between 75% and 200% of the median annual income.

(10) Chinese Consumers of the Future 2023, Boston Consulting Group (BCG).

(11) The job board Zhaopin in particular reported a drop in wages at the time of hiring in China's 38 largest cities in 2023, according to data compiled by Bloomberg: Nearly a Third of China's White-Collar Workers Reported Falling Wages Last Year - Bloomberg

2. Imbalances specific to the Chinese model

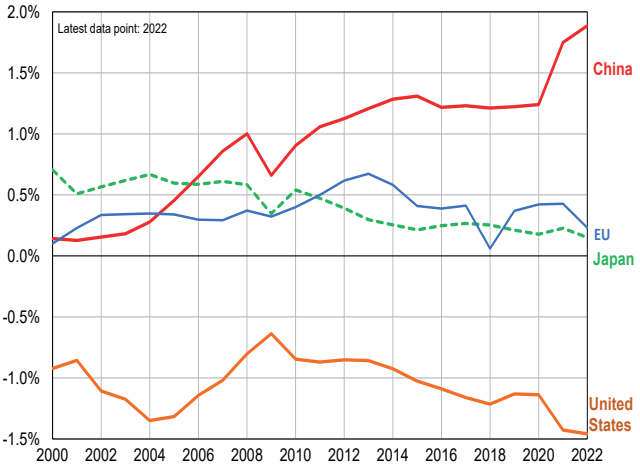
While China is experiencing economic slowdown as it moves towards the technological frontier, there are also imbalances relating to its growth model that is based on investment and exports. These imbalances are due to large-scale support provided to the manufacturing industry over the last few decades, fuelling a structural imbalance between supply and demand.

As regards demand, household consumption is structurally low, with the majority of the high level of household savings having been invested in property in 2021 (78%).[12] As a result, the property crisis is one factor hindering household consumption. The high level of youth unemployment (17.1% of people aged 16-24 in July 2024)[13] adversely affects consumer confidence.

As for supply, production overcapacity[14] has been a cause for concern for quite some time. Starting in 2014, overcapacity emerged in sectors relating to infrastructure and property (iron and steel, cement, aluminium, glass, shipbuilding and, to a lesser extent, solar power), partly because of 2008-2009 fiscal stimulus. In more recent times, manufacturing reached a record high in 2021 and its growth rate is not faltering. Along with this, China is also seeing a relative decline in the installed capacity utilisation rate (from 78.4% in Q2 2021 to 73.6% in Q1 2024), a drop in company profits,[15] and an unprecedented accumulation of inventories. A new phase of overcapacity appears to be on the horizon, driven by green assets (electric vehicles, wind turbines, solar panels and batteries), as well as by several traditional sectors of Chinese industry (chemicals, manufacturing products, electronics).

These imbalances entail a number of risks. The imbalance between supply and demand exacerbates deflationary pressures. Support for production – including for inefficient businesses – is detrimental to capital productivity, while investments in infrastructure continue to grow despite being less and less productive. Increasing government debt has especially benefitted publicly-owned companies, while financing conditions for the private sector have become tighter. It is still difficult to quantify the risk of allowing zombie companies to continue to exist: a low profit rate is not necessarily due to low productivity, with Chinese publicly-owned companies seeking to gain market shares rather than making profits. This support for publicly-owned companies contributes to increasing competition between Chinese businesses at both local and national level. This industrial policy and strong domestic competitiveness ultimately result in a drop in producer prices which strengthens the price competitiveness of Chinese goods for export, China's market shares in several sectors and the country's trade surplus (see Chart 6).

Chart 6: Balance of trade in manufactured goods (% of global GDP)



Sources: UN Comtrade, World Bank.

(12) Property accounts for approximately 78% of the value of assets owned by Chinese households, compared to an average of 35% in the United States and 57% in the euro area. The property crisis, which began in 2021, has triggered a negative wealth effect that has prompted households to save rather than spend their income over the long term.
(13) The authorities removed all trace of the previous figure for this indicator – youth unemployment of 21.3% published in June 2023 – before announcing a new youth employment rate measurement.
(14) Overcapacity occurs when the production capacity of businesses is underutilised. Overcapacity is deemed structural when businesses maintain or increase the level of their unused capacity without factoring in whether they will make a profit or loss.
(15) For example, the sector's profits fell from 8.6% in 2015 to 5.0% in 2023.

For several years, China's growth has gone hand in hand with a sharp hike in the levels of both private and government debt, with estimated total debt of 307.5% of GDP in 2023.[16] According to the IMF,[17] government debt is thus expected to total 88.6% of GDP in 2024 (versus 40.0% in 2014), and up to 122.0% of GDP for so-called "augmented" debt[18] (including other public funds and an estimate of the debt of local government financing vehicles – LGFV). Efforts made by local governments to secure financing for local businesses could have their limitations, even if other players such as major banks and the central government seem to have room on their balance sheets to assume more debt. Over the last few years, the number of LGFV defaults has increased, and several provinces have encountered difficulties in paying the interest on their debt.

Companies – both in the public and private spheres – also have high debt levels (166% of GDP in Q2 2023 according to the BIS), restricting the liquidity available. The structural adjustments required to gradually reduce the Chinese economy's debt, particularly for local governments and businesses, are expected to be introduced over the long term, hampering China's medium-term growth as was the case in Japan in the years following the Lost Decade (see Box 2).

3. Economic policies potentially ramping up adjustment costs

3.1 China sets its sights on "high-quality" growth

The 20th National Congress of the Communist Party of China, held in 2022, made it clear that opening the economy would play second fiddle to political priorities, in line with policies introduced over the past several years (the 14th Five-Year Plan for 2021-2025 and the Made in China 2025 plan). The nominal growth rate has become one of several targets, and political goals such as national security (industry, technology, food), ensured by increasingly "secure and verifiable" value chains, reflect a national policy that is more centred on "high-quality" growth.

The priorities were reiterated in March 2024 at the Two Sessions (annual plenary meetings of China's two parliamentary assemblies). The growth target was once again set at around +5.0% in 2024, and this goal is to be met by prioritising industrial policy and public investment (resulting in several heavily industrialised provinces having a 2024 growth target that is greater than the 2023 figure). Modernising the industrial system is the priority for 2024 (e.g. vehicles powered by alternative energy sources, hydrogen power development, biotechnologies) with scientific development being of secondary importance. Generally speaking, the Chinese authorities are continuing to focus development on new technologies (e.g. AI, electric vehicles, solar panels) with a view to ramping up production, exports and total factor productivity.

At this stage, and in spite of the September 2024 announcements,[19] China's monetary policy is expected in the medium term to remain accommodative. The People's Bank of China (PBoC) central bank has lowered its policy rates in small successive increments to sustain growth, but its efforts are hampered by risks of the yuan's volatility relative to the dollar and by the drive of households and businesses to lower their debt levels rather than consume or invest.

3.2 Risk of a long-lasting structural adjustment

In the short term, prioritising manufacturing could fuel overcapacity and increase China's dependency on exports, and public investment support raises debt levels: ultimately, the economic policy runs the risk of exacerbating imbalances in the growth model. The decision to continue focusing on exports could also pose the risk of worsening trade friction in the medium term amid heightened geopolitical tensions.

(16) See T. Alix, T. Carré and L. Chalmel (2023), "China's Public Finances: Short-Term Risks and Structural Issues", *Trésor Economics*, No. 327.
(17) Report on the 2023 Article IV consultation, 21 December 2023.
(18) Growth in "augmented" debt was 2.4 times higher than GDP growth in 2023.
(19) In late September 2024, the Chinese authorities announced (i) monetary measures (cuts to the one-year and five-year loan prime rates, and to the reserve requirement ratio for commercial banks), (ii) measures in support of the property sector (reduction of mortgage lending rate for households, launch of a re-lending facility, reduction of the minimum down payment on second-home purchases), and (iii) capital market measures (launch of a re-lending facility, an announced increase in investment of state-owned holding companies in financial markets).

All things being equal, the Japanese experience seems to demonstrate that to prevent a protracted adjustment period, there is a need to introduce measures supporting growth, set inflation expectations, more broadly speaking build trust with economic agents, and put in place measures for improved capital allocation and for mitigating the impact of an ageing population. However, admittedly, very little progress has been made with structural reforms (improvement of social safety nets and financial services,[20] reform of the *hukou* household registration system)[21] and with rebalancing consumption. Ultimately, a shift from China's growth model towards consumption, a move that international observers have urged China to make for several years (see Article IV of the IMF), seems unlikely.

From a financial standpoint, China is striving to limit the economy's indebtedness level as evidenced by its campaign to stamp out shadow banking in 2018, the prudential requirements on property developers in place since 2020 and, more recently, the expenditure restrictions imposed on the most indebted local governments. Work has also been done to improve transparency, with the gradual reintroduction of the liabilities of certain LGFVs on the balance sheets of the local authorities that set them up. Despite these efforts, the economy's debt levels continue to rise and will dampen growth prospects. In addition, little progress has been made in resolving distortions in capital allocation, as demonstrated by the continuation of implicit guarantees granted to publicly-owned companies which as a result enjoy preferential access to credit and bond financing[22] to the detriment of privately-owned businesses. Publicly-owned companies are better equipped to contribute to industrial policy goals and to act as a buffer in the event of shocks (for example with the buyback of assets owned by indebted developers). Scrapping implicit guarantees would lead to more costly lending terms, or even bankruptcy, for publicly-owned companies, and to rising unemployment that could trigger a recession.[23] It is for these reasons that cutting the implicit guarantees offered by the Chinese government to publicly-owned companies should not occur in the short term.

Despite claims of support for the private sector and the priority given to "reform and openness", China's business environment seems to be deteriorating. The predictability of regulatory developments, a prerequisite for boosting private investment, is limited. Stricter regulations in the service sectors (Internet, education, finance, healthcare) introduced between 2020 and 2022 worsened the business climate and generated greater uncertainty surrounding employment prospects, when the deregulation of these sectors could be a source of potential growth. Similarly, foreign investment fell in 2023: the authorities have recently stated that they are more open to welcoming foreign businesses, but concrete actions yet have to be enacted.

An ageing population in decline could be partially mitigated by an increase in the senior employment rate and by raising the retirement age, akin to the measures taken in Japan where the retirement age for both men and women was increased from 60 to 65 in 1994. In September the Chinese authorities announced that the retirement age for men will be raised from 60 to 63 and from 50 to 55 or from 55 to 58 for women depending on their occupation. This reform, slated to be rolled out over 15 years starting from 2025, is not expected to be sufficient to mitigate the problems raised by an ageing population.[24] Ultimately, given the worsening internal imbalances that, it appears, will not be resolved by the announced policies, China indeed runs the risk of facing a form of Japanification i.e. a slowdown or even a complete halt in the process of catching up with advanced economies (see Box 2).

(20) See T. Carré, Z. Huang and F. Surre (2022), op. cit. Household confidence could be bolstered through diversification of households' assets, which currently are concentrated in property. By improving financial services, financial regulation and the functioning of the equity market, households would have access to safer, more profitable and more liquid assets.

(21) See T. Carré, L. Chalmel, E. Villani and J. Yang (2022), op. cit. Introduced in 1958, hukou is a household registration system used to monitor China's population. There are two categories of registration: urban and rural households. An individual's residency status determines their eligibility for housing, public education, employment and social benefits. An urban hukou does not entitle the holder to the same rights in every city.

(22) Given such a dearth of transparency, it is very difficult to put a precise figure on the distortion in effect. See for example Z. Geng and J. Pan (2023), "The SOE Premium and Government Support in China's credit market", *NBER, Working Paper* 26575.

(23) See for example: "China's SOEs Are Stuck In A Debt Trap", SP Global, 20 September 2022.

(24) By way of comparison, the IMF recommends gradually raising the retirement age to 65 for both men and women in order to offset the shrinking working population.

Box 2: Putting the economic decline into perspective

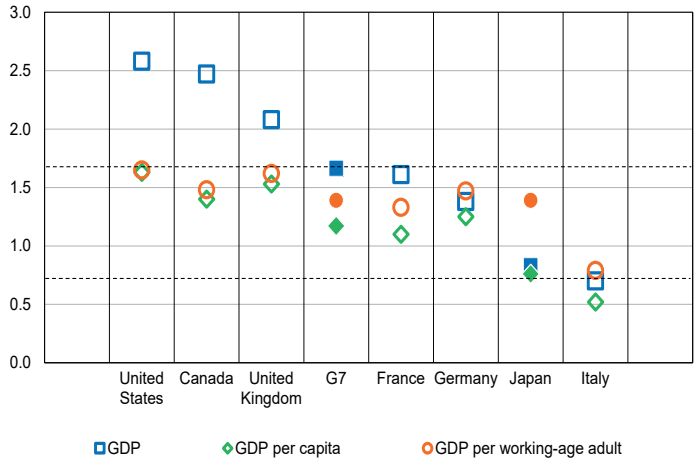
After several decades of strong growth, Japan's GDP increased a mere 0.8% per year between 1991 and 2019 compared to 2.6% in the United States, 1.6% in France, 1.4% in Germany and 1.7% for G7 countries on average,[a] a difference of 0.9 points of GDP (see Chart 7).

This gap was at least partly attributable to demographic changes: with a fertility rate below 1.5 births per woman and a rise in life expectancy from 79 to 84.4, the percentage of Japan's population aged 65 and over soared from 12.9% to 29.3%, a far greater increase than in other countries.

The performance gap for GDP growth per capita for the 1991-2019 period is narrower: Japan posted growth of 0.8% versus 1.2% for G7 countries on average. As for GDP growth per working-age adult, Japan's economic performance was equal to the G7 country average (1.4%) but weaker than the United States (1.7%) and Germany (1.5%) and stronger than France (1.3%) and Italy (0.8%). Fully adjusting for the demographic effect, which includes the ageing population, Japan's economic performance was therefore on a par with that of other G7 countries.[b]

As a final point, while Japan faces far-reaching economic challenges (low productivity, high levels of government debt),[c] it has a remarkably low unemployment rate (2.4% in 2023). Its human development index is also high (0.92 out of a maximum of 1) and on a par with the United States (0.93) and France (0.91). Ultimately, the Lost Decade brought an abrupt end to Japan's process of closing its productivity gap.

Chart 7: Average improvement in the G7's performance indicators, 1991-2019 (%)



Source: Fernández-Villaverde et al. (2023).

a. The Group of Seven (G7) includes the following countries: Canada, France, Germany, Italy, Japan, the United Kingdom and United States.
b. This analysis is based on the following article: J. Fernández-Villaverde, G. Ventura & W. Yao (2023), "The Wealth of Working Nations", National Bureau of Economic Research, *Working Paper*, No. 31914.
c. G. Blin-Vialart et al. (2023), op. cit.

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