



IMF Working Paper

Transforming China: Insights from the Japanese Experience of the 1980s

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IMF Working Paper

Asia and Pacific Department

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Abstract

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China is poised on the brink of a transition to a service-based economy. The Japanese experience of the 1980s provides several insights about the way to manage such a transition and the downsides to avoid. In particular Japan offers useful insights on (1) the limits to an export-oriented growth strategy; (2) the role of exchange rate, macroeconomic policies, and structural reforms in rebalancing the economy toward the nontradables sector; and (3) the risks associated with financial liberalization. The similarities between the Chinese economy today and the Japanese economy of the 1980s make these insights relevant for China. However, with the benefit of analyzing the Japanese experience and, given the important differences between the two economies, China should be able to successfully rebalance its growth pattern while avoiding the downsides encountered by Japan.

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Keywords: Plaza accord, asset bubble, and growth rebalancing.

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I. INTRODUCTION

This paper looks at the Japanese experience of the 1980s and asks the following question: what are the policies needed for China to transition to a high-productivity, service-based economy while avoiding falling into years of stagnation and deflation?

The Chinese economy today shares many similarities with the Japanese economy of the 1980s. Like Japan at that time, China's growth strategy is export oriented and capital intensive; the tradables sector plays a dominant role; savings rates are high; and the current account surplus is large. Like Japan in the 1980s, the Chinese economy has achieved a remarkable transformation over the span of three decades to become the world's second largest economy. This achievement reflects years of reform efforts to open up the Chinese economy and make it more market oriented.² But, this policy of export-led growth is becoming harder to sustain, given the economy's size and large presence in world markets.³ Like Japan in the 1980s, China today faces considerable domestic and international pressure to rebalance its export-oriented economy toward a more consumption-based one, with a greater share of growth coming from the nontradables sector. The prospects for China of continuing export-dependent growth have become even dimmer recently, as the global financial crisis has taken its toll on growth in advanced economies, particularly the United States and the euro area—China's major export markets—prompting analysts to revise downward the medium-term prospects for demand emanating from these economies. In the face of a weaker outlook in the demand for exports, the Chinese government has put in place a range of structural measures aimed at shifting the pattern of growth away from exports and investment toward private consumption. These measures have been accompanied by supportive macroeconomic policies, which like Japan in the 1980s, have fueled rapid increases in asset prices that many analysts now consider are becoming divorced from fundamentals.⁴

China's take-away from the Japanese experience of the 1980s is that:

- There are limits to an export-led growth strategy.
- Shifting toward a greater reliance on the services sector requires a combination of real effective exchange rate appreciation, macroeconomic policies to support demand, and structural reforms to develop the nontradables sector.
- Supportive macroeconomic policies can alleviate the short-term adverse impact of exchange rate appreciation on activity and employment in the tradable sector.
- However, if maintained for too long, these same supportive macroeconomic policies can sow the seeds of future volatility, inflating bubbles in asset markets.

² For a comprehensive review of China's reforms, see Chow (2002).

³ See Guo and N'Diaye (2009a).

⁴ Ahuja and others (2010).

- Such risks are compounded if this transition is being managed at the same time as the financial system is being liberalized. A careful management of financial liberalization is warranted.

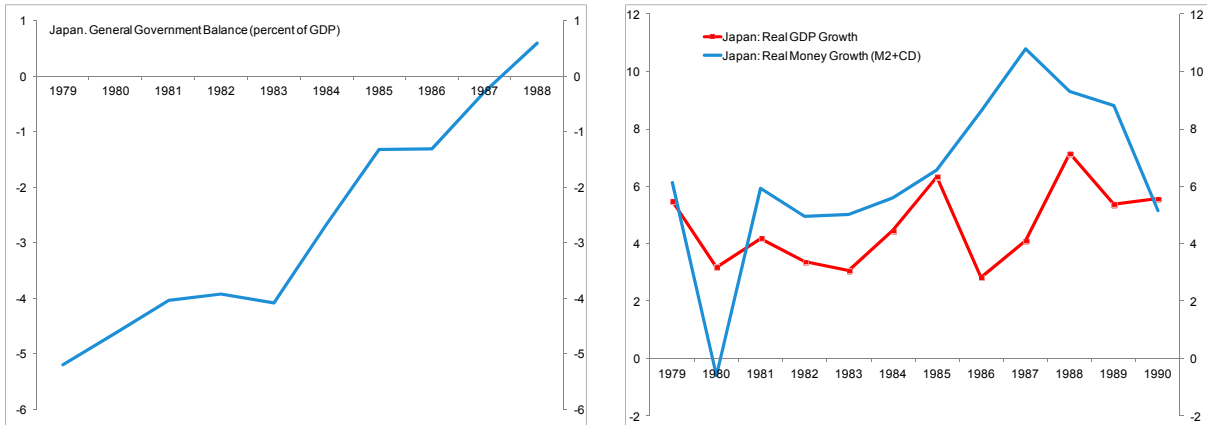
However, the comparison with Japan can only take us so far. The Chinese economy today differs in many ways from the Japanese economy of the 1980s, including in its stage of economic, demographic, and financial development, as well as in the structure of the economy, the political regime that governs it, and the global environment. Many of these differences could actually serve to help China avoid the economic stagnation Japan experienced and enable the economy to successfully rebalance its growth. However, achieving this rebalancing will require that a range of reforms are undertaken and that macroeconomic policies are skillfully implemented. The need to move ahead with reforms has become more pressing because of the demographic pressures the country will likely face over the medium term. Policies will need to balance the need to support domestic demand with the risks of fueling imbalances in asset markets. At the same time, the government will need to ensure that the financial system is well regulated and supervised in order to avoid risks emerging on the balance sheets of banks, households, and corporates. Reforms will need to include leveling the playing field between the tradables and the nontradables sector, further opening up the economy to foreign competition, developing financial markets, and increasing government spending on health and education.⁵

The remainder of the paper is organized as follows. Sections II and III discuss Japan's macroeconomic policy stance and currency reform, respectively, during the 1980s. Section IV focuses on the financial liberalization measures Japan introduced in the run-up to the asset price bubble. Section V presents an overview of the structural changes Japan has undergone during its development process. Section VI draws the key insights for China from the Japanese experience.

II. THE MACROECONOMIC POLICY STANCE

Japan entered the 1980s with large fiscal deficits—a result of the government's attempts to regain the growth momentum stalled by the oil shocks of the 1970s. Output growth had slowed from about 8 percent on average during the first half of the 1970s, to 4 percent during the second half. Growth remained at about that level in the first half of the 1980s, on the back of strong net external demand. Strong net external demand helped offset weaknesses in domestic demand as fiscal consolidation proceeded apace with higher social security payments and expenditure control. Monetary policy was torn between the need to support demand and concerns that low interest rates could further weaken the yen relative to the dollar given large interest rate differentials with the United States. Although monetary conditions were not wholly supportive, the monetary policy stance shifted from a tight stance—needed to fight the inflationary consequences of the oil shocks—to a looser stance aimed at supporting activity.

⁵ Blanchard and Giavazzi (2005), Barnett and Brooks (2009), and N'Diaye, Zhang, and Zhang (2009).



III. CURRENCY REALIGNMENT AND ITS AFTERMATH

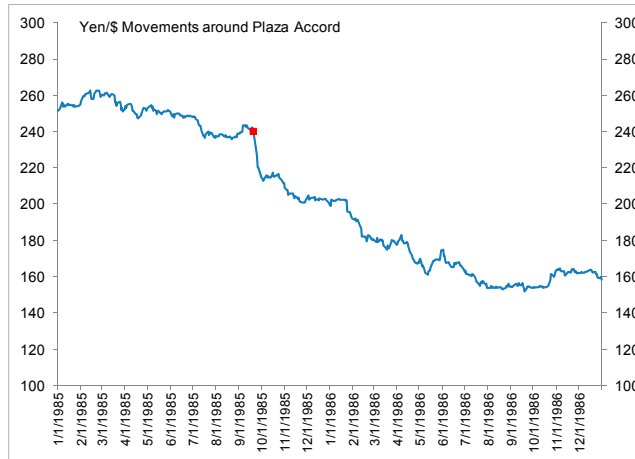
Abroad, a slower growth momentum and persistent twin deficits in the U.S. in the mid-1980s heightened pressures for protectionist measures.⁶ Against the backdrop of increased trade tensions, G5 member countries (France, Germany, Japan, the United Kingdom, and the United States) adopted the Plaza Agreement on September 22, 1985.

The Plaza meeting was prompted by a desire to achieve greater convergence in policies and performance among the G5 countries and to develop a more appropriate pattern of exchange rates, given that external imbalances among major industrial countries were expected to remain large—with a persistent current account deficit in the U.S. and matching external surpluses in Japan and, to a lesser extent, in Germany. The U.S. committed to reducing its budget deficit; Japan committed to continuing fiscal consolidation while allowing local governments to invest more, providing an environment conducive to private sector development, and pursuing monetary policy in a flexible manner with due attention paid to the exchange rate. Measures to promote private sector development in Japan included privatizing public enterprises, further liberalizing financial markets, enlarging the consumer and mortgage credit markets, and providing better access to domestic markets.

⁶ In January 1985, following talks between President Reagan and Prime Minister Nakasone, consultation committees comprising high-level officials from Japan and the U.S. were set up, and “Market-Oriented, Sector-Specific” consultations began in four sectors: telecommunications, forest products, pharmaceuticals and medical equipment, and electronics. Market-opening measures were then introduced in April.

Following the Plaza meeting and heavy coordinated intervention in foreign exchange markets, the yen appreciated sharply against the U.S. dollar (by 20 percent between end-1984 and end-1985, and by about 10 percent in the week following the Plaza accord).

However, for these foreign exchange trends to continue, it was necessary to move ahead with other policy commitments. In subsequent weeks, Japanese interest rates rose sharply after a prolonged period of stability. This rise was prompted by indications from the Bank of Japan that it would not offset the appreciation of the exchange rate with a loosening of domestic monetary conditions, but would instead be encouraging interest rates to rise further. As a result, short-



term interest rates jumped by some 1½ percentage points, and long-term interest rates rose by about 1 percentage point. By the third week of November 1985, short-term rates had risen by a further 25 basis points. However, subsequent weaknesses in domestic demand prompted a loosening of the monetary stance thereafter.

On the fiscal side, a stimulus package was announced on October 15, 1985 (to be implemented at the level of local governments and public enterprises, whose operations were financed by the Fiscal Investment Loan Program), and included liberalization of the conditions attached to loans provided by the Housing Loan Corporation. The measure was expected to generate additional loans of about 3 percent of private residential investment. The 1986/87 budget provided new three-year tax credits for interest on housing loans of up to 1 percent for private loans. These measures helped boost private consumption and residential investment, but this was insufficient to offset the declining contribution to growth from net exports and falling off of business investment in manufacturing. As a result, growth slowed substantially, falling from 6¼ percent in 1985 to 2¾ percent in 1986. Employment in manufacturing declined moderately, and disguised unemployment rose. Manufacturing profits fell by as much as 32 percent in the first half of 1986,⁷ with sharp declines in most industries, especially in steel, shipbuilding, electronics, and automobiles. Other sectors fared better, however, with a boom in construction and strong growth in services, including wholesale and retail trade. On the external front, notwithstanding a turnaround in trade volumes in the direction of external adjustment, the external current account surplus continued to widen, owing mainly to a decline in oil prices. Many analysts considered the continued widening of the current account as transitory, perhaps reflecting the “J-curve” effects of exchange rate changes.

⁷ The government provided support to hard-hit small- and medium-sized enterprises through subsidized loans under the conditions that those enterprises restructure to serve the domestic market.

In the face of continued external imbalances and protectionist measures, the G6 countries (G5 plus Canada) concluded the Louvre accord on February 22, 1987. According to the terms of this agreement, Japan committed to implementing an extensive package of economic measures geared toward supporting domestic demand and facilitating the flow of resources to developing countries.

IV. FINANCIAL LIBERALIZATION

Before the Plaza accord, Japan's financial system was highly regulated, and there were several barriers to foreign entry.⁸ Interest rates were regulated with segmented markets and shielded from external influence through capital controls. Both domestic and external factors played a part in the liberalization of Japan's financial system. Domestic factors included pressure from depositors who wanted higher returns on their savings; the increased share of self-financed investment by cash-filled corporations, which lowered the demand for bank credit; and the deteriorating fiscal position. There were also external pressures from the U.S., where a wave of deregulation had allowed Japanese investors to acquire significant holdings in U.S. assets, which, together with the weak yen, prompted calls for Japan to open up its financial markets and make yen-denominated assets more attractive.

The deregulation of Japan's financial system between 1980 and 1986 focused on expanding market access, liberalizing deposit interest rates, increasing the availability of financial instruments, and removing of barriers between the operations of banking institutions and securities dealers. Major changes included (i) easing of the restrictions governing a variety of offshore yen transactions—including the issuance of euro-yen bonds, euro-yen lending to Japanese residents and the issuance of euro-yen certificates of deposits (CDs); (ii) easing for the restrictions on domestic banks' issues of CDs; and (iii) loosening restrictions on some types of capital outflows (Box I). Other changes included the removal of restrictions on forward foreign exchange transactions, banks' spot conversion of foreign currencies into yen, and on the sale of foreign CDs and commercial paper in Japan. There were also various initiatives to increase the participation of foreign financial institutions in Japan's capital markets. The liberalization of capital inflows and outflows (which had started in the 1970s) and the growing internationalization of the yen resulted in substantial inflows of foreign capital into Japan in the 1980s. The main channels for these inflows were the foreign acquisition of yen-denominated securities in the Japanese market and, to a lesser extent, the issuance of external bonds by Japanese firms.

⁸ See Guttman (1987).

Box I. Japan and China Liberalization Measures

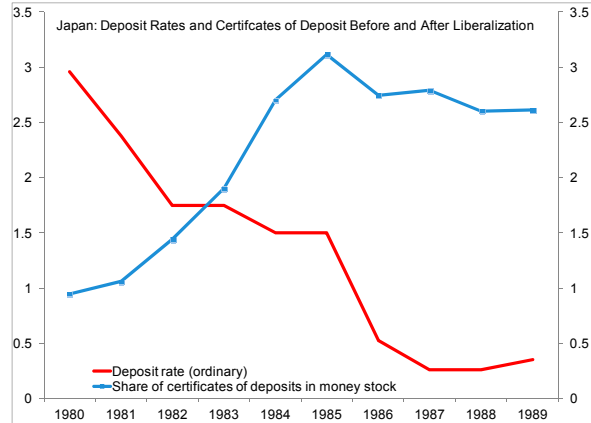
1980	Introduction of national bond fund with minimum holding period of 6 months
1981	Minimum holding period
1982	Liberalized rules on issuance of yen-denominated securities by non residents
1983	Removal of some restrictions on zero-coupon bonds
1984	Minimum size of certificates of deposits reduced from ¥500 million to ¥300 million
1984	Ceiling on foreign government-guaranteed bonds increased by 50 percent
1984	Credit rating required for yen borrowing lowered to AA, down from AAA
1984	Easing restrictions on issuance of euroyen bonds
1984	Removal of restrictions on foreign lending
1984	Removal of exchange swaps controls
1984	Non residents exempted from withholding tax on foreign currency government bonds
1984	Liberalization of short-term euroyen loans to residents and issuance of euroyen certificates
1984	Easing of restrictions on secondary market activities for banks
1985	Collateralized loans for securities houses and brokerage licenses for bond future trading allowed
1985	Minimum size of certificates of deposits reduced to ¥100 million and maturity to one month
1985	Removal of withholding tax on euroyen bonds for Japanese residents
1985	Pension funds and trust banking management by foreign banks allowed
1985	Foreign firms trading on Tokyo Stock Exchange
1985	Liberalization of time deposit interest rates of more than ¥1 billion
1986	Credit rating required for yen borrowing lowered to A, down from AA
1986	Liberalization of time deposit interest rates of more than ¥300 million
1987	Liberalization of time deposit interest rates of more than ¥100 million

China Liberalization of Interest Rates

1996	Abolished the upper limit on interbank lending rates
1997	Liberalized repo rates
1998–2004	Gradually increased the upper limit on lending rates
1999	Begun to gradually allow different institutions to negotiate rates on over RMB 30 million deposits with above 5-year maturity
2000	Liberalized foreign currency lending rates
2000	Liberalized foreign currency deposit rates for deposits over \$3 million
2003	Removed floor on foreign currency deposit rates
2003	Liberalized deposit rates in pound, franc, Swiss Franc, and Canadian Dollar
2004	Liberalized all foreign currency deposit rates with maturity above 1 year
2004	Removed ceiling on all lending rates (except for urban and rural credit cooperatives, which have a cap of 130 percent over reference rates)
2004	Removed floor on all deposit rates

Sources: Guttman (1987) and Feyzioglu, Porter, and Tackats (2009).

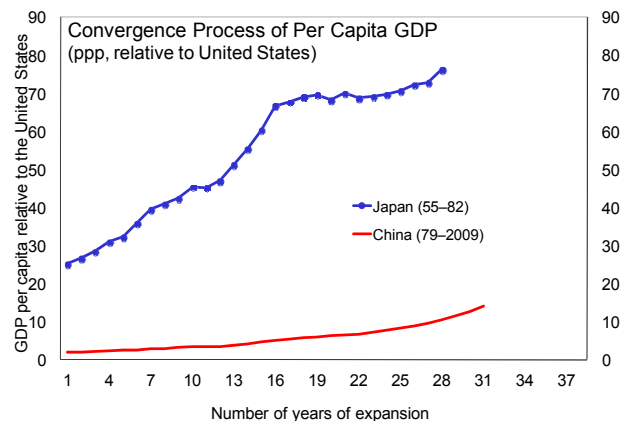
Liberalization of financial markets and interest rates led the Bank of Japan to rely more heavily on indirect instruments for monetary policy, rather than on direct controls on money growth.⁹ Liberalization also resulted in a significant decline in deposit rates, an increase in credit (for use both in Japan and abroad), and a rapid rise in the demand for money market certificates. This was at odds with the Japanese authorities' concerns that were expressed prior to the liberalization of interest rates that deposit rates would increase, lending rates would be stagnant, and bank profits would be squeezed.¹⁰ Liberalization also heavily influenced the portfolio choices of nonfinancial corporations, by providing them with a much wider range of liquid instruments that were remunerated at market rates. Financial reform and liberalization led to a large buildup of liquid assets by corporations, which, in turn, fueled broad money growth in 1985-86, mainly noticeable with the introduction of money market certificates (MMCs) and an increase in the availability of CDs. However, following the liberalization of interest rates on large time deposits, the growth of CDs slowed relative to that of large time deposits.



V. ECONOMIC OUTCOMES

GDP convergence

The liberalization of Japan's financial system marked the culmination of years of reform and the end of the longest expansion period in Japan's history (1955–82), during which per capita income caught up with that of the U.S. and Europe. Japan's per capita GDP increased 17-fold between 1955 and 1982, from 25 percent of U.S. per capita GDP to over 75 percent.



⁹ Monetary policy's focus on money growth had followed the first oil shock and the Bank of Japan's increased emphasis on controlling inflation.

¹⁰ See IMF staff report for the 1984 Article IV consultation with Japan. Following liberalization, the authorities stressed the importance of improvements in the supervision of financial institutions and other aspects of the regulatory framework to ensure stability of the system in a liberalized environment. They undertook a review of capital/asset and liquidity ratios and other prudential parameters and prepared legislation to strengthen and broaden the deposit insurance system.

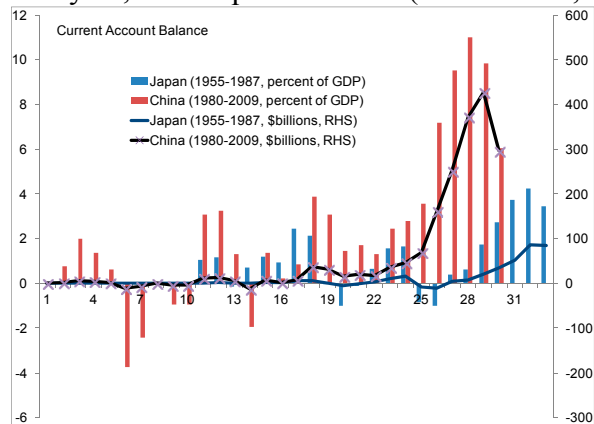
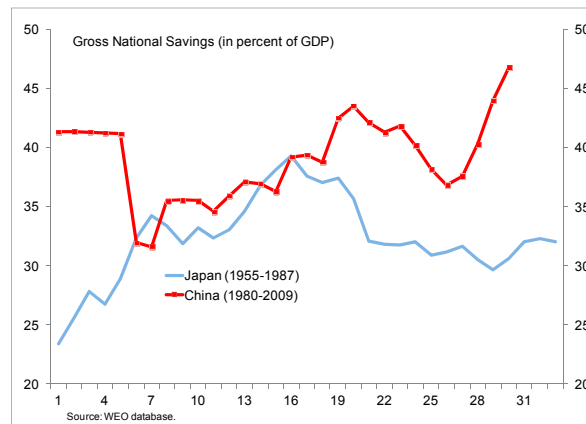
Japan's rapid catch-up was achieved through an effective use of abundant and cheap labor in the early stages of the country's development, as well as intensive use of capital and strong productivity gains. Domestic investment accounted for over 30 percent of GDP throughout that rapid growth period, supported by capital costs that were kept low through financial sector regulations.¹¹ In addition, the government's industrial policies in the early stages of development spurred investment in key manufacturing sectors, such as steel, shipbuilding, and chemicals, and targeted industries benefited from subsidized loans, subsidies to exports, import restrictions, and generous allocations of foreign reserves (which, given the existing capital controls, was critical for firms carrying out their expansion plans). Japanese corporations invested about 2 percent of GDP in R&D, similar to U.S. and German firms, and acquired new technologies through joint ventures and special agreements. The sectoral composition of investment shifted over time, with changes in the structure of industry away from raw material processing toward high-technology fields. This structural shift was largely the result of efforts initiated following the oil price shock in the mid-1970s and sustained by rapid technological advance toward industrial restructuring.

High savings rates

Japan's rapid capital accumulation was financed by high domestic savings, reflecting primarily private savings, particularly household savings rates. Gross national savings rose from a little under 22 percent of GDP in 1950 to a peak of about 40 percent in the early 1970s, before falling to about 32 percent in 1982. Several explanations for Japan's high savings rates during those years have been proposed, including cultural factors (Confucianism), an underdeveloped social security system, a generous bonus system for workers, various tax incentives, substantial down payments associated with high housing and land prices, life cycle, and bequest motives (see Horioka, 1988; and Ito, 1992). However empirical studies have shown that these factors alone cannot account for the high savings rate (Hayashi, 1986).

External surplus

Japan's large savings were not exported to the rest of the world until around the early 1980s, when Japan's current account soared, reaching about 4 percent of GDP by

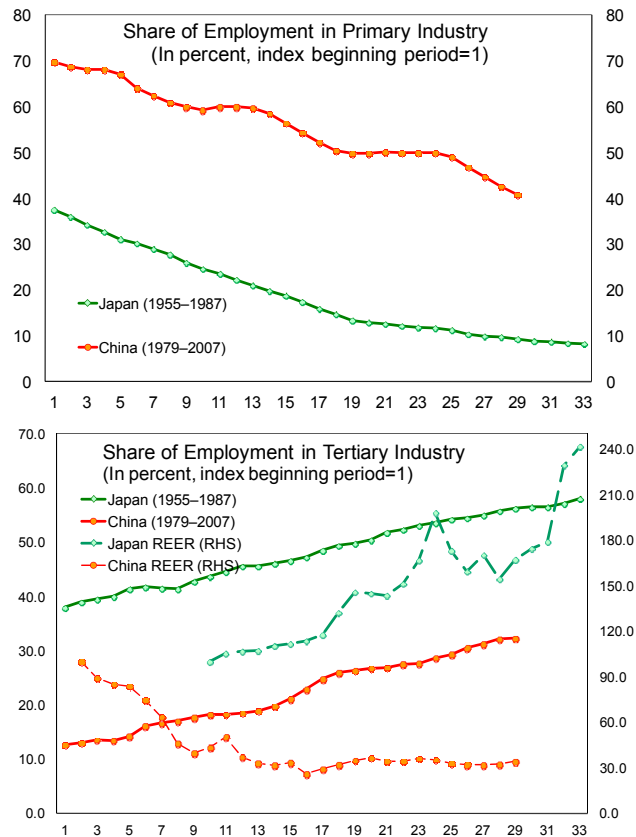


¹¹ See Ando and Auerbach (1988a, 1988b) for a comparison of the cost of capital in the U.S. and Japan.

1986. The rise in the current account was caused in part by the strength of the U.S. dollar against major currencies, particularly the yen. Between 1978 and 1984, the yen depreciated against the U.S. dollar by about 20 percent (from 195 ¥/\$ at end-1978 to around 251 ¥/\$ at end-1984). This depreciation reflected better growth prospects abroad, which encouraged Japanese corporations to adopt a relatively more outward-looking investment strategy; the desire to increase on-site production in order to avoid trade frictions and protectionist actions against Japanese-manufactured exports in other industrial countries; increases in loans by Japanese parent companies to their foreign subsidiaries because of relatively higher interest rates prevailing in overseas markets; the growing demand by various nations for Japan's industrial cooperation; and incentives offered by the governments of host countries, which increased the profitability of investment in production facilities abroad.

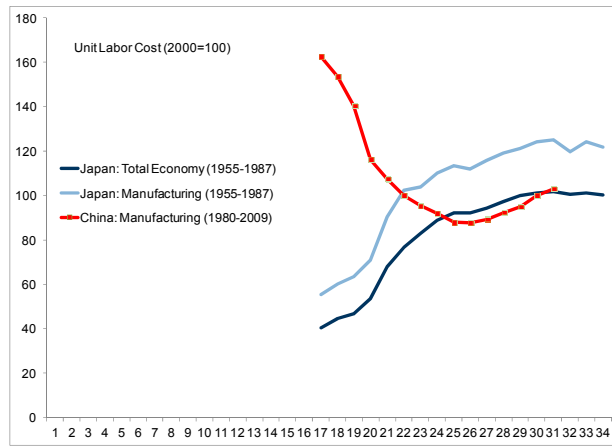
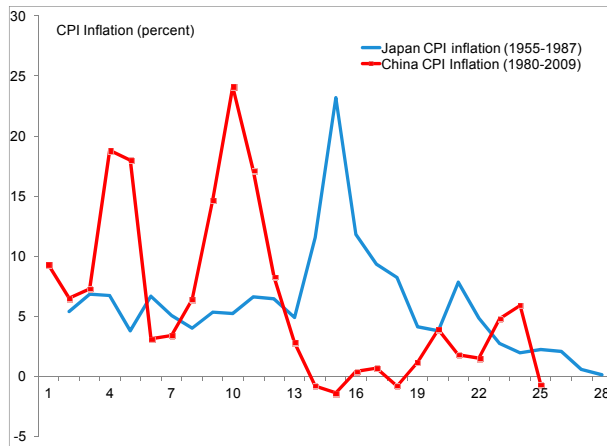
The shift toward services

The years of rapid growth and development in Japan were accompanied by shifts in the dominant sector of the economy, moving from agriculture to manufacturing and then from manufacturing to services. From 1955 to the early 1980s, the share of employment in agriculture fell from just under 40 percent to less than 10 percent. Manufacturing employment peaked at slightly over 35 percent in the mid-1970s; while employment in the service sector rose steadily, reaching slightly under 60 percent in the 1980s. The shift toward services was accompanied by an appreciation of the yen in real effective terms. However, structural reforms were needed to support and maintain this shift toward the service sector and consolidate its gains. Accordingly, in May 1986, the government proposed measures (the "Maekawa report") to promote a domestic demand-led growth strategy. Key measures included trade and financial liberalization, deregulation and administrative reform, reduced restrictions on land use, increased consumer spending supported by cuts in the income tax, and early implementation of a five-day work week. However, implementation of many of the recommendations from the Maekawa report was delayed, in part owing to stiff opposition from Japan's corporate sector.



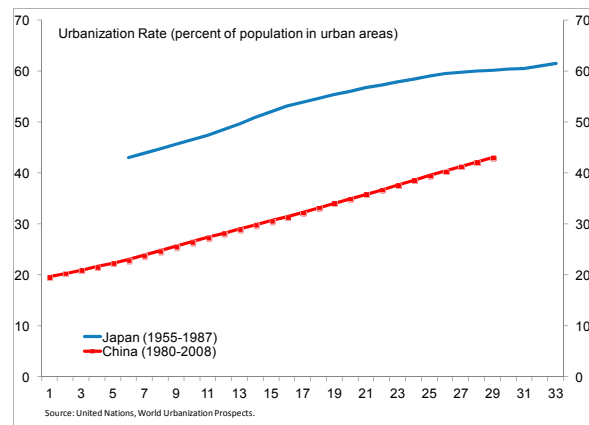
Changes in the industrial cost structure

As the Japanese economy transitioned toward a service-based economy, income rose, and by the early 1980s, Japan was no longer a cheap labor economy. Rising labor costs across all sectors, together with an appreciating yen, prompted less competitive manufacturing firms to relocate abroad. The yen appreciated in real effective terms by about 140 percent from the first quarter of 1964 to the fourth quarter of 1987 (about 3¾ percent a year), of which 40 percentage points occurred during 1985–87, when the Plaza and Louvre accords were signed. Inflation differentials played an important role in the real effective appreciation of the yen during Japan's years of structural change, particularly the inflation that followed the two oil shocks of the 1970s. Inflation rose to about 25 percent in 1974, remaining relatively high during the second half of the 1970s, and spiked again in 1980 from the effects of the second oil shock. Subsequently, the Bank of Japan's tight policy stance and improved productivity in the manufacturing sector helped keep inflation under control.

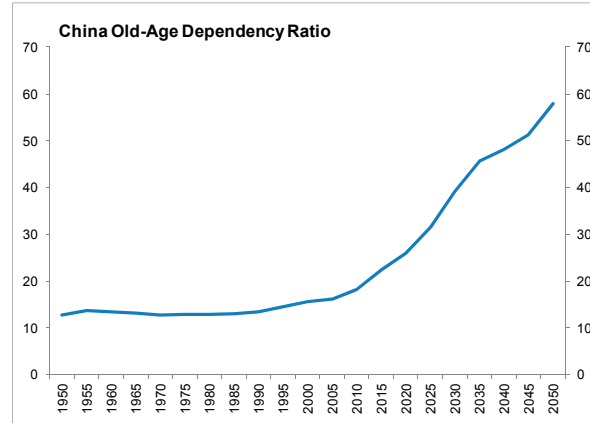
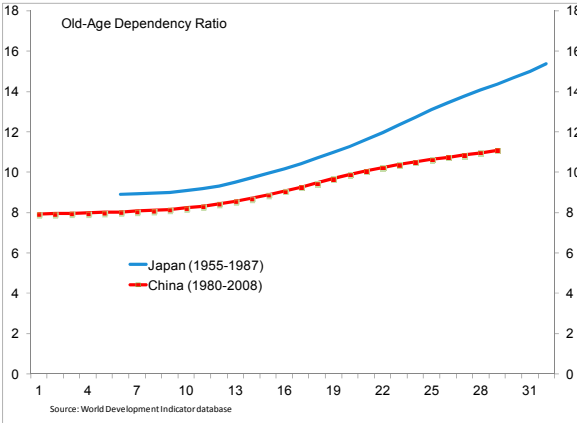


Urbanization and demographics

Changes to Japan's occupational and industrial structure were reflected in the urbanization of the Japanese economy. Demographic changes may also have driven the urbanization process, as the demand for services typically increase with an ageing population. These demographic pressures are less acute in China today, but they certainly are on the horizon. United Nations population projections show a doubling of China's elderly dependency rate by 2025. This trend will likely have a negative effect on growth and could complicate the reallocation of labor from the tradables to the nontradables sector.



The differences between the occupational structure of the Japanese economy in the 1980s and the Chinese economy today mirror the stage of urbanization of the two economies. In the early 1980s, Japan's urbanization was at a far more advanced stage than that of China today. In fact, urbanization in China today is at the level of Japan's at the onset of its longest expansion period. Disparities between rural and urban areas are more pronounced in China than they were in Japan in the 1980s. For China, the Gini coefficient expanded to about 50 percent in 2008, from 30 percent in 1980; but in Japan, it stayed within 35–40 percent from 1960 to the mid-1980s.



VI. INSIGHTS FROM THE JAPANESE EXPERIENCE

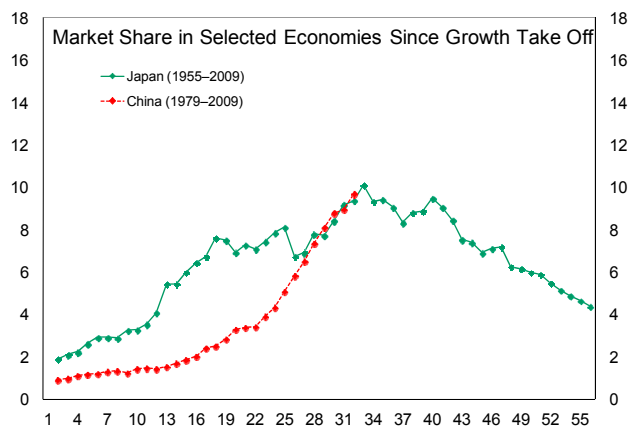
Looking back at the development process of Japan and of China, one finds many similarities, particularly in the savings and investment patterns. The level of China's investment, most of which is concentrated in the manufacturing sector, has been comparable to that of Japan in the 1970s during the first 20 years of the convergence process but has surpassed it in recent years, supported by various cost advantages, including a low cost of capital and utilities, pollution, energy, land, as well as tax incentives and an undervalued currency, and a large pool of savings. China today has an even higher rate of national savings than Japan in the 1980s, with most savings stemming from the private sector. The reasons for these high savings rate are believed to be similar to the ones mentioned above for Japan, especially those relating to lack of social safety nets and low level of public spending on education.¹² China's savings exceeded investment earlier during its development process than Japan, occurring in an external environment marked by a great appetite for foreign financing, with the U.S. running unprecedentedly high and persistent deficits, and by an undervalued renminbi.

There are also similarities in the industrial transformation of the two economies with the transfer of China's labor to the service sector following a similar trend as in Japan, but with

¹² See Barnett and Brooks (2009).

far more challenging initial conditions. From 1979 to 2007, the share of employment in the primary sector fell from 70 percent to 40 percent, while that of the service sector rose from 10 percent to about 30 percent. Unlike in Japan, however, the shift of labor to the service sector was accompanied by a real effective depreciation of the renminbi and declining unit labor costs until the mid-2000s—a trend that has been reversed since then. The fall in unit labor costs before the mid-2000s may have been related to the state-owned enterprises reform of the late 1990, which led to a layoff of over 40 million workers.

In terms of outcome, like Japan, China's development has been remarkable. China's economy grew at an average 10 percent annually, with per capita GDP over 26 times higher in 2009 than it was in 1980, the date that marked the beginning of China's reforms. So far, 500 million people have been lifted out of poverty, and an estimated 380 million jobs have been created since 1978. However, although China has now become the second largest economy in the world behind the U.S., it is still a developing economy with a per capita GDP less than one-tenth that of the U.S. and much smaller than that of Japan in the 1980s. Thus, China has considerable room to grow, provided that the right policies are put in place to enable a timely and orderly transition to a domestic demand-led economy. However, China's presence in global markets today is now larger than Japan's were at its peak. This is fueling protectionist pressure from several trading partners, particularly the U.S., where legislation giving Secretary of Commerce the ability to treat undervalued exchange rate as an export subsidy has recently been proposed.



The pressure on China to appreciate the renminbi and rebalance its economy away from exports and investment toward private consumption today resembles Japan's situation in the mid 1980s, although external imbalances are much larger and more persistent than they were then. Over the past four years, multilateral and bilateral discussions between large current account surplus and deficit countries (China, Japan, the U.S., the euro area, and Saudi Arabia) have led to commitments to reduce global imbalances through a shared strategy that includes structural reforms to increase domestic demand, exchange rate flexibility, and fiscal consolidation depending on countries' external position.¹³ Notwithstanding these commitments, little progress was made until the global financial crisis highlighted the urgency of resolving global imbalances. China, for its part, has introduced a set of measures over the past five years to reform its pension and health care system that go some way toward

¹³ See, for example, summary on multilateral consultation discussion at <http://www.imf.org/external/np/pp/2007/eng/062907.pdf>.

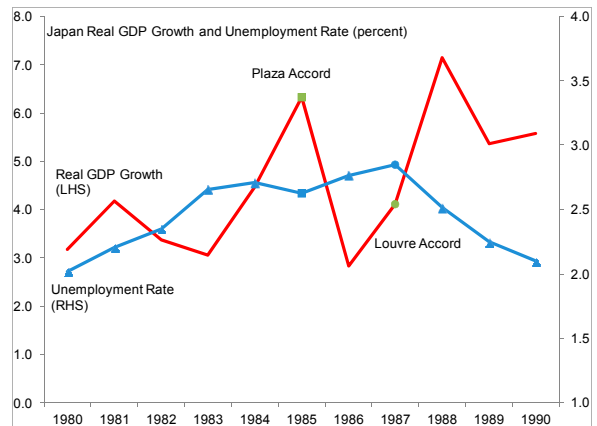
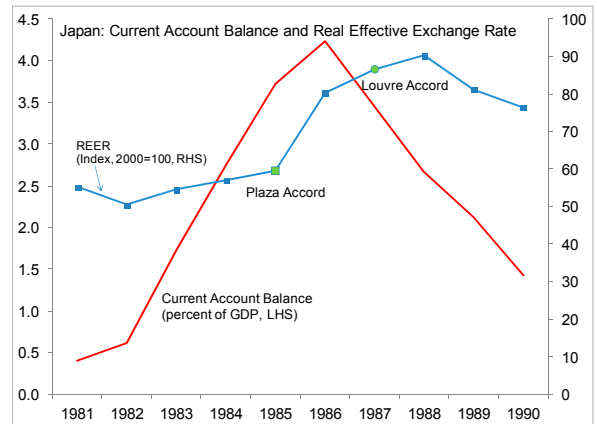
reducing households' precautionary savings and boosting demand, although not to the extent required to bring private consumption to a level consistent with that of other countries at a comparable level of development. The government has committed to pursuing its efforts to rebalance the economy, but the undervalued renminbi continues to generate headwinds against such efforts.

Overall, Japan's experience of the 1980s provides useful insights about the limits to export-oriented growth and the importance of a timely transition to domestic demand-led growth, including the package of reforms to the exchange rate, financial liberalization, and structural reforms needed to get there. Japan's case also highlights the dangers of asset price inflation and the potential headwinds that could arise from changing demographics in China.

Role of the exchange rate in the shift toward services

Japan's experience shows that shifting toward a greater reliance on the service sector requires a combination of real appreciation of the exchange rate, supportive macroeconomic policies, and structural reforms to develop nontradable sectors.¹⁴ Although some analysts have attributed Japan's economic stagnation of the 1990s to the yen appreciation following the Plaza meeting, there is no evidence that the yen appreciation caused the economic stagnation of the 1990s. In fact, analysis of the aftermath of the Plaza meeting shows that the growth and employment impact of exchange rate appreciation can be alleviated with supportive macroeconomic policies. By 1988, real GDP growth had rebounded to over 7 percent and the unemployment rate had already started to fall. The Chinese government recognizes the role the exchange rate plays in rebalancing growth toward private consumption and increasing the role of services and has vowed to reform its exchange rate system in a gradual manner.

From 2005 to mid-2008, the renminbi was allowed to appreciate against the U.S. dollar and in effective terms. The outbreak of the global financial crisis, however, put this policy on

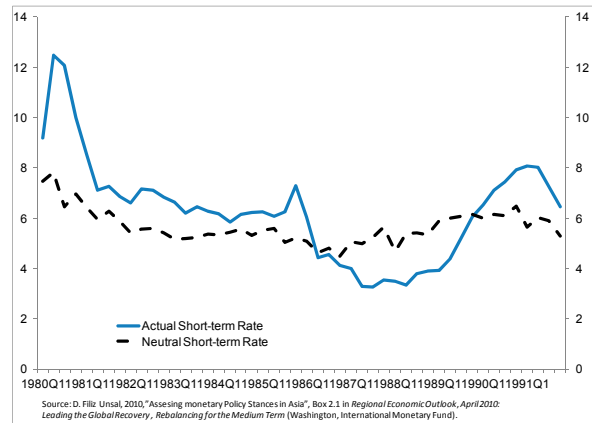


¹⁴ For a broad perspective on lessons from episodes of current account reversals see World Economic Outlook, April 2010, "Getting the Balance Right: Transitioning out of Sustained Current Account Surpluses."

hold for two years until mid-2010, but it has since resumed. A gradual appreciation of the renminbi could facilitate the rebalancing of China's economy.¹⁵ But some have argued that an appreciation of its exchange rate would open up the risk of the economy's falling into deflation and a liquidity trap (McKinnon, 2006); the uncertainty about future renminbi appreciation, according to this argument, would create a negative risk premium that would drive Chinese interest rates below world interest rates, bringing them closer to zero and leaving China unable to respond to the deflationary pressure. This argument rests on a theoretical world with perfect capital mobility and perfect substitutability of assets, while assuming there would be significant uncertainty surrounding a future appreciation. However, judging from the gradual and predictable appreciation path of 2005–08, such negative risk premia from uncertainty around appreciation would likely be negligible. Moreover, the idea that China could experience deflation as a result of appreciation assumes the renminbi would appreciate above its equilibrium value and ignores potential inflationary pressures that could stem from stronger domestic demand as rebalancing is supported by structural reforms that increase households' real income. In Japan's case, there were several sources of deflation in play at the time the currency was appreciating, including weak demand that followed the bursting of the asset bubble, the broken monetary transmission mechanism, and ineffective monetary policy. These factors are not at work in China now.

Financial liberalization

Japan's experience suggests that financial liberalization has to be carefully managed. Japan's experience with interest rate liberalization suggests that liberalizing interest rates in the context of a banking system with excess liquidity, if not properly managed with an appropriate setting of monetary policy, could cause deposit rates to fall and lead to an unintended injection of significant monetary stimulus to the economy. In contrast to Japan in the 1980s, China's financial system remains highly regulated notwithstanding some progress on liberalizing interest rates. Interest rate liberalization began in the mid-1990s and included the removal of the upper limit on interbank lending rates, the liberalization of repo rates and foreign currency lending, as well as deposit rates over certain amounts. However, restrictions remain, in particular a ceiling on deposit rates and a floor on lending rates. Model simulations by Feyzioglu and others (2009) suggest that liberalizing interest rates in China, given the properties of the banking system, would likely lead to higher interest rates with the extent of the rise also depending on the

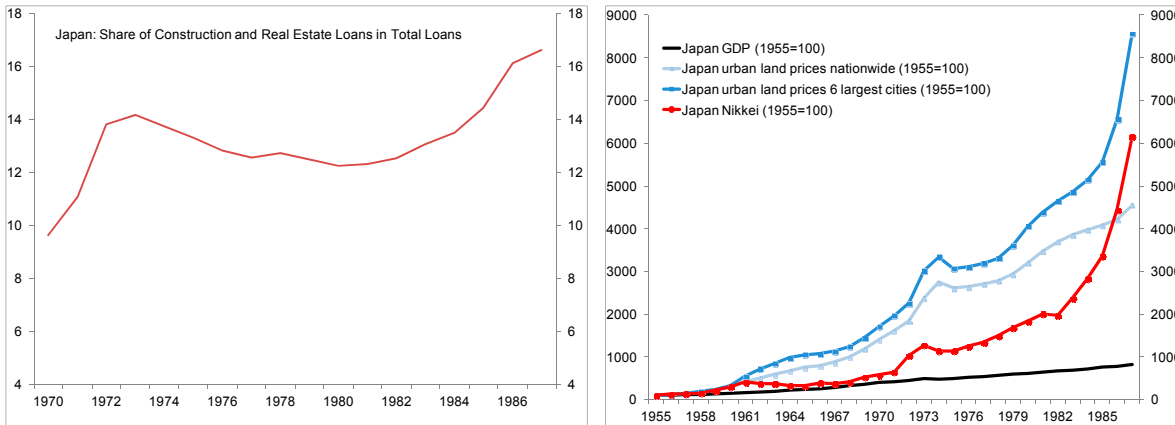


¹⁵ The issue of the required pace of appreciation of the renminbi to support rebalancing is beyond the scope of this paper.

management of monetary policy. Higher interest rates would help reduce investment in less productive sectors, reduce risks of overcapacity, make investment in services more attractive, and improve households' income.

Asset price bubbles

Japan's experience suggests that supportive macroeconomic policies, if maintained for too long, can inflate asset bubbles. Japan's move to a loose monetary policy following the Louvre accord, together with financial deregulation and incentives to boost consumer and mortgage credit, led to a rapid rise in Japanese equity and land prices. The Nikkei rose by an annual average of 30 percent, while land prices in metropolitan areas rose by an annual average of 25 percent, with particularly strong growth in commercial buildings prices. Nationwide increases in land prices were much more subdued however, rising only about 7 percent on average a year. Nevertheless, banks' exposure to property increased markedly, with the share of property-related loans in total loans reaching about 17 percent in 1987 (from about 12½ percent in 1980). The subsequent protracted adjustment in goods and asset markets and the needed deleveraging in household, bank, and non-financial corporate balance sheets contributed to Japan's "lost decade" of deflation, public debt accumulation, and stagnation.



In China, the government's countercyclical response to the global financial crisis, which included several measures to increase infrastructure spending and household consumption and rapid credit growth, has fueled strong increases in asset prices that many analysts now consider divorced from fundamentals. On the face of it, the situation in China is similar to that in Japan in the 1980s with rapid credit growth, investment, and increases in asset prices (Figure 1). However, there are fundamental differences between the two economies in the strength of the balance sheets of households, of corporations, and the government; the fundamentals that drive asset prices; and in the policy response to asset price developments.

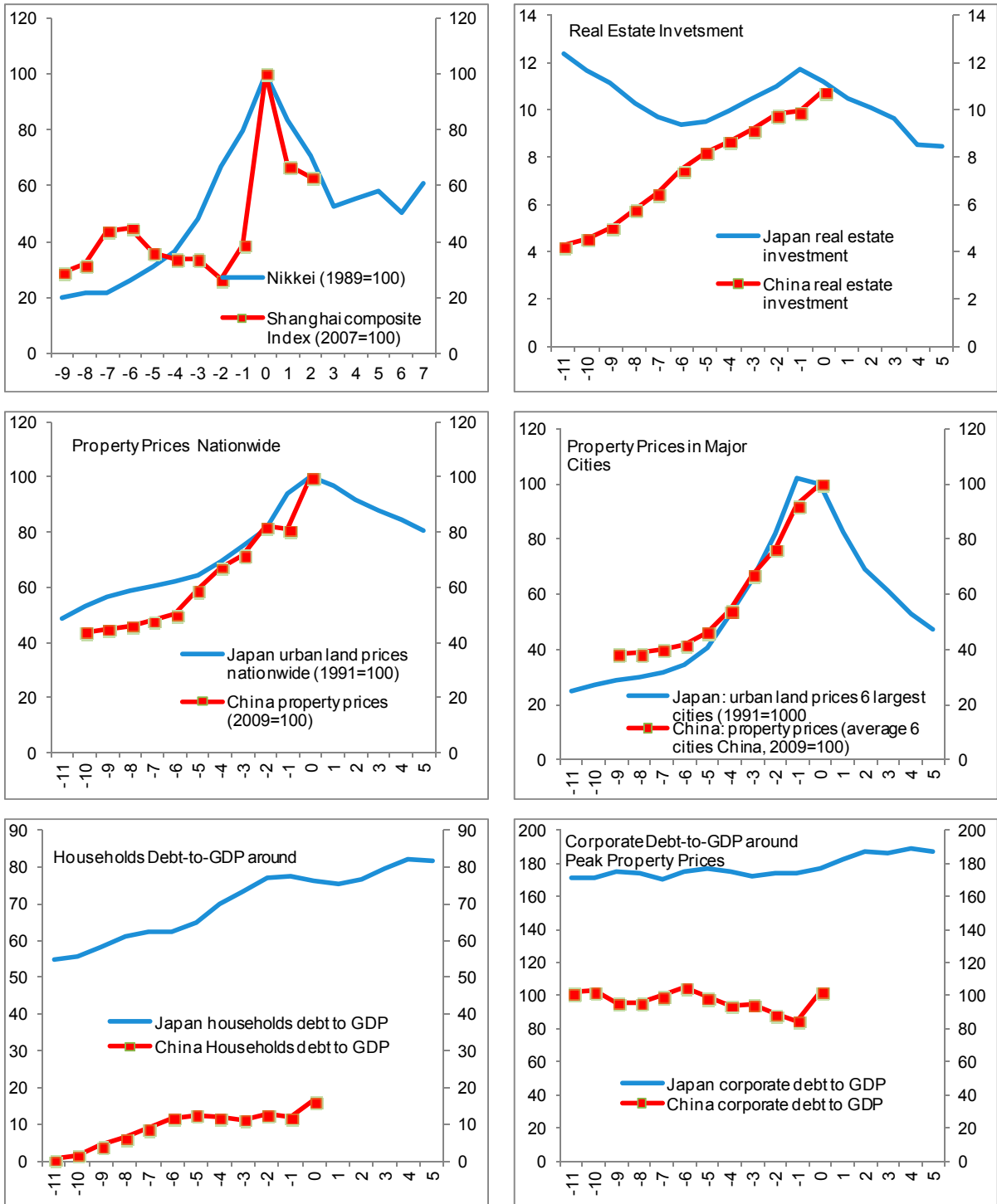
- *Leverage.* Chinese households' debt is one-fifth that of Japanese households in the 1980s; Chinese corporate debt is about half the size of Japanese corporate debt; while government debt stands at about 20 percent of GDP in China, compared with about 67 percent in Japan at the peak of the property bubble. Including contingent liabilities, the government debt would be about 35 percent of GDP.

- *Fundamentals.* Differences in fundamentals include the stage of urbanization, the structure of the population, and the stage of development with potential output growth in China of about 8–10 percent, compared with 4 percent in Japan in the 1980s. These data for China would imply rapid increases in asset prices, although not as strong as has been observed in recent months.
- *Policies.* In Japan, monetary conditions were kept too loose for too long, and leverage was allowed to build up. In China, the authorities have already started taking measures to stem the run up in property prices with increases in reserve requirements, tighter underwriting and prudential standards, and slower credit growth.

Another key fundamental difference is in the stage of development of the countries' respective financial sectors: Japan's was largely liberalized, while China's financial sector remains heavily controlled. While the propensity is nonetheless there for a run up in asset prices, this is not independent of policies. The right calibration of policies—including prudent monetary policy and an increase in real interest rates—should allow China to avoid the boom-bust asset cycle that was experienced in Japan.

Overall, the Japanese experience of the 1980s provides useful insights about the way China could manage a successful rebalancing to a domestic-demand led economy and the downsides to avoid. In particular, Japan offers useful insights to (1) the limits to an export-oriented growth strategy; (2) the role of exchange rate, macroeconomic policies, and structural reforms in rebalancing the economy toward the nontradables sector; and (3) the risks associated with financial liberalization. These insights provide some optimism that the ongoing rebalancing process of the Chinese economy can be managed.

Figure 1. Asset Prices and Balance Sheets around Peak in Japanese Land



Source: CEIC database.

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