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Popular Delusions

The lesson from Japan? China will be the biggest bubble the world has seen

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Studying the lessons from Japan's lost decade(s) is key for anyone seeking to understand today's post-bubble world. But a closer reading of Japan's financial history illuminates today's China far more. In the early 1980s, on the eve of its financial liberalisation, Japan was the rising power from the East set to overtake the West. Younger and growing rapidly, it was still a decade away from its climactic and catastrophic bubble peak. *This* is where China is now.

- Japan's deflationary experience since its bubble burst haunts policy makers and investors, who are confronted with a bewildering range of theories explaining what has gone wrong and how a similar scenario can or can't be avoided.

- But the real cause of Japan's deflation is probably more demographic than debt-related. If so, maybe we should be more worried about the side-effects of an ongoing stimulus overdose aimed at 'reviving the dead', rather than fighting a more ordinary bout of flu.

- Japan has been the first industrial economy to begin demographic contraction. Indeed, thanks to Deng Xiaoping's 1979 one child policy, China will soon face the same problem.

- But it is unlikely China will suffer the same immediate fate. In fact, further reflection on the similarities between China and Japan leads one to realise that many of the challenges confronting China today have *already* been faced by Japan, demography being only one.

- From the strained currency diplomacy to the accusation of favouring exports over domestic demand, from the Western marvelling at "Confucian capitalism" to the sense of inevitability about the rising of a great power in the East … all were as true for Japan 30 years ago as they are of China today.

- And Japan 30 or so years ago might be a more fruitful analogy altogether. There is a clear historic coincidence of manias and geopolitical shifts. In the 1980s, Japan's developing financial bubble reflected a shifting of the balance of power in its direction.

- But the geopolitical shift towards China now underway dwarfs that seen in Japan in the 1980s, and probably anything yet seen in the history of the modern world. A commensurately seismic mania would lead to excesses beyond all proportion to the periodic bouts of frothiness seen so far.

- Japan's experience also hints at what may be the future catalyst unleashing this frenzy: capital account liberalisation. Financial history is filled with financial liberalisations gone wrong and Japan's bubble can be traced *directly* to the removal of controls on international capital flows and banking in the early 1980s. Seeking a larger international role for the renminbi, China is now, albeit tentatively, embarking on a similar path. Full liberalisation, when it occurs, could be the starting gun for the biggest bubble the world has ever seen.

In trying to understand how our post-bubble world might look, "learning the lessons from Japan" has become an obsession. Policy makers scramble to yank as many policy levers as they can, lest they be accused of the timidity blamed for causing Japan's two lost decades. Investors pore over post-bubble market history to ensure their strategies are able to deal with what happens if those policy levers don't work. Economists…well, economists do what they always do: lecture everyone on the imperative of following the course of action implied by their latest models with a confidence flying in the face of their consistently appalling track records.

Japan has a rich financial history: it was the first non-Western economy to industrialise; it experienced arguably the largest bubble seen in financial history; it has since suffered a commensurately spectacular multi-decade slump; it has been the first developed country to experience demographic contraction. It would be foolish *not* to try and learn something from its experiences … but by focusing only on the last two decades are we learning the right lessons?

The myth of the malfunctioning Japanese economy

Using the bursting of Japan's bubble to explain its subsequent economic malfunction might not be as robust as it is intuitive. Economists armed with spuriously conclusive mathematical models conclude that Japanese policy makers have lost control: the headwind of economy-wide deleveraging has landed the economy in a deflationary death spiral.

Even more ominously, despite massive fiscal pumping and highly experimental monetary policy (in the spring of 1999 Japan became the first major economy to take its interest rates to zero before subsequently moving to 'unconventional measures') Japan *remains* in a "liquidity trap." As the Great Depression showed decades earlier, we are told, such fallout is natural following the bursting of an economy-wide bubble. Hence, now that the global credit bubble has burst, a similar fate surely awaits.

Or does it? Something else happened in Japan in the early 1990s which receives less attention but provides a simpler explanation for its post-bubble experience: demand is deflating because the workforce is shrinking (see the first chart on page 3). The table below shows that while Japanese real GDP growth has indeed significantly lagged behind that of the US over the past 20 years, ***per worker* GDP has broadly kept pace, even outpacing it over the last five.**

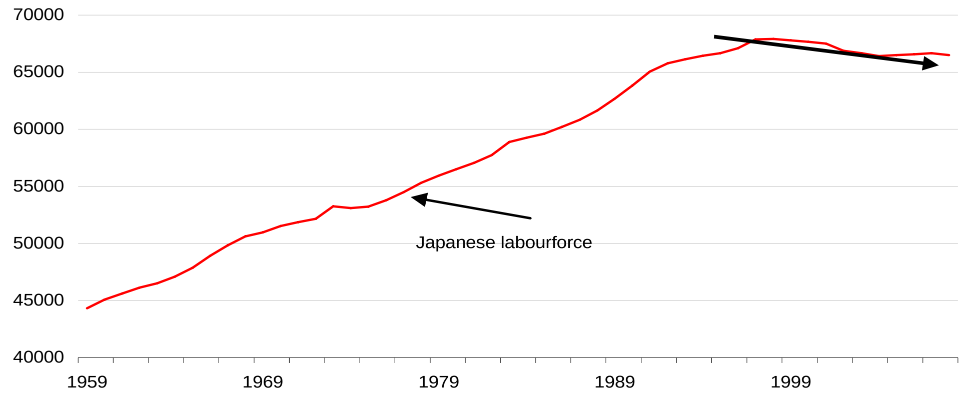
So where has Japan's macroeconomic malfunction been? Isn't it at least plausible that Japan's persistent demand deflation is simply attributable to its population shrinking, rather than to unbreakable debt-deflation dynamics or even policy errors? Can't this explain persistently falling demand and constant struggle against excess capacity?

What malfunction? Japan's growth in GDP per worker has kept pace with America's

	Japanese real GDP	US real GDP	JP real GDP per worker	US real GDP per worker
20 year annualised growth	1.6%	2.8%	1.3%	1.6%
10 year annualised growth	1.3%	2.6%	1.5%	1.5%
5 year annualised growth	1.6%	2.4%	1.7%	1.3%

Source: Datastream, SG Global Strategy

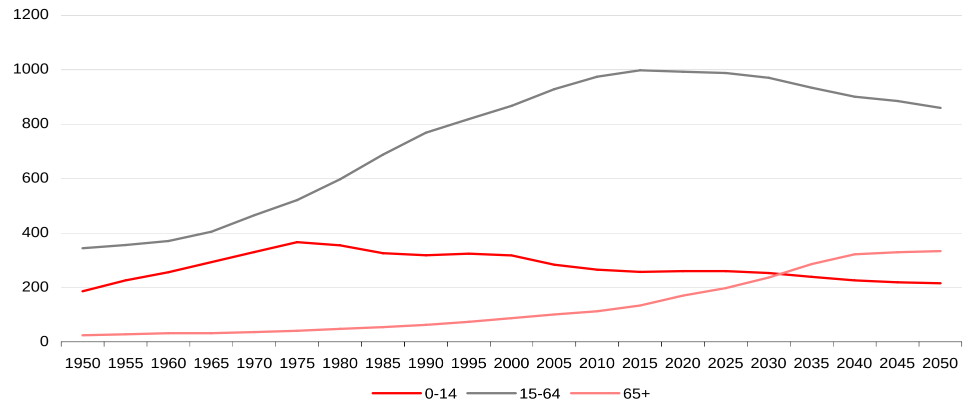
Something else happened to Japan in the 1990s (workforce, 000s)



Source: Datastream

If so, perhaps the US should be more worried about the effects of a stimulus overdose than the prospect of two lost decades, though that is a subject for another time. It is not America but China, thanks to the demographic time bomb planted by Deng Xiaoping's one child policy, which faces a similar problem (see the chart below)[1] [2].

Chinese working age population to plateau from 2015 (population 000,000s)



Source: UN

Japan as a template for China

But demographic deflation wasn't the only headwind the Japanese economy has faced. Its stock and property markets have been appalling places to be thanks to the deflation of arguably the biggest bubble yet seen. Remember, the Nikkei traded at a *market-wide* PE of around *80x* at its peak. Construction companies traded on 100x. NTT Docomo was privatised at about 70x. Home buyers had to take out *100 year mortgages* in order to afford a house! If current valuations are the best predictor of long-term returns then these numbers *alone* explain why the Japanese market has taken so long to deflate One day, China might suffer a similar hangover. But first it has to have the party.

[1] For an impressively detailed analysis of global demographic trends with lots of good charts see Veronique Riches-Flores, World demographics: the challenges facing the world economy, 4 May 2007

[2] As should other "demographically challenged" countries such as Italy, Germany and therefore anyone interested in the long-term future of the euro project

The parallels between China today and Japan during its industrialisation are eerie: the absence of what many in the West might call an effective democracy, the highly regulated economy, the Confucian ideology, the hard working population with a high propensity to save, the robust domestic investment rates, the tension in currency diplomacy, the shift in the geopolitical balance…all of these features which dominate our perception of China today were as dominant in perceptions of industrialising Japan.

The absence of democracy?

The one party system in China is well understood, even if the significance of the continuity between today's Communist party and the ancient dynasties is sometimes neglected. Less well appreciated is that Japan has never been what a Westerner might call "democratic". We tend to think they're like a Western democracy because they vote in regular and reasonably clean general elections and have a multi-party system. But notwithstanding its recent election defeat, the LDP has had an almost uninterrupted rule since WW2. Based on a loose coalition of factions who divide power among themselves, ex-colleague and former Yamaichi Securities chief economist John Shepperd used to tell anyone who would listen that the Liberal Democratic Party, "wasn't liberal, wasn't democratic and wasn't a party." Yet it should be noted that the absence of democracy proved no obstacle to rapid economic development.

State-directed "capitalism"

Following on from this, consider also Japan's version of "capitalism" which involves a far more significant role for government than anything seen in the West, including Continental Europe. This is rooted in the nature of its industrial take-off which, unlike the spontaneous industrialisations of Europe, was state directed from the outset.

The turning point in Japan was the Meiji Restoration of 1868. With India colonised and China enduring what it now refers to as its "100 year humiliation" at the hands of the "Great Powers" (mainly British opium dealers), the Japanese understood that they would be next unless they could quickly learn to compete. Anticipating Deng Xiaoping's arrival at the same conclusion in 1978, Japanese government policy became, quite simply, to catch up with the West. In both cases, therefore, the catalyst behind the drive to industrialisation was the government, not private industry.

The centrality of government to Asian life in general is conceptually alien to us. According to Martin Jacques

> *"Confucian societies, thus, have a rather different conception of government to that which we are familiar with in the West, where the state is viewed as an essentially artificial construct, an external institution that people seek to hold to account, which they view with a certain suspicion, whose powers they constantly seek to define, limit and constrain. For the Chinese – and the same can broadly be said of the other Confucian societies - the state is seen as a natural and intrinsic part of society, as part of the wider common purpose and well-being. The state, like the family, is subject to neither codification nor constraint. The Chinese state has never been regarded in a narrowly political way, but more broadly as a source of meaning, moral behaviour and order. That it should be accorded such a universal role is a consequence of the fact that it is so deeply rooted in the culture that is seen as part of the natural order of things.[3]"*

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[3] See "*When China Rules the World: The Rise of the Middle Kingdom and the End of the Western World*", pg 135

Yet the possibilities of such a government-heavy, even authoritarian approach, fires the Western imagination with as much admiration as dread. Untrammelled by democracy and with a command structure lending itself to long-run thinking, commentators are often heard wondering aloud if the Chinese might not have actually mastered the vagaries of the economic cycle … hasn't its uniquely regulated system proved its resiliency not only during the crisis of 2008, but arguably through the Asian crisis of 1997 and the tech bubble of 2000 too?

Here again we find an echo of 1980s Japan. Peter Tasker has eloquently argued that every bubble has its own narrative.[4] The one way traffic of policy makers, businessmen and academics to Tokyo in the 1980s not only marvelled at the uniqueness of "Japan Inc" - the long-term planning, the consensus approach, the primacy of the social contract over return on capital, the harmonious society – but interpreted its resilience in the wake of the 1987 global stock market crash as proof of its superiority.

Currency manipulation and reserve accumulation

Neither are the Chinese the first to be accused of maintaining an artificially low currency as a way of "unfairly" promoting their export industry. In the 1980s, as Detroit car workers destroyed Toyota and Nissan cars to protest against their importation, it was the Japanese who were widely blamed for the pain of domestic manufacturers.

Similarly, just as China's reserve accumulation has been blamed for artificially depressing world interest rates, thus causing the US housing bubble (e.g. Bernanke's "savings glut" argument[5]), Japanese willingness in the 1980s to finance the budget deficits caused by Reagan's supply side revolution won it few friends. Interestingly, by the second half of the decade, concerns about the soundness of such holdings, given residual distrust over the American government's commitment to safeguard the value of the dollar, led to a move by the Japanese into real assets like Californian property, Universal Studios and, most (in)famously, the Rockefeller Centre. Faced with a similar dilemma, China's real asset of choice appears to be commodities.

High saving/investment ratios, low domestic demand

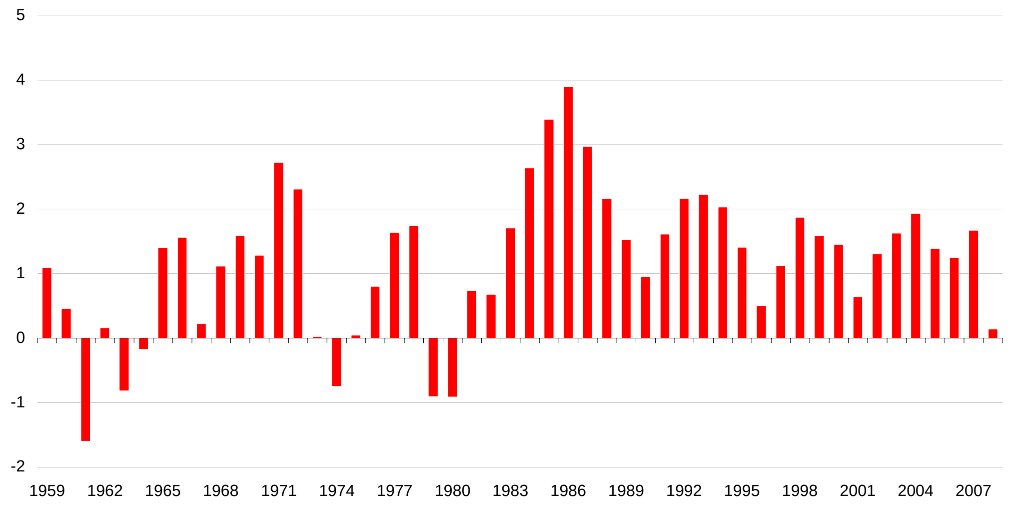
Related to the accusations of manipulating its currency, China is frequently accused of doing too little to promote the consumer sector of its economy. Indeed, as an exporter of capital to lower growth economies, China is frequently blamed for turning traditional economic logic on its head. But again, this is a rerun of developments already witnessed during Japan's industrialisation.

The chart below shows that Japan ran persistent trade surpluses (with the exception of the OPEC shocks) from its post war reconstruction to this very day.

[4] See "Japan serves up valuable minimalist lesson" by Peter Tasker, FT, 21/06/09

[5] Stanford's John Taylor persuasively argued that this glut didn't actually exist. See "The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong"

Japan ran trade surpluses throughout its post war reconstruction too (% of GDP)



Source: Datastream

The geopolitical swing

In his classic history of financial speculation, Edward Chancellor argues that manias frequently accompany significant geopolitical shifts (see the table below).[6] And not that long ago, Japan was seen as the newly pre-eminent economic model. Back in the 1980s, as Chancellor documents, the business best-sellers list was packed with titles such as "Yen! Japan's New Financial Empire and its Threat to America" and "Japan as Number One." The subtext behind Michael Crichton's thriller "Rising Sun" was a questioning of the wisdom of allowing Japanese foreign direct investment in US high-tech sectors. He told the Wall Street Journal his book was intended to "make America wake up."

Speculative manias and geopolitical shifts

Year	Country	Mania	Geopolitical Swing
1636	Netherlands	Tulips	Peak of Dutch hegemony
1696	England	Joint Stock Companies	Glorious Revolution
1825	England	Emerging Market issues	British Hegemony following Waterloo
1929	USA	Stocks	US dominance emerging; 'Great Powers' in disarray following WW1
1989	Japan	Real Estate, stocks	Anticipated economic overtake of US
2000, 2008	United States	Stocks, Real Estate	Undisputed hegemony following Soviet collapse
201?	China?	??	Overtaking of US economy?

Source: SG Global Strategy

Today it's the Chinese who are coming. A quick perusal of similar reading lists reveals titles such as the already quoted "When China Rules the World: The Rise of the Middle Kingdom and the End of the Western World" or "China Inc: The Relentless Rise of the Next Great Superpower."

[6] See Edward Chancellor's *"Devil Take the Hindmost"*

The lessons from Japan?

There is one important chapter in Japan's story yet to play out yet in China: liberalisation of the capital account. This was arguably the most important catalyst transforming the Japanese stock market from simply one with potential, to one which was an unsustainable bubble of unprecedented magnitude.

In 1980, interest rate markets and cross-border flows of capital were as tightly regulated in Japan as they are in China today. And like the Chinese today, the Japanese were accused by the Americans of using these regulations as a way of maintaining a cheap yen. Succumbing to heavy diplomatic pressure, the capital account was completely liberalised by the mid 1980s and the yen allowed to appreciate.

Most financial historians will tell you that financial sector liberalisation frequently precedes crisis – the sudden proliferation of new ways to finance activities in markets in which lenders have little experience seems to do more harm than good.[7] Japan was no different.

As the use of derivatives exploded, foreign institutions could issue in yen, while those of Japan could issue in foreign currency. But like the renminbi today, the yen was deemed a one way bet and the forward curve priced appropriately. Chancellor writes that swapping dollar denominated debt for yen resulted in a *negative* interest rate for the creditor so that Japan Inc. was effectively paid by Mr. Market to *borrow* money! Add in an option to convert the liability into ever-rising equity, and the capital available to a Japanese institution was cheaper still. **Perhaps more than anything else, this provided the monetary fuel for the flames that drove Japan's hot air balloon market to stratospheric heights of valuations.**

China wants the renminbi to have a more active role in international trade. In March, the PBOC governor Zhou Xiaochuan suggested the use of Special Drawing rights, basically a basket of currencies including the renminbi, as an alternative to the dollar as a reserve currency. Foreign banks have recently been allowed to sell yuan-denominated bonds in China. The Chinese authorities have set the year 2020 as the target date by which Shanghai is to be an international financial centre.[8]

Japan had similar ambitions for Tokyo back in the early 1980s, but hot financial flows and abundantly cheap capital mixed with nationalistic hubris proved a deadly cocktail. As the decade progressed, they increasingly believed their own propaganda and that the superiority of Japan Inc justified the market's astronomical stock and real estate prices. In fact, they were actually just falling into the age old trap of mistaking leverage for yet another superior economic model.

As China begins its capital account liberalisation it's difficult to see how it will avoid the same fate as Japan. Its economic growth will be as giddy, as will the West's wonderment at the unique Chinese way. And with the Middle Kingdom at last regaining its rightful place, the inevitable mix of national hubris with abundant liquidity will be as intoxicating. ***The lesson from Japan is that the journey towards China's climactic bubble is actually only just beginning***.

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[7] See for example Arthur Wilmarth Jr., "Does Financial Liberalisation Increase the Likelihood of a Systermic Banking Crisis? Evidence from the Past Three Decades and the Great Depression"

[8] See "Yuan may be reserve currency by 2020 – China Official", Reuters, 20 May 2009