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Will China's economy follow the same path as Japan's?

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Executive summary

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SINCE THE BURSTING of China's real-estate bubble in mid-2021, there has been a growing concern that the Chinese economy could end up like that of Japan in the early 1990s. Some structural patterns are strikingly similar: low private consumption over a long period, especially when compared to the rest of the world, and an excessively high savings ratio, though China's imbalances now are even larger that Japan's were then.

INITIAL POLICY RESPONSES to the bursting of their respective bubbles have also been similar. Both China now and Japan then were initially hesitant to ease monetary and fiscal policies, and opted to expand manufacturing, with an eye on external demand, supported by more research and development expenditure. In both cases, the outcomes were stubborn trade surpluses and a mercantilist attitude to their growth problems, leading to the United States taking protectionist measures. China also seems to be following Japan's offshoring of production to mitigate the impact of protectionism.

THE MAIN DIFFERENCE, though, is that China now is a poorer country than Japan was then, with still more convergence opportunities ahead. China is also a much bigger military and geopolitical contender than Japan ever was. China's geopolitical weight is behind the US technological containment of China, but also gives China more room for manoeuvre globally, especially in the Global South. It remains unclear – though globally significant – whether China will be able to deviate from the path followed by Japan in the 1980s and 1990s.

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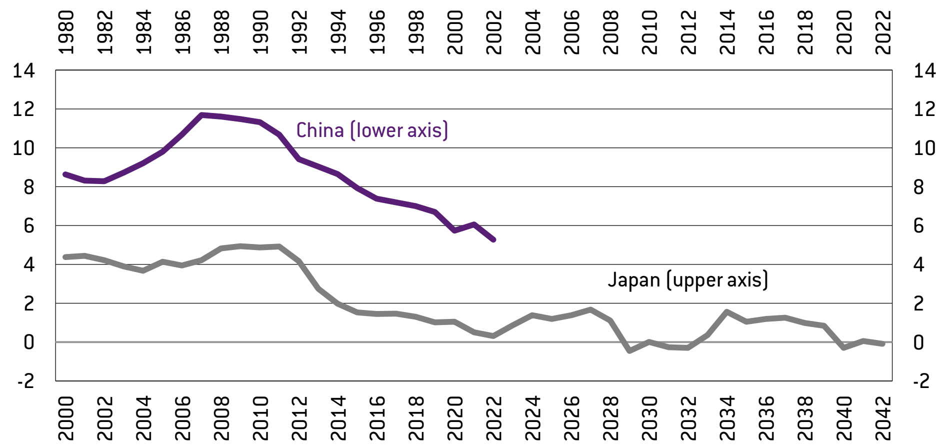
1 Is China replicating Japan's lost decade?

Since peaking at a remarkable growth rate of 14 percent in 2007, China's economy has experienced significant slowdown, gradually decelerating to 6 percent in 2019 and dropping even faster during the COVID-19 pandemic and thereafter. Growth now is barely 5 percent, at least according to official statistics, and is even less (4.2 percent) in nominal terms because of the negative growth in the GDP deflator (ie when inflation is taken into account). Such a rapid economic slowdown and other factors, such as the collapse of the real-estate sector[1], is behind the increasingly frequent comparison with Japan's experience in the 1990s, often referred to as 'the lost decade' (Figure 1).

Figure 1: Comparison of GDP growth rates of China (since 2000) and Japan (1980s-1990s)



Source: Bruegel based on Natixis, CEIC.

From this, the question arises: if Japan's experience then is comparable to China's today, does it offer a guide to understanding the future of the Chinese economy? Numerous studies have examined the explanations for Japan's lost decade, including fiscal inadequacy (Kuttner and Posen, 2002), insufficient monetary policy and the liquidity trap (Bernanke, 1999; Leigh, 2010), the role of financial intermediation (Kwon, 1998; Ogawa and Suzuki, 1998), and the over-investment that preceded Japan's lost decade and led to a low rate of return on capital (Bayoumi, 2001).

In a seminal paper, Hayashi and Prescot (2002) took a long-term perspective on Japan's economic slowdown and argued that the fundamental driving force was the transition to a new and lower growth path, brought about by a decline in total factor productivity (TFP). Griffin and Odaki (2009) meanwhile showed that the lack of exits by the least-productive firms, and the lack of entries by small productive firms, reduced TFP growth during the 1990s, but there was no strong evidence of misallocation of resources across incumbent firms. The finding seemed to suggest the lack of a creative-destruction process during Japan's lost decade. An econometric analysis by Imai *et al* (2017) further found that the decline in Japan's export competitiveness during the 1990s could be attributed to a decrease in innovation and growth in export industries.

Japan's economic success after the Second World War, which resulted in it challenging the US economy in the 1980s, has received attention in China and beyond as a potential compar-

1 See for example *Bloomberg News*, 'China's Property Crisis Enters a Dangerous New Phase,' 11 February 2025, https://www.bloomberg.com/news/features/2025-02-11/china-s-real-estate-crisis-property-sector-debt-is-getting-worse.

ison to China's economic success. This is even more the case recently as Japan went through the build-up of a real-estate bubble and its bursting ten years later, which resonates with what has been happening in China in the last two decades. The question then is whether China, like Japan, will also experience a prolonged slowdown following a period of rapid growth?

China observers have compared the experiences of the two countries carefully. Weede (2004) reviewed Japan's and China's development models (see also Nogimori, 2023), while Wu (2023) focused on the differences. García Herrero and Iwahara (2024) looked at the lessons for China from the real-estate collapse in Japan.

In this Policy Brief, we take a broader perspective by focusing on the savings-investment patterns of China and Japan, showing how Japan's macroeconomic imbalances in the 1980s are comparable to those of China in the 2000s when its imbalance was built up. We also examine similarities in terms of real-estate bubbles, demographics and deflationary pressures and some significant differences – especially China's military and geopolitical power and leading position in the Global South.

2 Savings-investment patterns

China and Japan have both had large macroeconomic imbalances with high savings and relatively low investment. That domestic savings could fully finance even high levels of investment and still leave excess savings made it easy for both countries to ride on an investment boom financed by artificially low interest rates. High investment was also accompanied by low private consumption in both countries.

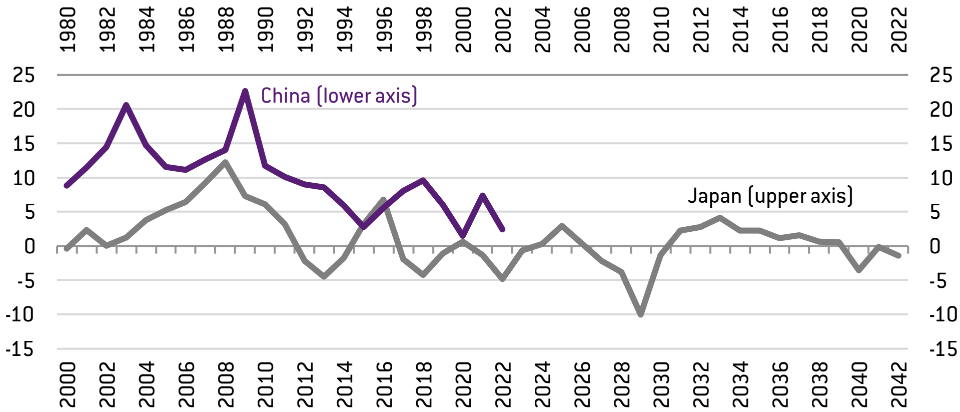
Growth in Japan's fixed asset investment (FAI) rate declined sharply from an average of 4.7 percent in the 1980s to only 0.34 percent in the 1990s. In China, the growth in FAI reached 14.2 percent after its accession to the World Trade Organisation (WTO) in 2001, fed not only by foreign direct investment in setting up manufacturing plants in China, but also by infrastructure investment (Figure 2). Subsequently, in the 2010s, China's growth rate slowed to 7.7 percent following the slowdown of the real-estate sector.

Japan's real-estate sector experienced an increase in value added of 3.7 percent in the 1980s but this slowed considerably to 2.1 percent in the 1990s. China's real-estate value-added grew by 10.7 percent in the 2000s, but this also slowed, reaching 5.11 percent in the 2010s (Figure 3). The trend looks similar but investment growth in China was always higher than in Japan, which explains why Chinese GDP growth always exceeded Japan's. It is also true that China's starting point, in terms of income *per capita*, was lower than Japan's, meaning China had more space for growth convergence, starting with a lower level of urbanisation.

That said, China's real-estate market adjustment has been more rapid than Japan's, raising concerns about a potential 'hard landing' in China's case[2] (Figure 2). The main risk appears to be associated with significant local-government debt, in particular unofficial debt through local-government financing vehicles (LGFVs) (Tao, 2015). Although policymakers have taken steps to mitigate these risks, the lingering imbalances suggest that the financial system has not entirely stabilised. Japan's financial sector was mainly hit by the real-estate crisis and the deleveraging of the corporate sector, less so by its local finances. Thus, the main sources of financial risk in Japan and China were and are somewhat different.

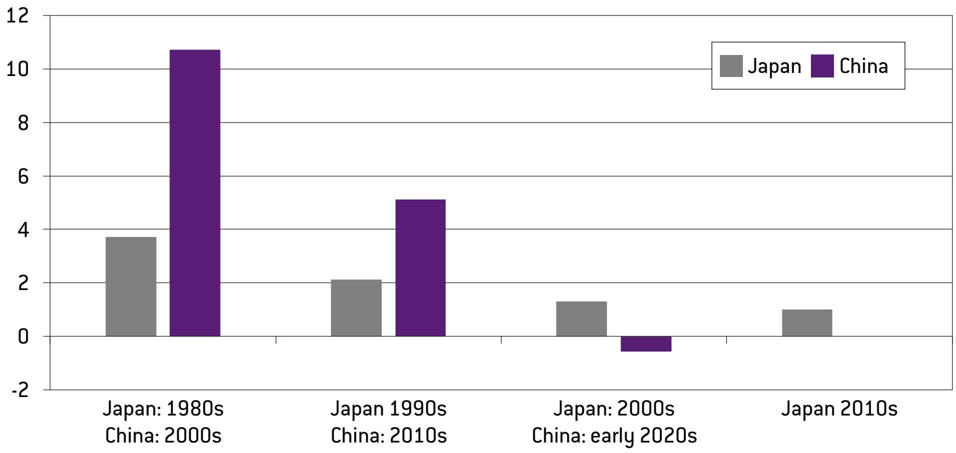
2 For example, Ann Stevenson-Yang, 'Soft Or Hard? China's Property Sector Is Coming In For A Landing,' *Forbes*, 17 January 2022, https://www.forbes.com/sites/annestevenson-yang/2022/01/16/soft-or-hard-chinas-property-sector-is-coming-in-for-a-landing/.

Figure 2: Gross fixed capital formation (real, year-on-year, %)



Source: Bruegel based on Natixis, CEIC.

Figure 3: Real-estate value added (%)



Source: Bruegel based on Natixis, CEIC.

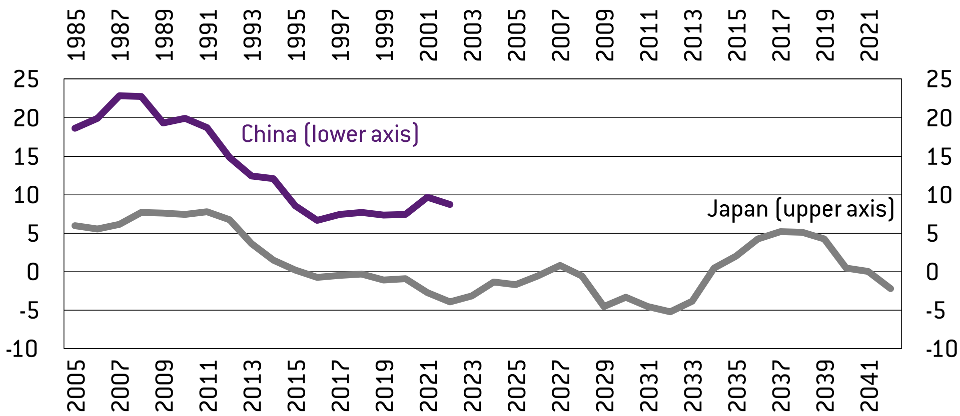
Generally, a decline in investment typically leads an economy to rely more on consumption, reducing the incentive for saving. This was what happened in Japan in the 1990s. Japan's total savings growth rate dropped from nearly 8 percent to negative levels during the economic deceleration of the 1990s (Figure 4). This was mainly caused by plunging fiscal revenues and deflationary pressures, which led to the deterioration of fiscal accounts well beyond the effects of corporate deleveraging during the so-called 'balance sheet recession'[3]. China has undergone a similar trajectory since 2008, but with a lesser decline in savings. Now, China continues to rank significantly above other major economies in terms of its savings-to-GDP ratio (Figure 5), even after the economic slowdown, which has already to some extent corrected the savings-investment imbalance.

The reasons for China's massively high savings, even surpassing Japan's, are partially related to the lack of a welfare state or, in other words, a public insurance mechanism (Yang, 2012). Private insurance remains rather limited, even after the reform of China's financial sector which started in the 1990s under Premier Zhu Rongji. Beyond these factors, the high

3 The term 'balance sheet recession' refers to a prolonged period of economic stagnation in which firms and households prioritise debt reduction over investment and consumption, often following a financial crisis. This leads to subdued aggregate demand, deflationary pressures and a weak economic recovery despite accommodative monetary policies (Koo, 2023).

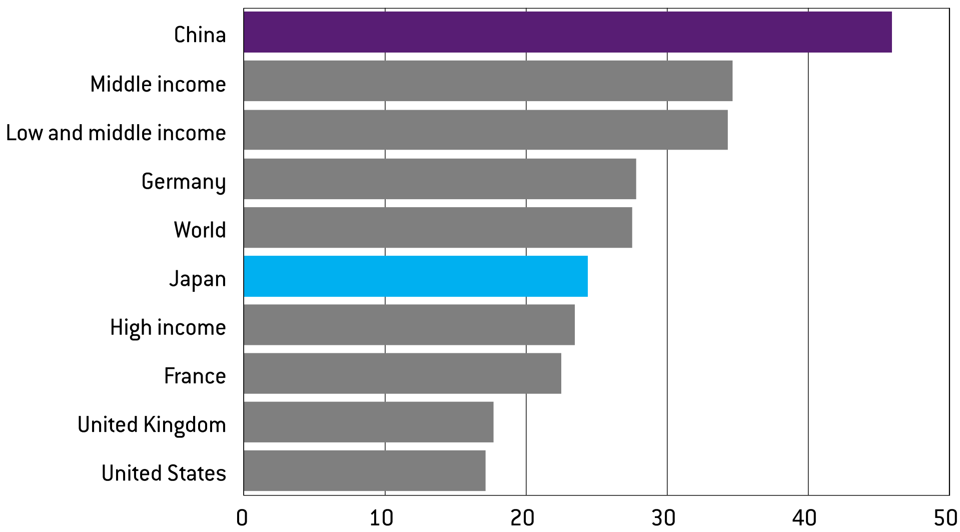
degree of uncertainty about the geopolitical environment, especially since President Donald Trump's first term and the ensuing US policies to contain China, as well as the COVID-19 pandemic, also explains why Chinese households take a precautionary perspective and still maintain higher levels of savings.

Figure 4: Growth rate of domestic savings



Source: Bruegel based on Natixis, CEIC.

Figure 5: Savings rates (%) in the early 2020s, major economies

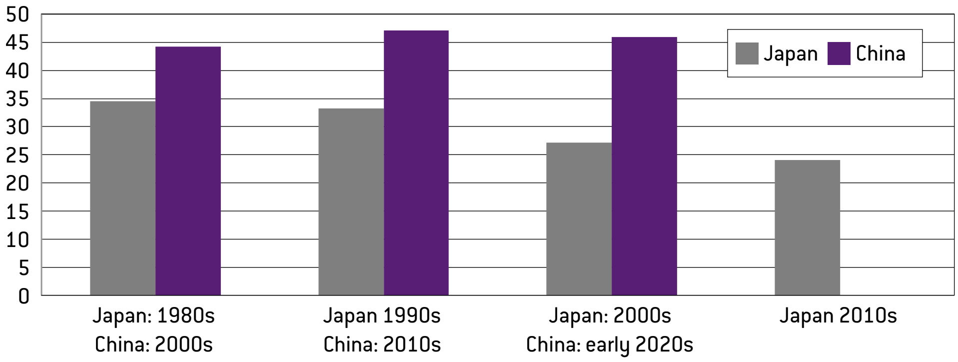


Source: Bruegel based on Natixis, CEIC.

All in all, both China and Japan have experienced significant decreases in investment, but while Japan achieved a gradual shift from an investment-driven to a consumption-driven growth model, China has barely reduced its imbalances, characterised by high excess savings (Figure 6) and low private consumption.

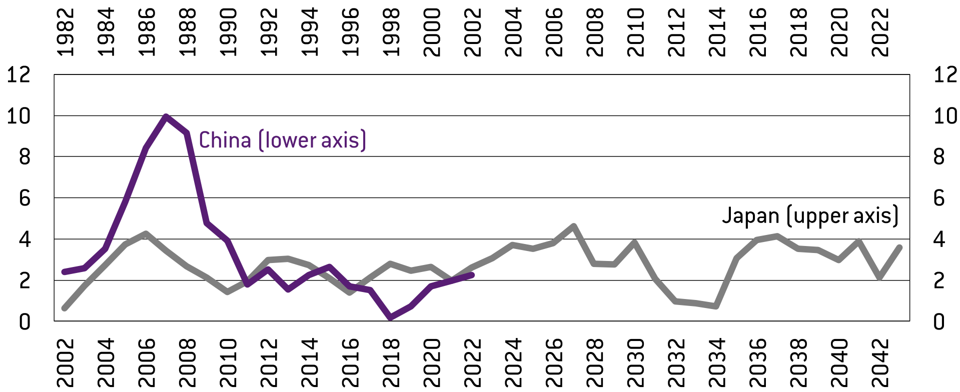
Consequently, China's savings rate continues to exceed its investment rate, leading to a persistent current-account surplus. This outcome contrasts with earlier expectations that the surplus would decline as China's GDP *per capita* rose and imports increased, driven by a growing middle class seeking high-end consumer goods. China's current account ratio has plateaued at approximately 2 percent, resembling Japan's situation in the early 2000s (Figure 7).

Figure 6: Savings rates in Japan (1980s-2010s) and China (2000s onwards)



Source: Bruegel based on Natixis, CEIC.

Figure 7: Current accounts, % of GDP



Source: Bruegel based on Natixis, CEIC.

Finally, the containment strategy towards China adopted by both President Trump and President Biden mirrors Japan's experience in the late 1980s. In Japan's case, this containment was primarily economic, focusing more on trade than technology, as Japan had not re-established military capabilities following its defeat in the Second World War. The United States engaged in trade negotiations that heavily favoured American interests, capitalising on its significant bilateral deficit with Japan, particularly in the automobile and electronics sectors. The US also implemented tariffs and quotas on Japanese imports and pursued voluntary export restraints on specific products. In addition, the US targeted Japan's semiconductor industry, exemplified by the 1986 US-Japan Semiconductor Trade Agreement[4], which aimed to boost the market share of American companies. The US also pushed Japan to appreciate the yen through the Plaza Accord[5].

The US containment strategy toward China has unfolded differently. Unlike Japan, China is perceived by the US as presenting not only an economic threat but also military and security challenges. As a result, economic containment, such as the trade measures during President Trump's first term (Dadush, 2019), represents just one part of a broader strategy.

4 See 'Statement on the Japan-United States Semiconductor Trade Agreement', 31 July 1986, Ronald Reagan Presidential Library and Museum, https://www.reaganlibrary.gov/archives/speech/statement-japan-united-states-semiconductor-trade-agreement.

5 See 'Announcement the Ministers of Finance and Central Bank Governors of France, Germany, Japan, the United Kingdom, and the United States (Plaza Accord)', 22 September 1985, https://g7.utoronto.ca/finance/fm850922.htm.

US containment of China has also expanded rapidly to encompass technology, particularly dual-use technologies, with stringent export controls on critical sectors including advanced semiconductors. The overarching goal of the US regarding China is much more comprehensive than it was with Japan, as the US seeks to maintain its hegemonic position globally.

3 China is following Japan's trajectory

Is the saving-investment pattern in China, similar to what happened previously in Japan, leading to a similar growth trajectory of a rapid deceleration after the bursting of a bubble?

Kohsaka *et al* (2002) argued that the Bank of Japan (BoJ) went too far in hiking rates between 1988 and 1989. This was done to dampen further growth of asset prices and contributed to the bursting of the bubble. In the same vein, one can argue that the monetary policy of the People's Bank of China (PBoC) in the run-up to and during the pandemic was also too tight, at least when compared to the rest of the world. This, together with additional regulatory tightening such as the so-called 'three red lines' for real estate developers[6], rapidly cooled investment enthusiasm.

While the BoJ did cut interest rates after the bubble burst, it did so very gradually, reaching zero only in 1999, even though deflationary pressures were persistent, especially for producer prices. In other words, Japan's real interest rates remained stubbornly high after the bubble burst until Governor Haruhiko Kuroda moved to negative interest rates in late 2016 with a huge additional expansion of the BoJ's balance sheet (Figure 8)[7]. A similar pattern can be found for China since the PBoC kept interest rates high after the real-estate bubble burst in mid-2021. Even though the economy was running below potential with deflationary pressures, especially for producer prices, the change in the PBoC's policy stance has also been very gradual.

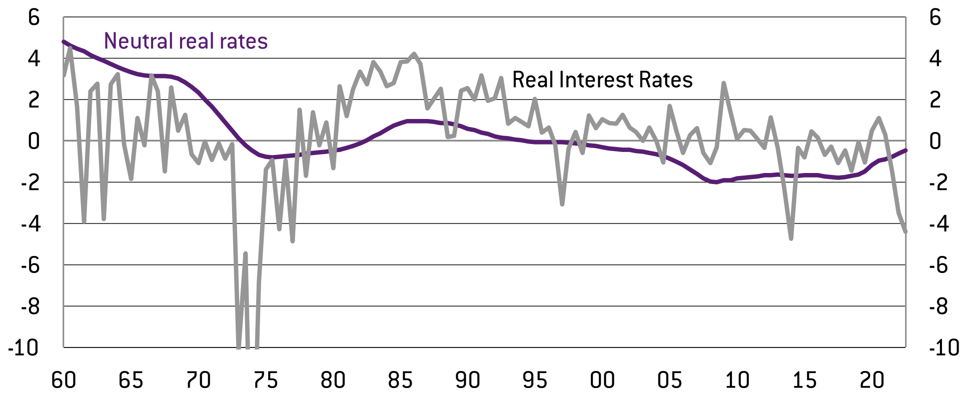
On the fiscal front, Japan has accumulated public debt very rapidly since the bursting of the bubble, reaching levels above 230 percent of GDP today. China is following the same path of accumulation of fiscal deficits, piling up public debt (Figure 9). But China has become very careful about the debt problem, especially at local-government level, and has started to restrict fiscal spending. As such, China's fiscal stimulus has also been limited, even though the pile-up of debt has already become so noticeable that the government continues to implement measures to address it. In November 2024, it issued a stimulus package worth $1.4 trillion, including a debt swap of hidden local-government debt (in the form of local government financial vehicles) into official local-government debt[8]. Such swaps, which have been happening for some time already, aim to reduce the financial risk embedded in the accumulation of excessive debt, especially non-official debt.

6 The 'three red lines' policy is a set of financial guidelines for real-estate developers in China. The policy was introduced in August 2020 to help control the real estate sector's debts and to improve its financial health (Yang *et al*, 2023)

7 See Bank of Japan statement of 29 January 2016, 'Introduction of "Quantitative and Qualitative Monetary Easing with a Negative Interest Rate"', https://www.boj.or.jp/en/mopo/mpmdeci/mpr_2016/k160129a.pdf.

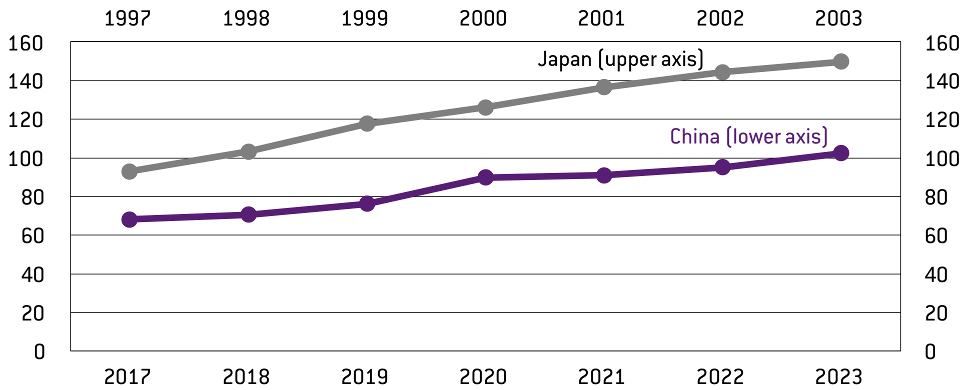
8 *Reuters*, 'What you need to know about China's $1.4 trillion debt package', 11 November 2024, https://www.reuters.com/markets/asia/what-you-need-know-about-chinas-14-trillion-debt-package-2024-11-10/.

Figure 8: Japan, interest rate (%)



Source: Bruegel based on Natixis, CEIC.

Figure 9: Public-debt-to-GDP ratios

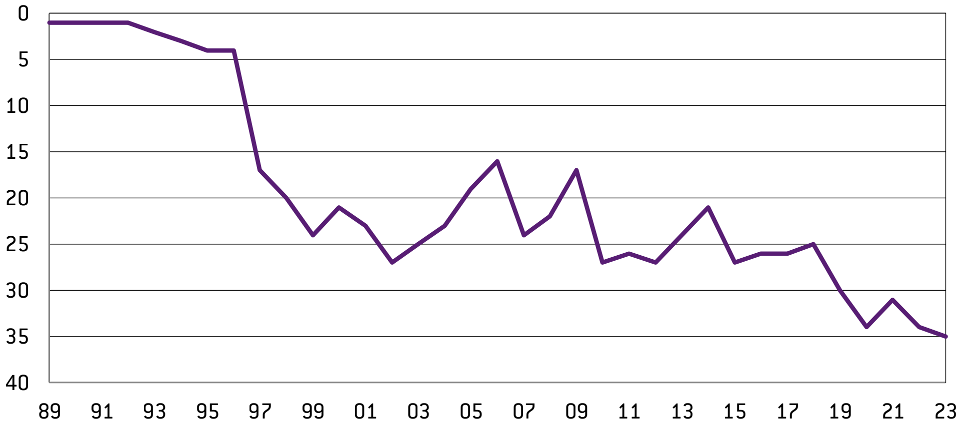


Source: Bruegel based on Natixis, CEIC.

The other similarity is that both Japan and China doubled down on industrial policy as a response to the structural deceleration. In particular, the Japanese government set up a programme of financial assistance to banks (injecting over 18 percent of GDP by 1998) (Fujii and Kawai, 2010) and tax incentives for specific industries deemed strategically important, including information technology, biotechnology and environmental technologies (Callen and Ostry, 2023). It also promoted financial support for research and development (R&D) and public-private partnerships. Japan's massive industrial policy did not stop the reduction in the share of manufacturing in the Japanese economy and, most importantly, Japan's declining innovation ranking (Figure 10) (Fukao and Kwon, 2005). China is following the same route, increasing its R&D expenditure and carrying out special projects to support high-technology sectors.

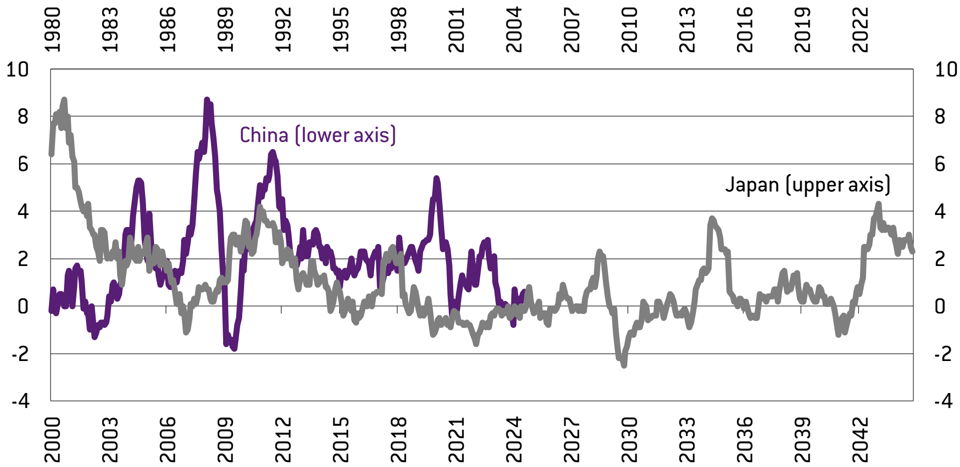
Stemming from the excessive focus on manufacturing and industry, both economies have suffered deflationary pressure, especially in producer prices. Japan endured prolonged deflationary pressure, whereas China has experienced two distinct periods of deflation: first in 2015 and again starting in 2022 (Figures 11 and 12). China managed to mitigate the deflationary pressures in 2015 through a stimulus, but has been more hesitant to follow the same route during the second episode.

Figure 10: Japan, global competitiveness rating



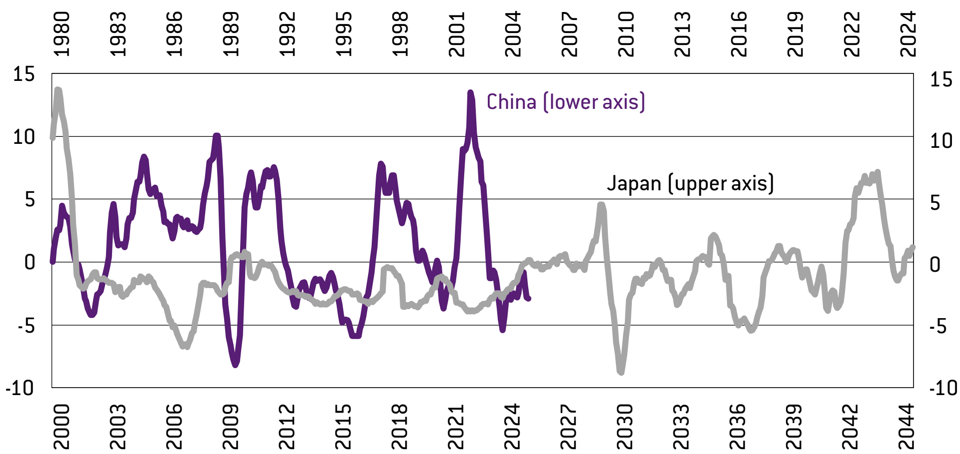
Source: Bruegel based on IMD, Natixis.

Figure 11: China and Japan consumer price index comparison (year-on-year, %)



Source: Bruegel based on Natixis, CEIC. Note: data as of October 2024.

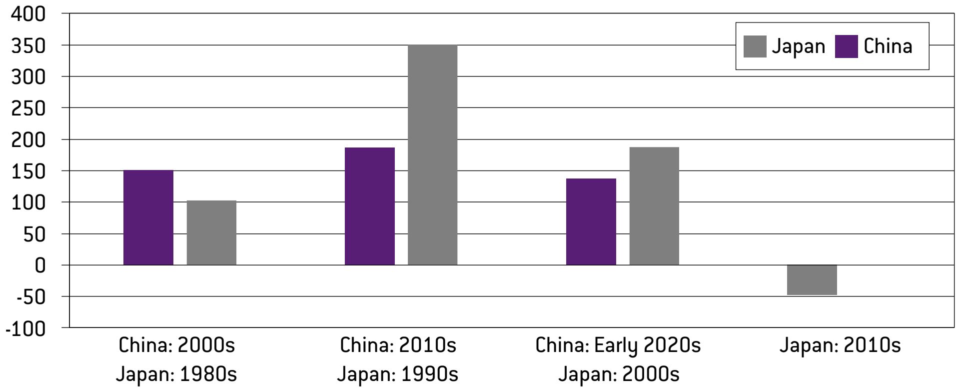
Figure 12: China and Japan producer price index comparison (year-on-year, %)



Source: Bruegel based on Natixis, CEIC. Note: data as of October 2024.

Another relevant similarity is the use of export markets as an outlet for excessive manufacturing capacity. Japan tried to mitigate its structural slowdown by expanding overseas markets, leading to a current-account surplus (Figure 13), but that effect faded away and had even disappeared after twenty years as Japan became more of a tourist destination than an exporter of manufactured goods. So far, in the wake of its slowdown, China still maintains a significant current-account surplus, with particular improvement in higher-end technology exports.

Figure 13: Goods surplus as a % of current account surplus

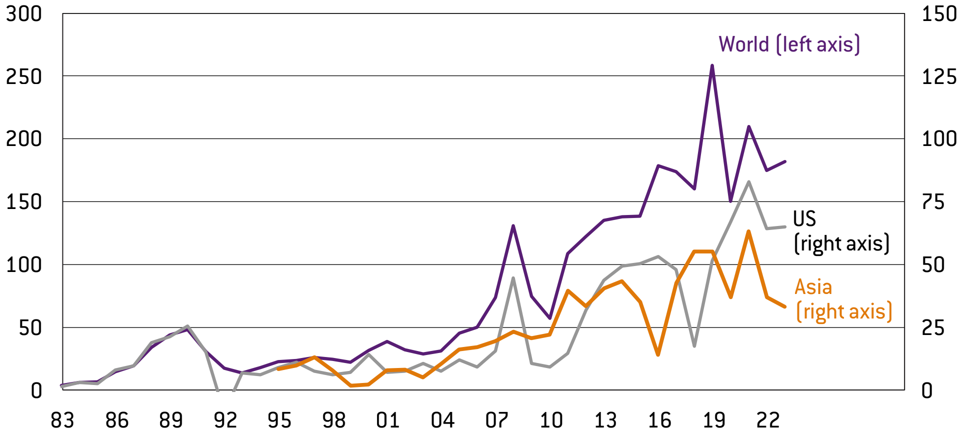


Source: Bruegel based on Natixis, CEIC.

Japan and China both decided to expand investment overseas through foreign direct investment (FDI) and lending. For Japan, FDI emerged as the primary channel for expansion, with Southeast Asia and China as key destinations under the 'flying geese' strategy (Kojima, 2000). In addition to greenfield investments in manufacturing, Japan also pursued mergers and acquisitions, which became particularly feasible, and not expensive, when the yen appreciated following the Plaza Accord. The bursting of Japan's economic bubble further accelerated its shift toward acquiring overseas assets, driven by a steep decline in domestic growth and persistently high labour costs within its manufacturing sector (Figure 14). Meanwhile, Japanese banks emerged as significant global overseas lenders, including in Latin America before its major sovereign crisis in the 1980s.

China has also significantly expanded its overseas presence, primarily through lending, with a particular emphasis on infrastructure financing. Its cross-border lending efforts have predominantly targeted emerging economies, especially those involved in China's flagship Belt and Road Initiative. Compared to Japan, China's greenfield investments in manufacturing are a relatively recent development, with the developed world selected as a key destination to expand markets and to acquire technology assets.

Figure 14: Japan, outward FDI flows by destination ($ billions)



Source: Bruegel based on Natixis, JETRO.

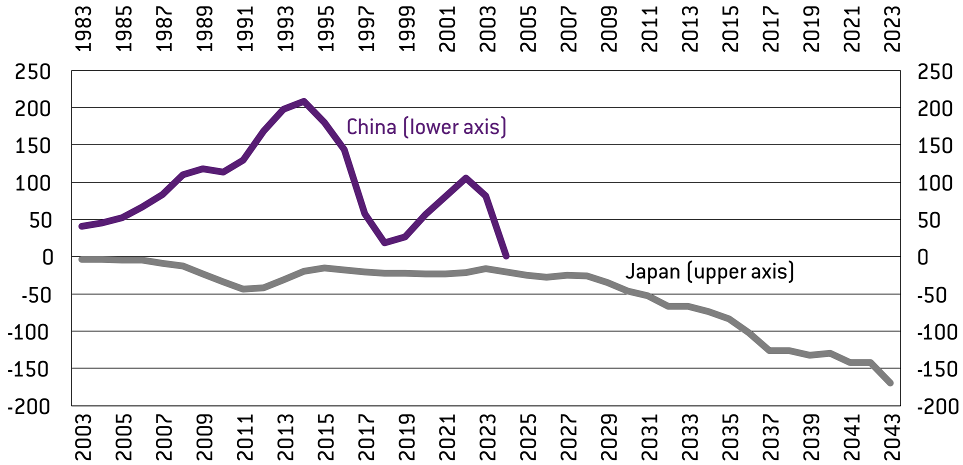
4 What might make China different from Japan?

Despite the many similarities between 1980s and 1990s Japan and China today, there are also major differences. Some are in China's favour, but others would make China's situation even more challenging than that of Japan three or four decades ago.

A potentially significant difference is the level of outbound investment. Japan became the largest net external creditor decades ago and, despite the shrinking size of its economy, continues to hold this status. It maintains substantial overseas investments, both in terms of FDI and portfolio flows. In contrast, while China ramped up outbound FDI from 2013 to 2016, this flow has slowed significantly since (Figure 15). On the portfolio side, China has never fully allowed capital outflows, resulting in much more limited overall overseas portfolio investment (Figure 16).

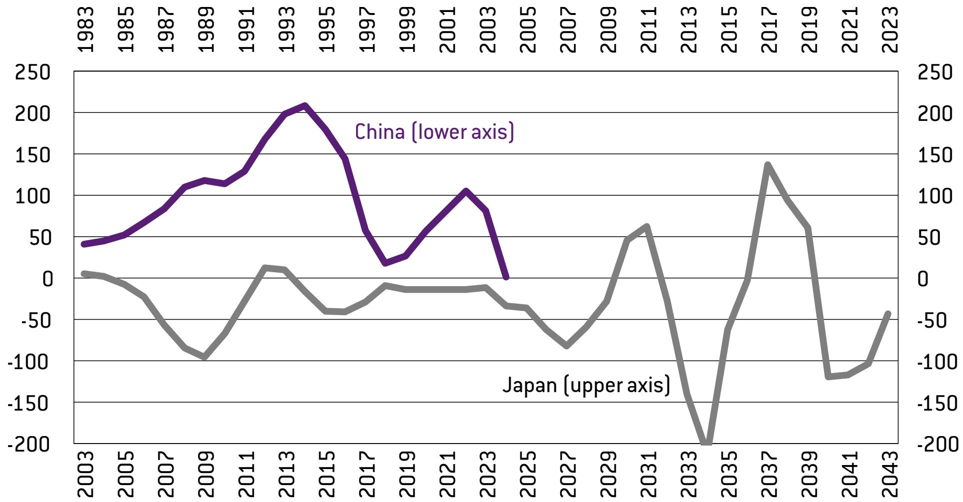
Japan's income from overseas investments has played a crucial role in sustaining its current-account surplus. In contrast, China's trade surplus is more prominent, accompanied by minimal net income from overseas investments (Figure 17). Consequently, China is more vulnerable to protectionist measures than Japan ever was. China faces heightened scrutiny from international markets, particularly from the US and increasingly from the European Union (García Herrero and Vasselier, 2024). Chinese wages are also currently lower than those in Japan were, making it less straightforward to relocate production overseas, as the wage differentials are not as pronounced.

Figure 15: Net direct investment (three-year moving average)



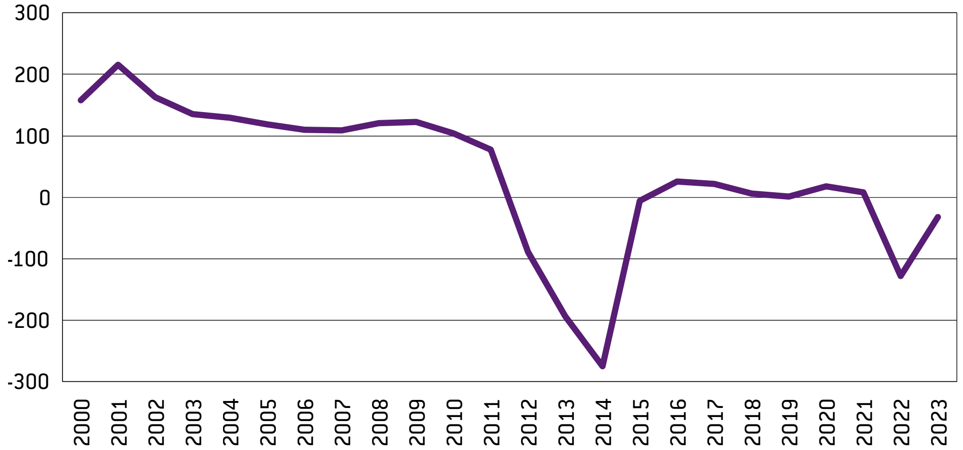
Source: Bruegel based on Natixis, CEIC.

Figure 16: Net portfolio investment (three-year moving average)



Source: Bruegel based on Natixis, CEIC.

Figure 17: China, goods surplus as a % of current-account surplus



Source: Bruegel based on Natixis, CEIC.

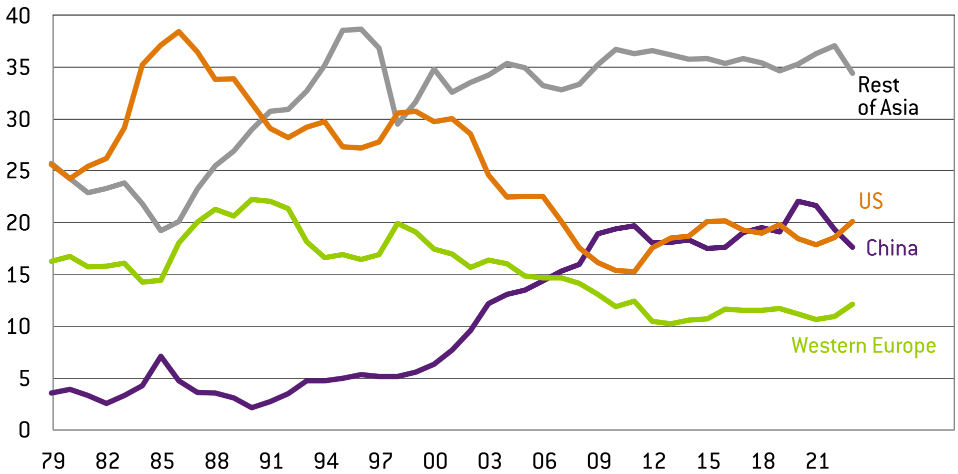
Japan's exchange rate policy was also different to that of China today, at least so far. Japan accepted a sudden rapid appreciation of the yen after concerted intervention pushed by the US in the mid-1980s under the Plaza Accord. China has so far avoided any push from the US Treasury to appreciate its currency and has generally kept the renminbi relatively weak to foster external competitiveness. Capital controls are still important tools for China to achieve this goal, while Japan abandoned them long time ago.

Another significant difference lies in the impact of the real-estate crisis on the banking sectors of Japan and China. Japanese banks were significantly more exposed to real-estate developers than their Chinese counterparts today, as regulations in China have limited the ability of banks to finance real-estate ventures. While Chinese banks have less direct exposure to developers, they are heavily exposed to the local-government financial vehicles (LGFVs), which have been instrumental in funding real estate and infrastructure projects, but are currently facing serious financial difficulties. Similarly to Japanese banks, Chinese banks are experiencing a shrinking interest-rate margin, which is impacting their profitability (Garcia-Herrero and Ng, 2024).

In summary, while China has thus far managed to mitigate the effects on its banking sector of its economic deceleration and real-estate market adjustments, it remains uncertain whether it will ultimately follow in Japan's footsteps. The ongoing decline in bank profitability and the emerging risks to asset quality could pose significant challenges in the future.

Internationally, Japan's more subdued role in global governance, resulting from its diminished political status after the Second World War, contrasts starkly with China's increasingly assertive posture. Japan historically aligned itself with US policies without forging an alternative path (Figure 18), whereas China has taken a different approach. Beginning with the Belt and Road Initiative, China has expanded its economic influence as well as its soft, and in some cases hard, power on the global stage. This strategy could work to China's advantage if it successfully rallies support from the Global South. However, it also faces the challenge of US containment measures. Furthermore, Japan's approach to self-reliance is more measured than China's. Learning from Japan's experiences, China has adopted a more proactive strategy to ensure its independence from Western influence, particularly in critical sectors such as semiconductors, while striving to maintain its competitive edge.

Figure 18: Japanese exports to main destinations as % of total exports



Source: Bruegel based on MoF, Natixis.

Finally, China's technological trajectory may diverge significantly from Japan's, as China has achieved breakthroughs in critical technologies that suggest it is closer to the global frontier than Japan was at a comparable stage. This has bolstered China's efforts to ensure technological self-reliance, particularly as the US intensifies its containment measures. However, the most important issue is not frontier technology but whether these advances translate into improved overall productivity. Current evidence indicates that Chinese TFP has been declining alongside its economic slowdown (Cerdeiro and Ruane, 2022), raising doubts about whether these technological breakthroughs will be able to offset the continued structural deceleration.

5 Conclusions

Japan offers valuable lessons for the world as an economy that once appeared poised to surpass the US, only to subsequently experience structural deceleration characterised by a declining population and low potential growth.

As China goes through its own structural deceleration, some trends resemble Japan's experience, particularly the collapse of the real-estate bubble and increased reliance on the manufacturing sector and industrial policy. These similarities are reinforced by the macroeconomic imbalances both countries have grappled with for decades, including excessively high savings rates that have led to over-investment and persistent current-account surpluses.

This investment-heavy economic model has two significant consequences: the rapid accumulation of public debt and deflationary pressures resulting from overcapacity.

However, there are also major differences between Japan a few decades ago and China now. For instance, China's economy features an even lower share of private consumption relative to GDP and a relatively small volume of overseas investment. China's substantial advancements in innovation, particularly in critical technologies, have also bolstered its technological self-reliance. That said, the tangible impact of this innovation on growth, specifically through increased productivity, remains to be seen, even for China.

Japan's experience does answer definitively the question of whether a focus on technological progress alone can reverse the decline in growth, especially if increases in industrial capacity are not accompanied by greater domestic consumption. The external market ultimately served as only a temporary solution for Japan, because rising protectionist measures in the West limited its ability to export its way out of economic stagnation. China faces a similar challenge of an oversupply relative to demand, raising the spectre of deflation that led to two lost decades for Japan.

One of the main difficulties in moving away from supply-side policies, both for Japan in the 1990s and for China today, is that policymakers have vivid memories of past successes. The macroeconomic imbalances (excessive savings and insufficient consumption) that once fuelled growth for both Japan and China have since become liabilities. While China risks following a trajectory that is similar to Japan's, it may be too early for China's policymakers to fully pivot away from its current growth model.

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