



INTERNATIONAL BUSINESS

For China and Japan, the Economic Challenges Ahead Are Similar

By BETTINA WASSENER APRIL 17, 2014

HONG KONG — Japan and China do not always see eye to eye on politics. But when it comes to economic policy, Tokyo and Beijing have remarkably similar goals: Both want to push through far-reaching changes in their economies in the face of mounting debt and rapidly graying populations.

In China, the authorities are trying to steer the economy toward more domestic consumption and growth in the service sector. In Japan, the government of Prime Minister Shinzo Abe is trying to haul the economy out of years of deflation and lethargic growth.

To what extent each country succeeds will be of critical importance, not just to Asia, but to the world. China, with a gross domestic product of about \$9 trillion last year, and Japan, with its \$5 trillion economy, are the second- and third-largest economies in the world, after the United States. Much hinges on whether these economic powerhouses can succeed in their overhauls over the next few years.

“You have two of the largest economies in the world firing on just one cylinder,” said Frederic Neumann, co-head of Asian economics at HSBC. “This is a critical period.”

Analysts and business people have welcomed the changes that have been introduced or at least announced in China and Japan over the past 18 months.

“They have recognized that they really need to do something,” said Gemma Godfrey, head of investment strategy at Brooks Macdonald Asset Management in London. “Don’t underestimate how important that is.”

But faster growth is tough to achieve, and much of the hard work is yet to come.

In China, statistics show that the economy grew 7.4 percent year-on-year in the first quarter — down from 7.7 percent in the last quarter of 2013.

And in Japan, a sharp drop in economic expectations among supermarket managers and restaurant workers, in a gauge released last week, hinted at worsening business conditions in coming months. The central bank refrained from stepping up its economic stimulus efforts this month but may need to do so later this year to help offset a slowdown in consumer spending that is expected to set in after a sales tax increase came into effect at the start of the month.

What is more, analysts say, both Beijing and Tokyo now have to move beyond simply pump-priming their economies with cheap money, as they did after the global financial crisis. They now face the tougher challenge of making their economies and business environments more efficient and competitive.

“For both China and Japan, the problems are deep-seated and structural,” said Rob Subbaraman, an economist at Nomura in Singapore. “It’s not a case of being able to cut interest rates to stimulate growth — they have to do more.”

In China, the leaders who took the helm last year have pledged to tackle corruption and environmental degradation. Thousands of companies have been ordered to cut down excess capacity. Taxes for small businesses have been cut. The renminbi has been given more leeway to fluctuate. Beijing has permitted several small defaults, sending a signal that it will not always bail out failed investments.

It has been a “tough love” approach — necessary to guide the economy from adolescence to maturity but bound to be painful along the way.

And in the eyes of many analysts, the jury is still out on whether China can avoid a hard landing that could send ripples around the world.

“The process is fraught with risks,” said Eswar Prasad, a professor at Cornell University and a former head of the International Monetary Fund’s China division. “Given how congealed the system is, if they introduce some economic risk, they risk unleashing a set of dynamics that could turn against them.”

He added: “The scale of the problems and the economy mean that it will be a tough balancing act.”

With its much more advanced economy, Japan faces somewhat different

issues, but the overhaul efforts are just as crucial to the country's long-term economic prospects.

Unlike the main challenge for China, the one for Japan is not to move up the manufacturing chain or to increase urbanization or infrastructure, analysts say. Instead, the rapidly aging country needs to shake up restrictive labor laws and get more women into the work force.

So far, the action in Japan has been mainly in the form of government spending plans and aggressive monetary stimulus.

This approach, begun last year, has helped push up growth and earnings at many Japanese companies. Sony, Toyota, Nissan and others have benefited from a weaker yen. Toyota said last month that it would raise wages for the first time since 2008. Office rents in Tokyo could climb more than 5 percent this year, as companies become more confident, the real estate services firm JLL believes. The Nikkei 225 stock index is nearly 70 percent higher than in November 2012, before hopes of an economic push began to take root.

But in Japan, as in China, much of the heavy lifting still remains to be done, and many analysts worry that the initial sugar rush to the Japanese economy could fizzle.

"The aggressive quantitative easing and government spending plans were low-hanging fruit," said David Mann, head of regional research in the Singapore office of Standard Chartered. Creating structural changes and making the service sector more efficient "will be much harder to do," he said.

Underlining this, a business survey earlier this month showed that although the mood among large companies brightened in the three months through March, many companies were wary about the next few months. The worry is that consumer spending and economic growth will be tested by the sales tax increase that kicked in on April 1.

The rise in the sales tax, crucial for getting a handle on government debt and injecting some much-needed inflation into the economy, may only "stabilize but not reduce government debt," said Rajiv Biswas, chief Asia economist at the consulting firm IHS. Because Japan's population is shrinking, the number of savers who ultimately fund Japan's debt by buying government bonds is declining.

Investors, now more skeptical of the challenges ahead, have sold out of Japanese stocks in recent months. The Nikkei 225, down 11.5 percent since

the start of 2014, is one of the world's worst performers this year.

Investors may now have to wait to get clarity on whether the reform efforts in Japan and China succeed. The "full verdict" is likely to take at least two to three years to materialize, said Mr. Neumann, the HSBC economist.

"Policy makers can't simply pull a rabbit out of a hat," Mr. Neumann said. "Both economies face fundamental challenges. There are no quick fixes."

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