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Transcript: Richard Koo on Balance Sheet Recession Risk in China
Richard Koo literally wrote the book on balance sheet recessions, or the idea that large levels of debt can weigh on future growth for years and even decades to come.
Now, the Nomura Research Institute chief economist sees a similar risk emerging in China. The country has been struggling with vast levels of debt and slowing economic growth in the wake of the Covid-19 pandemic. In this episode, Koo discusses the signs he sees that a balance sheet recession is already underway as China's companies shy away from borrowing more money for future investment. He also suggests some ideas for just what China's authorities should do about it. This transcript has been lightly edited for clarity.
Tracy Alloway (00:10):
Hello and welcome to another episode of the Odd Lots podcast.
I'm Tracy Alloway.
Joe Weisenthal (00:14):
And I'm Joe Weisenthal.
Tracy (00:16):
Joe, do you remember at the beginning of the year there was so much excitement about China reopening?
Joe (00:23):
Yes, absolutely. You know, it is interesting because I think if you go back to last fall, there was all this talk, it's like, "Why isn't China giving up on Covid Zero? When is China going to give up on Zero? And they're like "Oh, it's not going to happen anytime soon." And then one day it just happened and everyone's like, "okay, here comes China, here comes all the demand from China. It's on."
Tracy (00:43):
That's right. And so a big plank or portion of the bull thesis for 2023 was that because China was reopening its economy after basically being shut for three years, you were going to get all this additional economic activity. And while we have seen markets rally, it is definitely not because of China.
In fact, China really seems to be struggling here. So you know, Chinese manufacturing is still at or near contraction. I think exports are flagging. Inflation is basically around zero, which might sound great to a number of other countries right now. But of course it means that in China growth is subpar.
Joe (01:25):
Yeah, I mean, I think the big story for the world too has been oil demand and there was a lot of expectation. It's like, okay, commodity prices are kind of soft, but China is going to reopen, oil demand is going to surge. And that was expected to contribute to further inflationary pressures throughout the
world: oil, copper, etc. And so, yeah, that totally caught that market by surprise and changed a lot of the sort of macro dynamics globally that people were expecting.
Tracy (01:56):
Yep. So now is the perfect time to dig into what is going on with the Chinese economy. And you know, to some degree the weakness this year sort of highlights these longer-term concerns around China. How is it actually transitioning or developing its economy? Is it going to be able to achieve the ultra-high levels of growth that we've seen in the past? Or is it going to fall into something like a middle income trap? What's going on with Chinese local government debt -- that's been in the headlines quite a bit recently?

And all of that put together has given rise to this idea of 'Japanification' risk for China. So the notion that you might have ultra-high levels of debt that weigh on future growth because everyone has to spend their money basically paying down their debt rather than investing in new and exciting things.
Joe (02:46):

Yeah, it's weird because I feel like now there's two conflicting themes that I think about with China. So one is exactly as you said, that there is this sort of sluggish growth, overcapacity, indebted cities and so forth, lack of domestic consumption.
And then the other one is this sort of awe that the world has at like the booming electric vehicle exports, that they finally got the first flight of their domestic widebody aviation, that first plane, the Comac, that we talked about with Brad Setser.
And of course all the anxiety about the chip progress that the country has made, which is why the Biden administration has cut off access to various high tech, cutting edge semiconductor equipment. So there's these two things. There's this sort of like shock and awe at the success they're having in batteries, cars and so forth. At the same time, like the macro numbers do not look good.
Tracy (03:39):
It's true. China is always a giant waiting in the wings to take over everyone else's economy and also simultaneously this bundle of vulnerabilities that people are worried is going to tip into a massive financial crisis. That's always the case.
But, okay, I have to say we really do have the perfect guest to discuss all of this. We're going to be speaking with Richard Koo, chief economist at the Nomura Research Institute, which is the research arm of Japan's biggest brokerage, Nomura.
And of course he is also the man who basically wrote the book on balance-sheet recession. So Richard, thank you so much for coming back on Odd Lots.
Richard Koo (04:18):
Oh, thank you for having me.
Tracy (04:19):
Yeah, really appreciate it. Maybe just to begin with, I know you've been talking and writing about this theme of a potential balance-sheet recession in China. You also have a book that came out, I think just last year, called Pursued Economy, where you talk quite a lot about the trajectory of China's economy. But talk to us about what you're seeing now that suggests there may be signs of a Japan style balance-sheet recession in China?
Richard (04:47):
Well, a lot of Chinese journalists, economists have been contacting me on this issue also. Are we going to be Japan soon?
Or are we already on that path? And my answer to that is that, well, there are a lot of similarities between what happened to Japan 30 years ago and what's happening to China today, but there are also important differences.
And what the Chinese economists are worried about is that China may be falling into what I call balance-sheet recession.
And balance-sheet recession is triggered by this whole notion that people feel uncomfortable with their balance sheets, suppose their debt is too large relative to their assets. And that typically happens after bursting of a bubble. If the bubble is financed with debt and asset prices collapse, but the liabilities remain, people realize that their balance sheets are underwater, and if it's the balance sheet underwater you have to fix it.
Well, how do you fix it? You pay down debt. Wel,l that's the right thing to do at the individual level. But when everybody does this all at the same time, we get into a fallacy of composition problems, in that in a national economy, if someone is saving money or paying down debt, you need someone else to borrow and spend the money to keep the economy going.
And in the usual economy you get too few borrowers, you bring interest rates down. Too many borrowers, you push interest rates higher, and then that's how you keep the economies going.
But when the big bubble bursts and asset prices collapse, everyone will be paying down debt. No one will be borrowing money even at zero interest rates because if your balance is underwater, you're not going to borrow money, even if interest rates come down to zero. And that's the prospect that Chinese are worried about.

And China got this huge bubble, especially in residential real estate. And the amount of price increase that China observed on the residential real estate is almost the same as what happened to Japan 30 years ago in Tokyo and Osaka.

And so when the real estate bubble started collapsing last year, all these Chinese economists began to worry about a Japan- like situation where so many people are paying down debt all at the same time and [the] economy could then fall into a deflationary spiral.

I think that is actually already happening in China. A lot of people are saying, very few people are borrowing, so many people are paying down debt, even with these low interest rates.

And that's a very bad sign macroeconomically. Individually they might be doing the right things, but collectively, they may be killing the economy.

But there's also a big difference between the Chinese situation and the Japanese one. And that is that Chinese are already very much aware of this risk called balance sheet recession. And 30 some years ago when this thing was happening in Japan, no one in Japan, including myself, had any idea about this balance-sheet recession because it was not taught in economic textbooks. I mean, certainly not when I was going through.

And so when the economy began to lose forward momentum, Bank of Japan brought rates down to very low levels. Nothing happens. Structural reform, nothing happens. Fiscal stimulus, well, fiscal stimulus always worked. But that was cut short because they thought, every time the economy shows even the slightest sign of growth, they said: “Aha, we don't need a fiscal stimulus anymore – the economy is improving.” And then the economy tanked again and it tanked again because people were still repairing balance sheets. And when a large bubble burst and asset prices collapse badly, it's going to take five, 10 years easily to repair those balance sheets.

And in the Japanese case, the bubble was led by the commercial real estate. The commercial real estate prices fell 87% nationwide, you know, not just in little corner of Tokyo, but the entire country. And so the balance sheet challenge that Japanese companies faced was absolutely massive.

They all stopped paying down debt all at the same time. And that's how we got into this very slow growth. But the government didn't know how to handle this type of recession because in economics we were never taught to look at balance sheets. And so Japanese responses were very inconsistent, I should say.

Whereas in the Chinese case, they're fully aware of this recession called balance sheet recession. That's why they have been calling me very frequently these days. I was told – I have no way to prove this – but one Chinese professor told me that about half of the PhD dissertations written on economics in China today are based on my work on balance sheet recession. Now I don't know whether he was just making that number up, but what that suggests to me is that now that Chinese government know that there is this disease called balance-sheet recession. And they should know how to handle it also.

Because once you know that this is a recession which is produced by lack of borrowers, and the borrowers are not coming into borrow money because they have balance sheet problems, so the private sector themselves cannot change their behavior -- after all, they're doing the right things: trying to repair their balance sheets -- then the government has to come in and borrow and put that money back into the income stream, which means fiscal stimulus is absolutely essential once you're in balance sheet recession.

And so my guess is that Chinese government will put in the fiscal stimulus, which they're actually quite good at, and that will keep the recession from turning into a depression or something. So that's the key difference between the Japanese situation 30 years ago and what the Chinese may be faced with today. That they already know what disease they're dealing with.

And they're not going to waste any money, waste any time trying monetary easing or structural reform policies. My guess is that they'll go straight into the fiscal stimulus to keep the economy from losing its power.

Joe (11:45):

So you mentioned that one advantage perhaps that China has is having seen the experience of Japan. Incidentally, the US also had that advantage when we had the 2008-2009 financial crisis.
You wrote a whole book on it, The Holy Grail of Macroeconomics.
Of course, US policymakers didn't exactly listen or heed the warnings of that book, and we had this pretty awful decade for growth. You know, I'm curious though, just in terms of balance sheets diving in, like how do you see the distribution of debt in China? So the federal government doesn't have much debt, we know that. How much is it corporates versus real estate developers versus households versus local cities and municipalities? What does the distribution of debt in China look like?
Richard (12:35):
Well, can I first comment on your first comment about the US?
Joe (12:41):
Sure.
Richard (12:43):
Well, when I was trying to explain to my former colleagues at the Federal Reserve that we were suffering from balance sheet recession in Japan, and therefore we need fiscal stimulus, not structural reform. And as a formal recipient of doctoral fellowship from the Board of Governors, I had been going back to the Fed to give seminars on this issue throughout the nineties.
And as you mentioned just now they did not take any of my warnings. I was bashed every step of the way with a Fed economist saying "Come on, just Bank of Japan printing the money and everything will be fine." But I would try to explain that that doesn't work when there are no borrowers.
Well, once 2008 Lehman Crisis happened, someone, I don't know who, brought my book to the attention of Chairman [Ben] Bernanke. And he read it, The Holy Grail of Economics, the book you mentioned. And he told so many other people at the Federal Reserve to read it as well.
And if you notice that, at the beginning, he was arguing that, yes monetary policy can handle it as he was a disciple of Milton Friedman who argued that if the Fed acted more responsibly during the Great Depression, things wouldn't have gotten so bad. But after reading my book, he started talking about fiscal cliff, which is the opposite of what Friedman was saying.
And I thought that was a very important change in the US policy. When Chairman Bernanke at various events kept on saying, we cannot afford to fall off the fiscal cliff, the government has to continue borrowing and spending money, meaning that fiscal policy is absolutely essential. And I think that is the key difference between the United States and Europe. Because Europe really did not heed any of my advice, especially at the top level and so they fell into a really serious balance-sheet recession. And that recession lasted for almost 10 years.
Whereas in the United States, which is the epicenter of this global financial crisis, because of the efforts made by Chairman Bernanke at the Fed, and Larry Summers also who actually endorsed my book, The Holy Grail of Macroeconomics, he talked about the importance of fiscal stimulus. It has to be speedy, substantial, and sustained.
So the Obama administration was trying to put in fiscal stimulus, they met a lot of resistance from the Republicans. But at least the US was trying to do all the right things. And I think that's why US came out of balance-sheet recession much faster than the Europeans.
So I would say that my book actually did have an impact on the US policy. If it had an impact earlier, it would've probably helped the US economy even sooner. So that's one comment I want to make. And that is that US policymakers realized that they're facing balance-sheet recession a year or two into the recession and made all the appropriate changes to fight it.
Now going back to the Chinese issue of where the debt might be. You know, a lot of people like to talk about the size of the debt. But what is really important is the difference between the size of the debt and the size of the savings.
And the fact that the Chinese interest rates – for example, 10-year Chinese government bonds today is offering what? 2.6% – suggest that savings are far bigger than the debt. Because if the debt or the borrowings are bigger than the savings, interest rates should be higher, not lower. And the fact that

10-year government bonds is down to 2.6% suggests to me that overall China's biggest problem is that there are too much savings relative to borrowings.
So having said that, who has the capacity to borrow and spend this money? Well, as you correctly mentioned, the federal government or the central government probably has plenty of room left to borrow and spend. But the regional governments, I understand, are in very sad shape because they can't sell the land as easily or as expensively as before. And they have used up quite a bit of their resources in the previous years trying to support the economy and also during the Covid-19.
And so the feeling I get is that regional governments are really overburdened already and probably they will require quite a bit of help from the central government going forward if they're going to be the ones implementing fiscal stimulus which is needed during the balance-sheet recession.
Tracy (17:54):
So just on the idea of fiscal stimulus, historically it does feel like a lot of China's stimulus has come in the shape of support measures to companies or these huge construction projects, big infrastructure and development projects of one sort or another.
What would be the ideal form of stimulus this time around?
Because of course China is trying to balance various needs and goals here. It's talked a lot about retooling its economy away from manufacturing and real estate and more towards consumption. And yet historically we haven't seen a lot of fiscal support for households and individuals. It just hasn't been a very big thing in China.
Richard (18:40):
In terms of, I mean fiscal stimulus can come in various forms, right? You can have tax cuts or fiscal policy or government actually borrowing and spending money and the spending can go in very many different places.
First of all, tax cuts during balance-sheet recession is not going to be very effective. And the reason is quite simple.
Those people who get a tax cut will use the money to pay down debt. And that's good at the individual level perhaps, but collectively that won't help the GDP from collapsing. And so during balance-sheet recession, tax cut should not be the main force supporting the economy.
So the government has to borrow and spend money. So within that, what will be most effective? And I would argue that all those residential housing projects that were started but are now put on hold because the construction companies either have gone bankrupt or are having so much financial problems, they cannot move forward.
I would recommend Chinese government to go in there and help those construction companies so that all the promised construction will be actually completed. I think that will be the most effective way to spend fiscal stimulus, fiscal money.
Because that way those people who were feeling very insecure, I mean they paid for the apartment house already or put the down payment. Now they're wondering whether they'll get anything from all the investments they made. They will at least get the apartments built and they can, you know, look forward to perhaps a somewhat larger apartment as a result. And the same part will be helping the construction industries.
And one key difference between the Japanese and the Chinese situation is that construction is such a large part of Chinese GDP. Construction accounts for something like 26% of Chinese GDP, whereas during the bubble days in Japan it was only around 20% and it wasn't a big part of the picture. Whereas in the Chinese bubble it came with a huge construction boom. And so when asset prices collapsed but construction boom also goes bust, then you are hit from both the real side as well as from the balance sheet side. And balance sheet side, there's not much one can do. But on the construction side, if government comes in and helps finish those projects that were started, I think that kind of money will probably go a long way in helping the Chinese economy.
Joe (21:28):
Can I ask what about the role of the foreign sector when we sort of break down the Chinese economy and a sort of sectoral model?

So it's like okay, we know that domestic households have a high level of savings. We know the federal government has not borrowed a lot, but on the other hand the trade surpluses are massive. And again, I sort of mentioned in the intro that one of the themes right now is that Chinese advanced exports, particularly in areas like batteries and EVs and other cutting edge stuff is kind of booming. If that continues to boom, can that go some ways in sort of mitigating the need for federal government borrowing?

Richard (22:11):

Absolutely. I mean if Chinese companies keeps on coming up with new fantastic products, and both Chinese and non-Chinese are willing to borrow money to buy those products, then that will be helping the Chinese economy in massive, massive fashion.

And I realized as you mentioned already, that there are many Chinese companies that are highly innovative coming out with a lot of interesting products and they should find plenty of export markets for those products. So that part is definitely there.

My concern however, is the same concern that Japan had back in those days. At that time, 30 years ago, Japan was running the largest trade surpluses in the world. So many people wanted to buy Japanese cameras, Japanese cars, Japanese appliances. And because it was running such large trade surplus, it could not push it even more, in that if Japan were to export even more by for example, bringing the Japanese yen down a little bit, Americans will be very upset. The USTR will be knocking on the Japanese and say, “No, you better open your market, not sending these additional products to us.”

And I was actually involved in the trade friction back 30 years ago. At that time the US ambassador to Japan was Mr.

Walter Mondale, the former vice president who passed away recently. He found out that this guy, Richard Koo, who is frequently appearing in Japanese television programs, actually carries an American passport. So he asked me to come over and he basically asked me to represent United States in all these Japanese TV programs on US-Japan trade friction.

And at that time US-Japan trade friction was really, really bad. Serious, ugly, you name it. It was really terrible. I would go to the US Embassy to get a full briefing from staffers there and then go to the television studios to try to explain American position to the Japanese audience even though I was actually employed by the Japanese Research Institute. And all these other Japanese on the program are waiting with their guns to shoot me down. You know, that was that kind of situation.

So I learned a lot about trade friction back in those days.

And Japan really could not rely on additional exports because it was already running such a large trade surplus. So if Japan could have used exports by bringing the Japanese yen down a little bit and export its way out, that would have shortened the balance-sheet recession by some considerable years. But that option really was not available to Japan at that time ‘cause it was such a large trade surplus country.

And I think that applies to China today as well. As you know, China, as you mentioned, China is the largest trade surplus country in the world. And if China tries to bring exchange rates down and try to export its way out, I'm sure a lot of countries will be complaining.

So there's something the Chinese can do in that export side, especially if they're coming with new products so that other people in United States, Japan or Western Europe, have no reason to resist because there's no domestic manufacturers for those new products. Still, overall, I don't think it's a good idea for China to rely too much on exports because that could produce backlash in, call it, trade friction, which is what Japan faced 30 years ago as well.

Tracy (25:55):

Just going back to today, we've been talking a lot about both the parallels and the differences between China's current situation and the one that Japan found itself in a few decades ago, but we haven't yet touched on demographics and of course population growth -- or the lack of it -- is something that is much discussed when it comes to Japan's economy. Is a similar concern going to emerge for China?

Richard (26:23):
Well, I know that's the kind of a standout Washington consensus, if I may, on Japan, but if you look at the actual statistics, Japan's population peaked 2009. What that means is that the bubble burst 1990. So there was 19 years – almost two decades – where Japanese population was actually growing. But Japan was still in deflation.
In fact, in that 20 years Japan experienced the most serious deflation because everyone was paying down debt. And so I would argue that most of the decline that a lot of people refer to 'population,' one can use that on perhaps the recent 10 years, but certainly not the first 20 years of after the bursting of the bubble. The first 20 years came almost exclusively, exclusively from balance-sheet problems, not from population problems.
Having said that, then you look at the Chinese situation and we noticed that Chinese population starts shrinking, well, this year or last year. That's the same year the bubble burst.
So Japan had 19 years before the population starts shrinking. In the Chinese case, bursting of the bubble and decline of the population are happening on the same year. And that is likely to make Chinese policy response that much more challenging.
Joe (28:08):
You know, you mentioned that one constructive thing that the federal government in China or the central government could do is just make sure the apartments get built. That people have all this uncertainty because they've put down payments on apartments, they're waiting for that, the developers are then hobbled and that creates all kinds of stagnation.
Suppose that happens, is there something further that's next? Because presumably China doesn't want to just go back to the old model where construction is 25% or 26% of GDP, or presumably that wouldn't be your prescription to just go back.
So let's say that somehow they were able to clean up the mess at the developers and remove some of that overhang. Is there some structural move that should be then done further, whether it's direct support to households, something with the safety net, etc., that the government should then undertake to sort of continue on these reforms and not fall back into a debt trap?
Richard (29:08):
Well, I'm actually concerned about the fact that Chinese companies stopped borrowing money long before the bubble burst.
When you look at the Chinese flow funds data, and if you look at the corporate sector, they stopped borrowing money around 2016.
Well, up to 2016 they were borrowing quite a bit. 2015, they were borrowing quite a bit of money. So household sector was saving money, corporate sector was borrowing money and that's how economy's are supposed to move forward.
But starting 2016, the corporate borrowing starts shrinking quite substantially. And that was, in my view, the most disturbing development in the Chinese economy that we should pay greater attention to. And that is because as you mentioned earlier, Chinese companies are coming up with all these new products, great products on electric vehicles, batteries and other areas. They should be borrowing money at this stage of Chinese economic development just like, you know, United States in the fifties and sixties or Japan in the seventies when they had lots of competitive advantage, great new products, those companies should be borrowing money, not saving money.
But for some reason Chinese companies start reducing their borrowing starting in 2016. So they were like in the balance recession long before the bubble burst. And I really want to find out what is the cause of this Chinese non-borrowing before the bubble burst? After the bubble burst, you can explain everything on balance sheets, but with the borrowings shrinking before that, you cannot use balance the argument to say why these companies are not borrowing money.
And if the reason why these companies are not borrowing money is due to these renewed trade issues with the United States, then it's a much more serious problem for the Chinese economy because the trade friction and the possible decoupling with the outside world, decoupling with the

western world, means Chinese companies will be losing some of their best customers and the richest customers because the western nations have a far higher per capita GDP than the rest.
So if the decoupling happens, all of these companies will lose their export markets or they cannot rely on export markets as much as they were able to do before. And if that's the companies are not borrowing money, then Chinese economic problem has a much deeper problems to resolve.
And as a result of these companies not borrowing money, but the household sector still saving money, Chinese government actually had to borrow money and spend it to keep the Chinese economy going for five, six years before the bubble burst. And that borrowing's mostly done by the regional governments, is putting regional governments in very difficult position now because they have basically used up quite a bit of their borrowing power already before the balance-sheet recession starting.
And there I think they'll have to come up with a lot of new financing techniques to make sure that these regional governments can continue to borrow and do whatever the fiscal stimulus that is needed to fight the balance-sheet recession.
But until we find out why Chinese companies stopped borrowing money around starting 2016, it's very difficult to predict where the Chinese economy is going. Because if Chinese companies reduce their borrowings starting 2016 because of decoupling fear with the West or regulatory uncertainties, because Chinese government have been putting in all sorts of regulatory shocks to the IT industry, to the education industry, financial industry, and of course the real estate industry. If those are the reasons why Chinese companies are holding back the investments and borrowings, then even after balance sheet problems are resolved, those problem will be still with us and that will be a huge drag on the Chinese economy going forward.
Tracy (33:44):
This was going to be my next question actually, which is that I think in 2015 we had some supply side reforms from China, but then in later years we had various crackdowns on things like the technology sector, on property developers, some parts of the education system. Very famously when it came to real estate we had the three red lines missive, and things like that. Are there signs in your opinion that this type of regulatory uncertainty is making companies more nervous about perhaps ramping up their borrowing or their investment?
Richard (34:21):
Well it's very difficult to ask that directly because you know how it is in China, people are not free to say things these days. But talking to a lot of people, I get the sense that those are the concerns that many companies have.
And on top of it, China is in the middle of what economists will call 'middle income trap.' You know, middle income trap is if you are the lowest cost producer, all the companies will be moving factories to China because you can produce things at the lowest cost in China. But once your wages start increasing and other places like Vietnam, Indonesia, Bangladesh start offering even more attractive places to produce products, then these factories will start moving abroad.
And China is in the middle of the middle-income trap. Per capita GDP of about $20,000 US, at that point, they should be very careful to encourage more companies to come in and stay invested in China.
But those regulatory interventions from the Chinese government is doing the opposite of what Chinese government should be doing. So if you add that on top of all the other things that China is already in the middle-income trap. Per capita GDP $12,000, that's when these things become very important. That may be one of the key reason why people or companies are not investing in China.
Joe (35:57):
You know, I just want to ask one last question from my perspective and I actually would love to just shift at the end here to your perspective on the US. You know, if the US in 2009 was a bit slow out of the gate with the fiscal response, it certainly was not slow in 2020, in 2021.
Persistent fiscal support in 2022 and 2023 with some of the public investment acts, etc., how much would you attribute say the above-trend inflation in the US to the fiscal support? And do you see

some sort of fiscal cutbacks as necessary in order to get inflation back to target or can monetary policy and just sort of stabilization and normalization get the job done?
Richard (36:48):
Wow. So we are moving to the US right? If I may, I think what happened to the United States, of course, at the beginning, during the pandemic, people kind of allow inventories to fall because they never knew when people will come back to their stores again. And then once they realized that our Covid-19 problem is behind us -- I don't know whether it's actually behind us, because I'm seeing quite a few people getting sick recently, even in Taiwan. And so I don't know whether we are really behind this thing -- but suddenly everybody starts ordering for more goods to replenish the inventories.
But here of course you get into a fallacy of composition problems again, right? If you're the only one doing it, it's not a big deal. But when everybody does it all at the same time, then there will be bottlenecks everywhere. And I think that's how the whole thing started. This inflation talk started.
But what else that happened is that, you know, United States lost, what? 22 million jobs during the pandemic? The first part of the pandemic. When that many people lose jobs all at the same time, now these workers cannot afford to stay in the same city waiting to find jobs in the same industry any longer.
Many of them had to find jobs that will pay them in any industry, in any geographical location.
But when people start moving all over the place to look for jobs, their expertise, know-how, skills will be lost. Because they're not going back to the same jobs. And I think that really effectively moved labor supply curve to the left. That is to say, if you want to get the same people with the same set of skills, you just have to pay more. Because there's so few of them left in in your neighborhood.
And if you look at countries where unemployment skyrocketed like United States and Canada, wages have also gone up quite sharply this time around. Whereas when you look at Japan where companies try to hold onto their workers as long as they can, and so unemployment rate in Japan only went up to 3.4% -- that was the worst. And that was just for a month or two and then started coming down again.
Most of the workers are still with the company. All the skills are still available. So when the demand picked up again, the kind of labor shortage that United States and Canada face, we did not see in Japan. And as a result, wage increases are much lower than US or Canada.
And so a lot depends on what kind of labor market you had.
In the case of our United States, because of this rather sharp leftward shift of labor supply curve, US ended up having wages going up sharply higher. And that's adding to the inflation that we're talking about now. Whereas those countries where workers stayed with the companies wages are moving up much more slowly.
So we have to make adjustments for these key differences between the countries, I think.
Tracy (40:07):
You know, I have just one more question, which is when we last had you on the podcast, I think it was something like May 2020, and a lot of these decisions about how to respond to the pandemic were just being made at that time. And I think the headline of our podcast was something like, Richard Koo on why the recovery will be difficult. So looking back now, was there anything that surprised you about the speed or shape of the recovery in the US or the western world?
Richard (40:39):
Well, actually the vaccines were developed much faster than anyone had right to expect. You know, typically these things takes five to 10 years before it's fully approved. But this time around they were approved much sooner. And people of course came out with these highly innovative vaccines that no one had thought of before. So that was a big surprise from the medical side.
And the government also putting, as I mentioned earlier, this massive monetary and fiscal help to the people so that they really didn't have to deplete their savings, as it were. I thought recovery will be slow because, one of the reasons I thought recovery would be slow is because I thought a lot of people would be depleting their savings during these lockdowns.

And so once the economy begins to normalize, I thought these people would be rebuilding their savings.
But if they're rebuilding, replenishing their savings to the previous level or possibly go even higher, that would be like another balance-sheet recession in that so many people would be replenishing their savings. And as a result there'll be extra savings in the private sector and will that slow economic recovery.
That was one the thoughts that I had back in those days.
But instead, the government supplied quite a bit of support to these households and we end up talking about excess savings in the household sector that can propel the economy further. That was not in my mind when we last spoke, what? In May of 2020. So those are the surprises that I was not anticipating at the time.
But then you turn this thing around in the Chinese case.
Chinese government really did not give as generously as the American government or the European governments to these people who were suffering on the lockdowns. And as a result, the sense I get is that a lot of Chinese households and Chinese companies, small and medium-sized companies, they had to really draw down their savings to weather the lockdowns.
And if those Chinese companies felt that they don't have enough savings to weather the future rainy days and they would like to increase their savings to make sure that they have enough ammunition to fight the next round, then we may end up having something like balance sheet recession. But this time, it's on the asset side of the balance sheet, not on the liability side of the balance sheet.
But the effect would be the same if all these Chinese households and companies try to rebuild their savings all at the same time, then Chinese economy would be that much more weak.
It's very difficult to get any data on something like this from the Chinese side, but my sense is that this could be a bigger problem in China than in United States or in in Europe.
Tracy (43:53):
Well Richard, you brought us back full circle to China. So thank you so much. We really appreciate you coming back on Odd Lots! A delight to have you here with us once again and hear what you are thinking about the current situation in China and elsewhere in the world. So thank you so much.
Richard (44:09):
Oh, thank you. You're welcome.
Tracy (44:23):
So Joe, that was so much fun. I thought it was really fascinating the distinction he drew between what happened in Japan and what might be happening in China now. And the idea of the big difference being that today people do have this idea of a balance-sheet recession in their minds. So you can identify the problem, diagnose it, and then try to identify policy solutions that will hopefully help fix it. Whereas in Japan, after the property bubble burst, no one was really quite sure what was happening or what the economic consequences of it might be.
Joe (45:01):
Right, which is why, you know, the title of his book is The Holy Grail of Macroeconomics, which is all about that Japanese balance-sheet recession. You know, the idea being you can look at Japan and just learn so much about how economies work.
I still think he gives US policymakers too much credit for the amount of fiscal support. Although compared to Europe, I guess we did do better. But it'll be interesting, you know, I remember we just talked to Brad Setser and his conclusion was that Xi Jinping is like a deep fiscal skeptic or at least a deep skeptic in support to households. So it'll be really interesting to see if and when the government decides, look, GDP is slow, it's not getting better, we really have to do something.
Tracy (45:47):
Yeah. Well, in my mind – and I remember we spoke about this with Brad Setser as well – it is very strange to me that China does seem to have this reluctance to support the household sector in ways that we have seen in other parts of the world.

So I think during the Covid pandemic -- and remember the shutdown in China, those shutdown measures were in many respects much harsher than what we saw in other parts of the world -- there was really very little support. If you lost your job, if you became unemployed, you basically had to live off of your savings. I think there were some people in parts of China that got consumption vouchers, spending vouchers, things like that, but it really wasn't for that much money.

And so if you're trying to reorient your economy towards more of a consumption-driven one and simultaneously revive economic growth, it seems to me like supporting households and individuals would appear to be a slam dunk. But for some reason that just hasn't happened.

And the other thing I would say, and I think this is what is confusing to a lot of people, is that now we see more support or more momentum towards potential fiscal stimulus. And it seems like once again, it's going to take the form of perhaps bailing out property developers, finishing up some of those big construction projects. And yet just a couple years ago we saw President Xi Jinping really crack down on that sector. And so there seems to be a little bit of whiplash here, maybe a little bit of mixed messaging, but I guess in China, the idea of opposing or conflicting messages are not that unusual.

Joe (47:28):

You know, what I thought was really interesting, and I hadn't really thought about this before, which was that, you know, obviously China runs a massive trade surplus and this idea that eventually gigantic trade surpluses invoke some sort of political reaction globally. That eventually the world does not want to be the buyer of last resort for your economy. And you can only push it so far, which I thought was like super interesting.

And that really started under Trump obviously with the tariffs and then has sort of continued under Biden with some of the various trade restrictions and so forth. But this idea that sort of like politically there might not be even... Yes, exports may be growing, but there isn't a lot of juice in the squeeze to that just because at some point you sort of get this global political backlash to your export dominance.

Tracy (48:18):

Yep, absolutely. Shall we leave it there?

Joe (48:20):

Let's leave it there.