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MARKETS

‘Japanification’ Haunts Slow-Growth Europe

Is Europe turning into another Japan, fated to decades of sluggish growth and high debt?

‘I don’t think Japanification is in the cards at all,’ European Central Bank President Christine Lagarde recently said. But others aren’t convinced. **PHOTO:** FRANK RUMPENHORST/DPA/ZUMA PRESS

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This article is part of the Journal’s quarterly markets review, which this quarter analyzes Japan’s bear market three decades after it started.

One of the first questions posed at the inaugural news conference of the new president of the European Central Bank, Christine Lagarde, was blunt: Is Europe turning into another Japan, fated to decades of sluggish growth and high debt?

“I don’t think Japanification is in the cards at all,” she said at the Dec. 12 meeting. Her yardstick was growth of credit to companies and households: The eurozone has managed to get its banks lending again following the financial crisis faster than Japan did after its credit boom collapsed at the start of the 1990s.

Not everyone agrees with Ms. Lagarde. There are economic and demographic parallels between the eurozone and Japan, even if their characteristics are far from identical. And in financial markets, your view of Japanification really depends on where you look. In bond markets, it has already happened. Elsewhere, not so much.

future inflation are very low and confidence for the ECB to get back to target is very low."

The criteria commonly understood to describe an economic fate like Japan's are an absence of economic growth and inflation, brought about by a burst credit bubble and a shrinking population. It also can seem inescapable: If people expect prices to be lower in the future—and debt to increase in value relative to other things—they are less likely to spend money today no matter what stimulus is applied to the economy.

In financial markets, Japanification manifests as ultralow yields on government bonds and a stock market that crashes and fails to rebound. European bond yields are among the lowest in the world. German government yields are negative at all maturities out to its 30-year bonds.

But stock markets recovered in Europe after the financial crisis: The Stoxx Europe 600 index (excluding U.K. companies) is 9% above its 2007 peak. The same number of months after the Japanese stock-market bubble peaked in 1989, the Topix 500 was worth only about one-third of the precrisis level.

In part, that is because Europe, like the U.S., learned from the Japanese experience of dealing with a burst credit bubble. They quickly slashed interest rates and pumped money into the economy via bond purchases specifically to avoid Japanification.

While the main European index, the Stoxx Europe 600, has recently set records, several smaller country indexes, including Spain's IBEX 35, France's CAC 40 and Italy's FTSE MIB, are still below recent peaks set before the 2008 financial crisis, according to FactSet.

Japanification is the "right word to use for fixed-income markets. It's not the right term to use for the European economy," says John Normand, head of cross-asset fundamental strategy at JPMorgan Chase & Co.

"If you really thought Europe was Japanifying comprehensively...that there was going to be zero nominal [gross domestic product] growth, you probably wouldn't want to be anywhere near the equity market and the credit market," he adds.

Europe's companies and economy might not be growing much by U.S. standards, but they are still getting some traction. This is why Mr. Normand says it still makes sense for investors to hold riskier European assets, such as equity or corporate debt, even though the ECB's interest rates are likely to remain negative for years.

Others agree: "Older people tend to own the wealth and as they come into retirement they shift that wealth into bonds," says BNP's Mr. Shing. "But the shift out of equities into bonds doesn't work now because the government bonds don't provide the income."

The European and Japanese economies also face very different global environments. Japan's progressively pushed down inflation everywhere. Trying to kick-start your own inflation while everyone else's declines is tough.

For the eurozone, the past 10 years have brought a reversal of globalization, especially in finance. Growth, meanwhile, has been much less reliable.

Eventually, trade disputes and rising protectionism might force inflation higher but also hold back economic growth globally.

> "Japan was trying to reflate in a sea of global disinflation," says Jim Reid, credit strategist at Deutsche Bank. "Europe reacted earlier and there is a global desire to increase inflation."

However, inflation alone isn't great without economic growth, and a big problem for Europe is that its economy is much more dependent on exports than Japan's ever was. Selling goods and services overseas contributes about twice the share of GDP for Europe as for Japan, Mr. Reid adds.

Like Japan, Europe has an aging population, with some countries, such as Germany and Italy, aging faster than others. But it is broadly more open to immigration and is able to boost its workforce that way. As in Japan, structural problems persist in Europe, with some countries, especially Germany, highly dependent on exports, making them vulnerable to trade conflicts. In addition, richer governments are reluctant to spend public money, or share financial risks, with poorer European nations.

On the bright side, Europe has much more capacity to spend its way out of trouble because the total government debt of the 19 eurozone countries remains less than half the level of Japan's as a share of GDP, according to official data.

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What do you think other markets can learn from Japan's? Join the conversation below.

Ms. Lagarde, like former ECB head Mario Draghi, has demanded that governments with the capacity to spend should start investing more to lift the economy. Investment in infrastructure and technology, for example, is needed to boost weak productivity at home and counter a slowdown in global demand for the eurozone's exports. But Europe is politically fragmented with markets that aren't well integrated, particularly when it comes to banking and finance.

The secret about Japan's experience is that the slow grind hasn't been catastrophic. Improvements in productivity have boosted GDP per person and that mea standards of living

Japan may have low growth, low inflation and high government debt, but it has maintained high living standards and a relatively stable and equal society, says Mr. Reid. Can Europe hope to reach a similar outcome?

“Because it’s not an integrated economy, Europe’s chances of mimicking Japan in this way are very low,” he says.

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