



ECONOMIC PARALLELS

# China's future and the echoes of Japan's lost decades



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# Abstract

China's weak economic recovery since the pandemic has raised questions about the country's growth model. As the world's second-largest economy, China's fate has profound implications for global markets. Until now, China had adopted and perfected the East Asian growth model and risks following a similar path to Japan until the early 1990s when its economy fell into a deflationary trap. Similarities between Japan in the 1980s/90s and contemporary China abound, notably around high debt levels, weak domestic demand, worsening demographics and difficult external trade relations.

This paper examines the parallels and finds that China indeed shares many of the characteristics of "Japanification," but also possesses many strengths to offset a similar trajectory, which has plagued Japan's economy for decades. In particular, government authorities in China have the resources to launch a credible proactive policy response to lift near-term growth expectations, as well as the ability to institute structural reforms to balance the demographic transition and property sector drag. Investors will be watching for those signals to be assured that Japanification will be averted.

# Contents

- 3** Is China the next Japan?
- 4** What caused Japan's "lost decades?"
- 7** Comparing China's current debt bubble to Japan's in the 1980s/90s
- 12** Why China may fare better or worse than Japan
- 15** What can China do to avoid Japanification?
- 20** China faces complex challenges to avoid Japanification
- 22** Conclusion

# Is China the next Japan?

**A key question repeatedly arises in macroeconomic discussions: What is China's economic outlook? Positioned as the world's second-largest economy, contributing about 18 percent to global gross domestic product (GDP) as of 2022,<sup>1</sup> China has experienced notable transformations in recent years.**

Following its controversial response to COVID-19, the nation's economic recovery after its much-awaited reopening in early 2023 proved to be short-lived. Despite an initial boost around its reopening, China experienced sluggish growth, near-zero inflation and continued distress in the property markets.

In fact, China today is experiencing similar structural headwinds that Japan faced in the 1980s/90s, including an aging population, significant debt levels, property market downtrend and deflation risk, to name a few. Given the similarities on various fronts between today's China and Japan in the 1980s/90s — and the significance of China

in global growth and GDP — it is important to ask the question, “Is China the next Japan?”

This paper examines the question from the historical context of the Japanese experience. We first explore the economic drivers of Japan's so-called “lost decades” of stagnation. With this as the backdrop, we next assess how today's China may fare better or worse than Japan on various fronts.

We conclude the paper with recommendations on how China can avoid Japanification through short-term economic stabilization and long-term structural reforms.

# What caused Japan's “lost decades?”



**The term “Japanification” has long been used to describe an economic situation in which deteriorating demographics and policy missteps cause structurally low growth, low inflation and low interest rates. How did Japan get into such a situation?<sup>2</sup>**

Japan’s experience after the bubble burst demonstrates that the structural issues of Japanification arose through two main channels, namely:

1. Decline in labor input; and
2. Downward pressure on long-term growth expectations among businesses and households driven primarily by demographics.

Japan entered the demographic challenge in the early 1990s, which led to a meaningful decline in labor input. This reduction in labor input paved the path for the first channel of economic decline. A decline in working-age population reduced consumption, domestic investment and hence, inflation, ultimately creating a vicious downward spiral. This effect was a direct hit to aggregate demand from demographics, a well-documented economic effect.

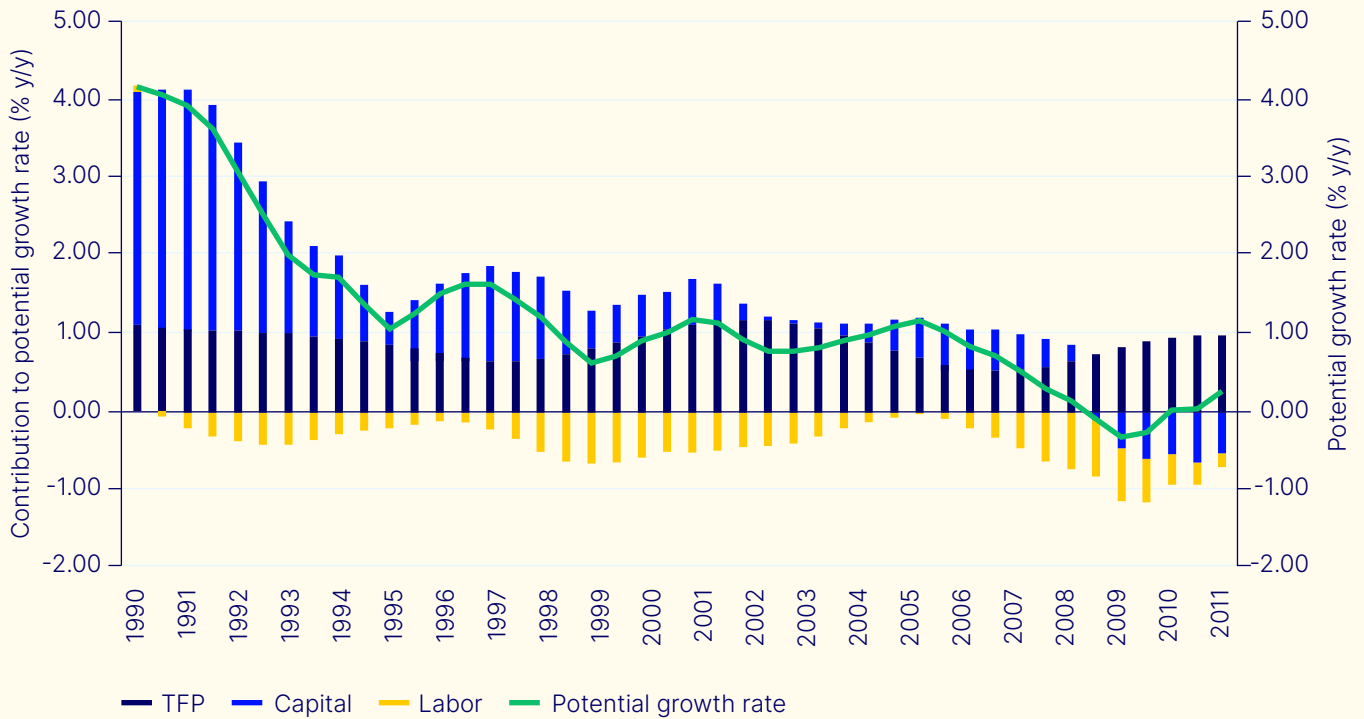
The second channel was more pernicious — namely the “expectations” channel. The negative feedback loop caused by the expectations channel lowered forecasts of future growth for the Japanese economy as a whole and thus expected lifetime income. With reduced growth expectations, asset prices deflated.

The need to address the debt overhang among corporations as an aftermath of the bursting asset bubble, together with the initial strong forbearance for failures from banks, amplified this adverse selection effect from a financial perspective.

The negative loop from lowered growth expectations depressed spending on consumption and investment, which further adversely impacted investments.

**Figure 1: Drivers of Japan's potential growth rate**

**Decomposition of potential growth rate in Japan**




Source: Cabinet Office (Japan)

As can be seen in Figure 1, most of the decline in Japan's potential growth in the 1990s can be explained by the falling contribution of investment (CapEx) on worsening growth expectations and negative contribution of labor.

It is worth noting that policy response from the Japanese government to fight deteriorating long-term growth expectations was less than ideal. As the economy entered a downturn, corporates rationally reduced leverage to pay off debt instead of increasing borrowing and spending.

Fiscal impasse turned out to be a major policy blunder — instead of pumping money into the system to keep growth higher, the government held back on fiscal expansion. These actions further contracted corporate spending, resulting in layoffs and wage compressions, and diminishing consumer purchasing power, effectively creating a negative feedback loop that entrenched anemic credit expansion as well as lowered growth expectations. The painful conversion of short-term problems into long-term structural issues ensued as a result.



# Comparing China's current debt bubble to Japan's in the 1980s/90s

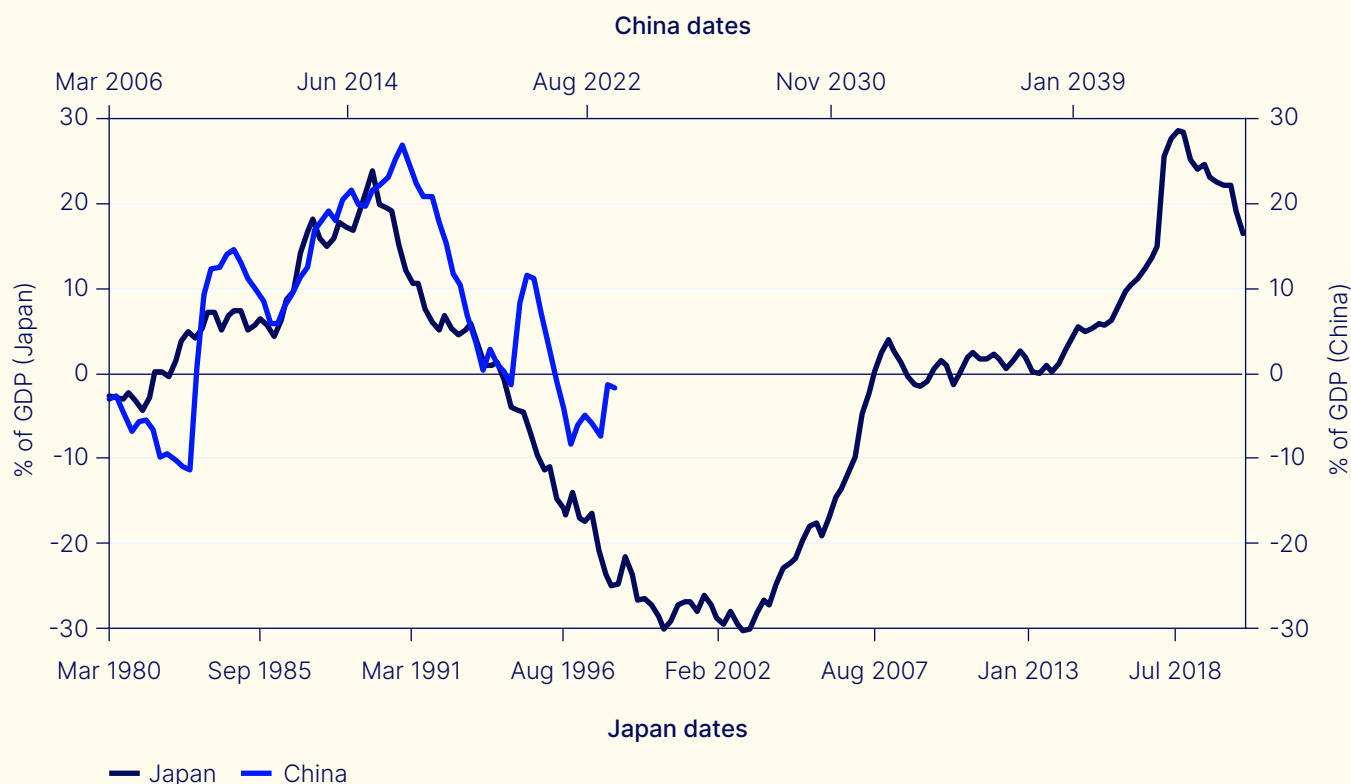


## How does the Japanese experience compare to the current situation in China? A good starting point is the assessment of how China's debt bubble today compares to Japan's in the 1980s/90s as measured by the credit-to-GDP gap, which is a measure of leverage.

As seen in Figure 2, by mapping Japan's trajectory over China's period of leverage, a worrisome similarity in the paths of credit expansion and contraction emerges.

We believe that China shares some of the structural features of Japan's crisis that cannot be easily reversed or changed, making the Japanese experience especially relevant for policymakers.

Figure 2: Credit-to-GDP ratio of China and Japan

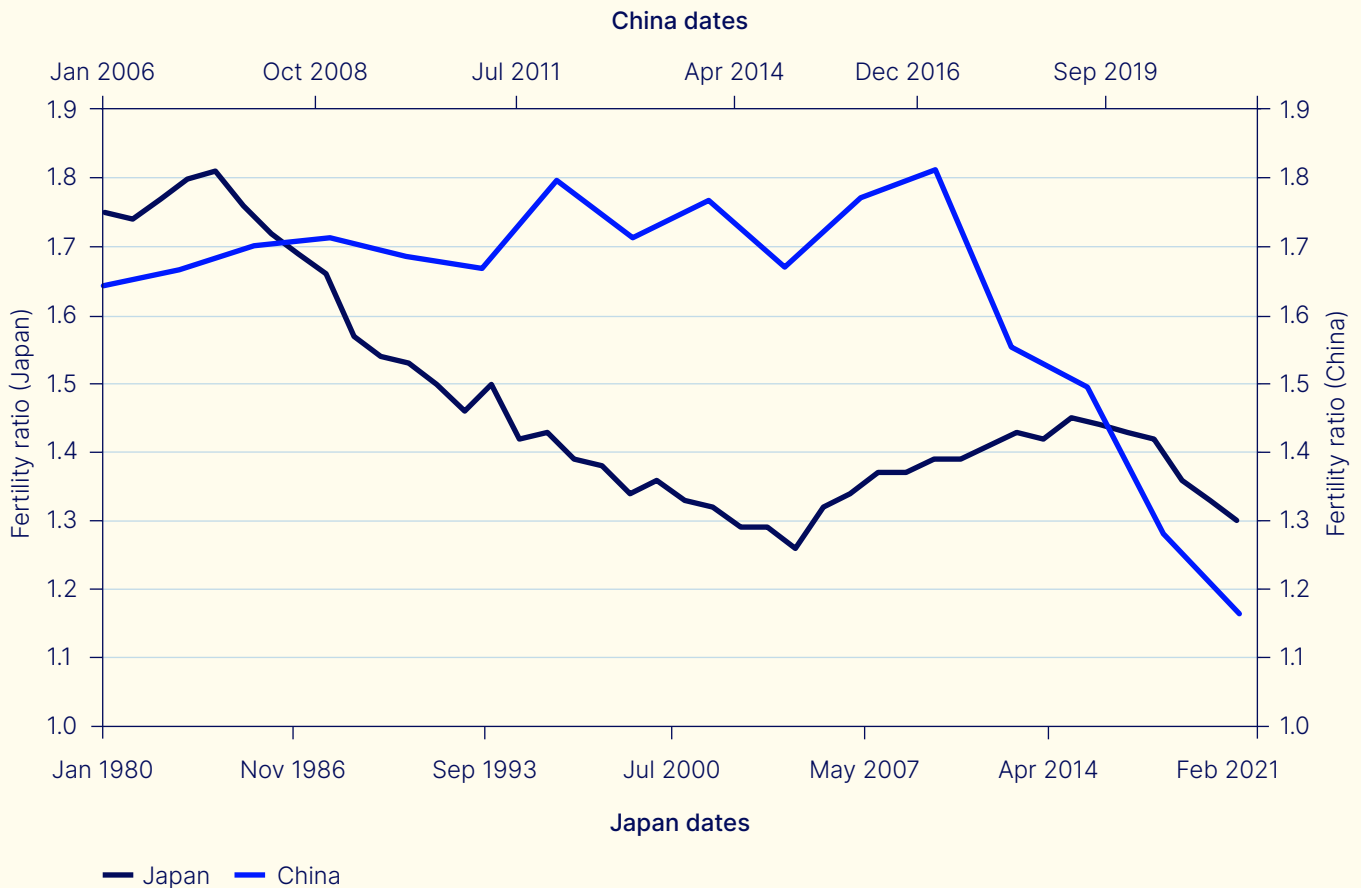


Source: Bank of International Settlements

The first challenge in China is demographic decline, wherein the average total fertility rate in Japan was near 1.7 births per woman in the decade preceding the peak in credit

expansion. China's drop has been steeper and below Japan's all-time low of 1.29 since 2020, as seen in Figure 3.

**Figure 3: Fertility rate of China and Japan**

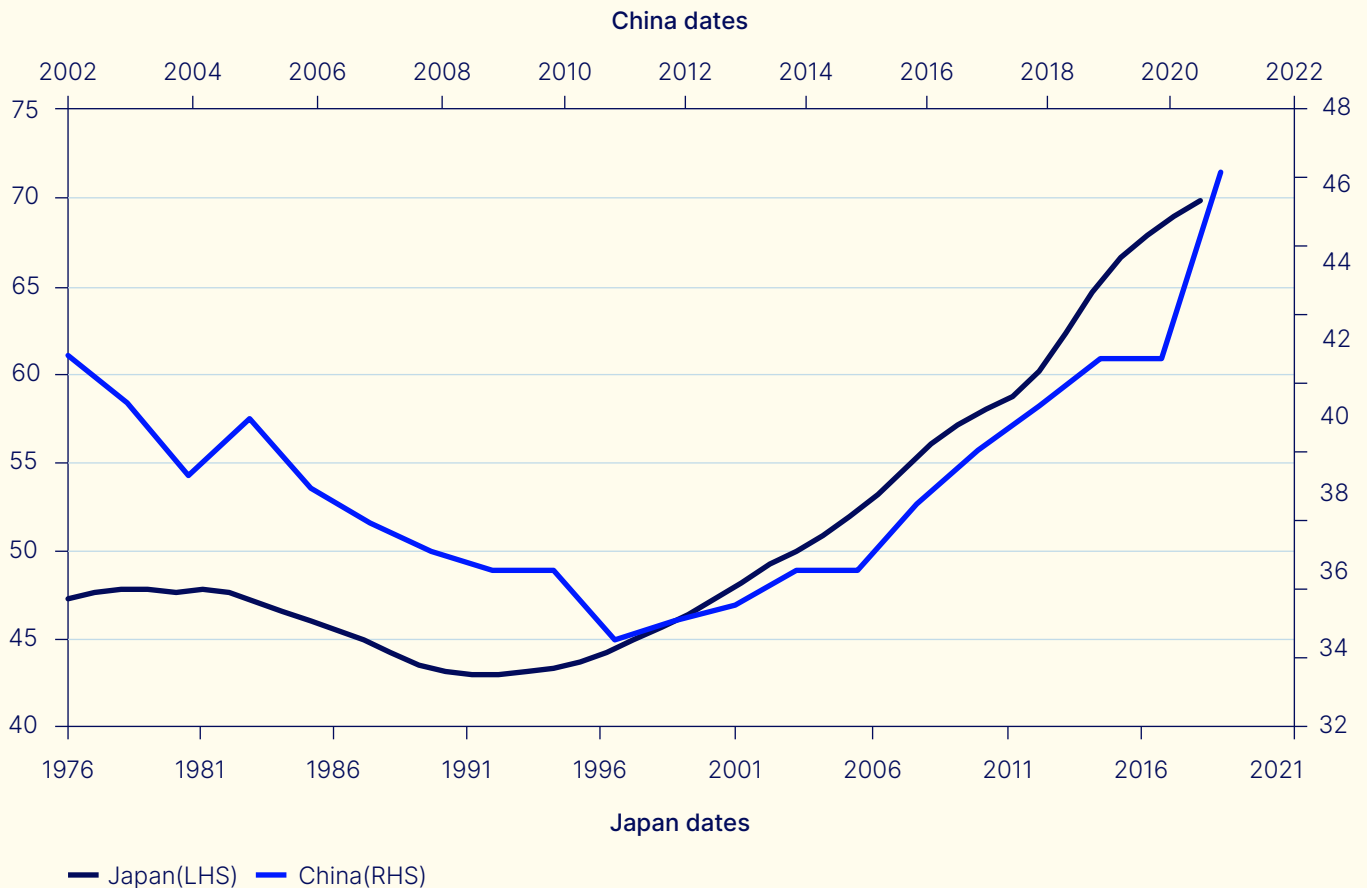


Source: Macrobond

This steep drop in fertility has a predictable effect on the dependency ratio for both countries.<sup>3</sup>

As seen in Figure 4, the dependency ratio shows a higher uptick in China compared to Japan. This is a challenge for aggregate demand in the future.

**Figure 4: Dependency ratio of China and Japan**



Source: Macrobond

Second, the size of the debt bubble is worrisome. Though the overall magnitude is smaller for China, the directionality is similar to Japan. While the sovereign balance sheet carried little debt (at roughly 50 percent of GDP) for both countries, leverage resided in other sectors — largely in the financial sector in Japan and the non-financial corporate sector and local government in China. Proportionally, Japan’s private sector debt hit 350 percent of GDP compared to China’s current non-central debt government debt ratio of roughly 250 percent of GDP.<sup>4</sup>

The reinforcement of weak demand from the all-important expectations channel is another stark similarity present-day China has with 1990s Japan. Weakening of future economic prospects is especially concerning today as China’s economy has already witnessed a notable downturn after several decades of rapid growth fueled by investment, indirect financing (e.g., via banks) and heavy reliance on exports.<sup>5</sup> The bursting of the debt bubble will mean that China’s growth model is damaged, and the negative spiral can take hold.

This leads to the third similarity, namely the external backdrop from geopolitics. In Japan’s case, the geopolitics of its goods trade surpluses led to a diplomatic agreement in 1985 called the Plaza Accord.

An orchestrated plan in the Accord to depreciate the US dollar (USD) effectively resulted in the appreciation of the yen. This was followed by an ill-timed monetary stimulus in Japan to help counter export weakness that arose as a result of currency appreciation, which in turn led to an acceleration in the domestic credit boom and stoked the asset bubble.

At the present time, the adversarial geopolitical relationship between China and the US is escalating international protectionist efforts such as friend-shoring, so external demand is also likely to weaken in China, affecting its demand. Thus, from a geopolitical stance, things are slightly worse for China, but as outlined later, prudent currency management and monetary/fiscal policy initiatives should help avert the repetition of the Japanese experience in China.

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**Softer expectations of growth and wage increases are likely to reinforce weak demand, similar to Japan in the**

# 1990s

# Why China may fare better or worse than Japan

**As outlined above, China today exhibits several structural issues similar to those experienced by Japan at the onset of its crisis. However, the degree and severity of these issues between the countries are different — with some favoring China and others not. We outline these here.**

First, on the positive side, China has a higher degree of monetary policy autonomy and limited risk of currency appreciation effects from changes in the hegemonic USD compared to those of Japan during the 1980s/90s. China began to peg the renminbi (RMB) to the USD in 1994, moved to a managed-float regime in 2005, and has been able to maintain the RMB fluctuations against the USD within a relatively narrow range.

Second, China today has arguably stricter capital control of both the asset and liability sides of the debt problem compared to Japan in the 1990s. This helps smooth the procyclicality of short-term capital flows and also allows for more independent monetary policy to be implemented.

Finally, China has a lower urbanization ratio and GDP per capita compared to Japan in the 1990s. According to the UN's projection, urban population growth is likely to be much higher in China (+13 percent versus 5.7 percent in Japan) due to China's low urbanization rate (63 percent versus 77 percent in Japan in 1991).

In addition, China's GDP per capita is significantly lower than Japan in the 1990s (US\$12K versus US\$30K in real USD terms).<sup>6</sup> This difference gives the Chinese economy a higher potential growth rate than Japan in the 1990s, which should make the deleveraging process less painful.

Despite several advantages that China has compared to Japan in the 1990s, China is viewed as being in a worse position than Japan in several important respects.

To start with, China has higher policy uncertainty than Japan. This situation inevitably leads to deterioration of investor sentiment. The regulatory crackdown on social media and education firms, and the unexpected clampdown on leverage in the property sector that led to a liquidity crisis at Evergrande, highlight this issue. If investors expect policy to remain volatile and transparency is limited, they could start to demand a greater premium for holding Chinese assets, which will subdue foreign direct investment.

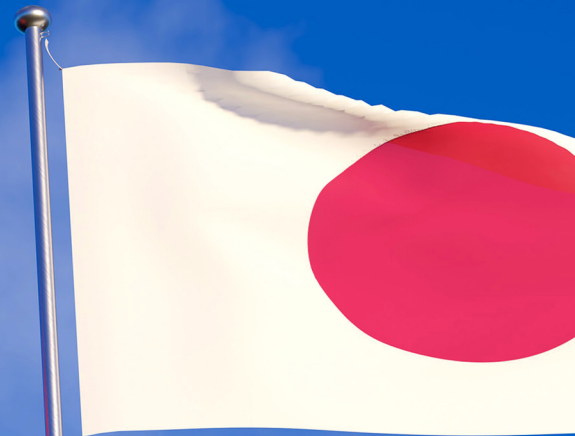
Second, China has experienced a more pronounced property boom than in Japan. The direct impact of a housing slump on the real economy can be expected to be bigger in China than that previously experienced by Japan for two reasons:

1. The urban residential property vacancy rate is around 20 percent in China<sup>7</sup> versus 9 percent in Japan in 1990,<sup>8</sup> and house prices are more stretched relative to household income in China (28x)<sup>9</sup> versus in Japan (18x) in 1990.<sup>10</sup>
2. The property linkage to the rest of the economy is tighter in China. Residential investment share of GDP was about 1.5x as high in China in 2020<sup>11</sup> as that of Japan in 1990.<sup>12</sup> Property accounts for about 70 percent of Chinese households' total assets<sup>13</sup> compared to around 50 percent in Japan in 1990.<sup>14</sup>

Third, as noted earlier, China's population is aging faster than Japan's in the 1990s, which will lead to an earlier decline in total population. Given China's significantly lower GDP per capita compared to Japan, Chinese households promise to become old and indebted before becoming rich, further dampening domestic demand.

Finally, unlike the US-Japan trade dispute in the 1980s, present-day US-China strategic competition goes well beyond trade, touching upon national security, health, technology, energy and international affairs. As negative views of China continue to mount in the US, China's business attractiveness will likely continue to weaken, and its ranking in global investment planning may drop further.

# What can China do to avoid Japanification?





## **So far, we've explored how Japan entered the era of "lost decades," how China today is and isn't similar to Japan in the 1980s/90s, and how China may fare better or worse than Japan did during that dark economic period.**

We now explore what China can do to avoid "Japanification" and limit the economic damage from policy mistakes that exacerbated losses in Japan.

As can be learned from Japan's experience, proactive and coordinated short- and long-term policy response to achieve (1) short-term economic stabilization and (2) long-term structural reforms will be required to avoid prolonged slowdown and eventual stagnation.

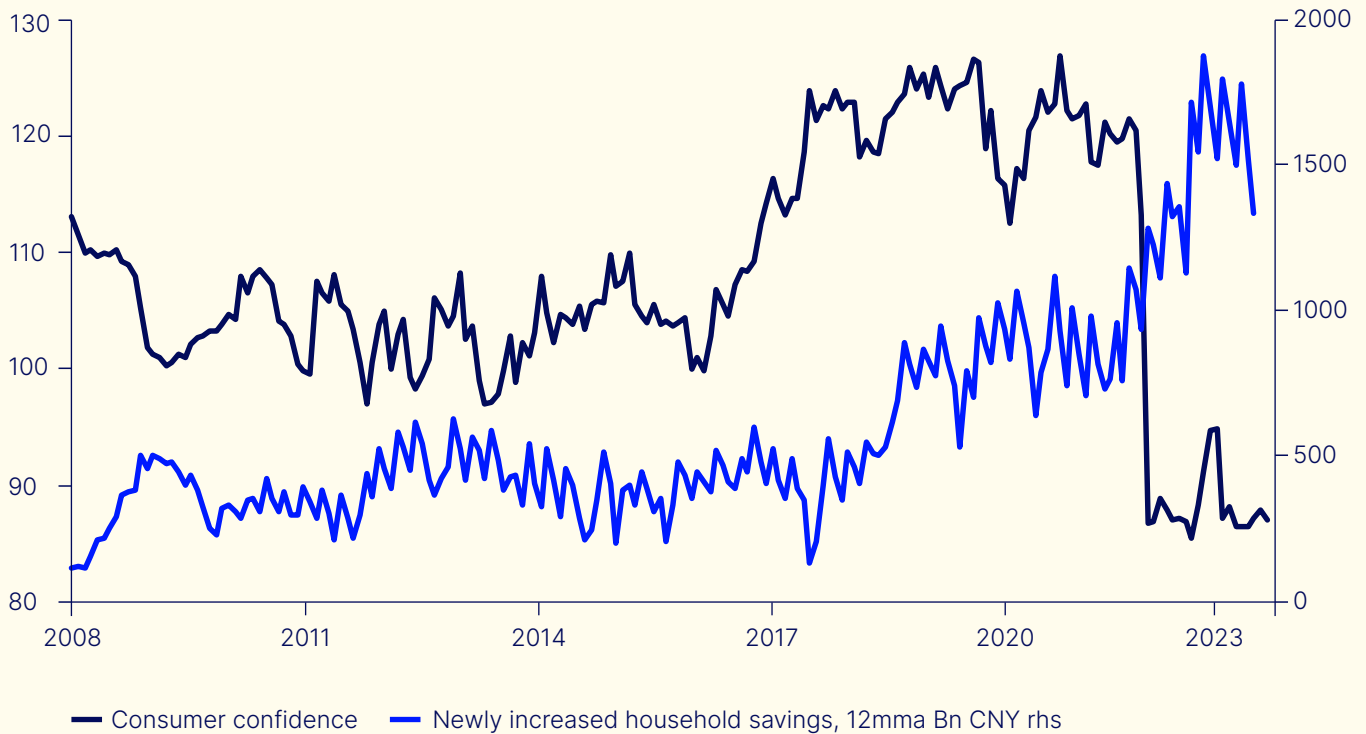
### **Short-term economic stabilization**

In order to achieve short-term economic stabilization, a judicious combination of accommodative monetary policy and expansionary fiscal policy is required to ensure ample liquidity and guarantee growth.

China has been adamant in its decision not to resort to the quantitative easing seen in the developed world during the global financial crisis (GFC). In the current scenario when households deleverage and corporates refrain from adding leverage due to decreased confidence, the government needs to step in as a "borrower of last resort" to stabilize asset prices and drive up investor sentiment. We strongly believe that such governmental action will be critical if China is to avoid Japanification.

The savings rate in China has increased substantially due to the rising uncertainty about future economic growth and household finance in the COVID-19 period, as can be seen in Figure 5.

Figure 5: China consumer confidence versus household savings



Source: Bloomberg

This behavior substantiates a lack of confidence in government investment activities and has negative implications for growth. On the household front, deteriorating income prospects coupled with sluggish property prices (which constitutes 70 percent of household wealth) adversely affect growth expectations, which in turn negatively impact capital formation and investment. This is a serious concern.

Much of the wealth of the Chinese economy is tied to the property sector. Thus, the struggling property sector has a substantial impact on the overall wealth in the economy and reduces the confidence of both domestic and international investors with low-risk appetites. Reversal of this trend would require much more forceful policy guarantees and steady-state geopolitics.

## Long-term structural reforms

In the longer term, structural reforms are likely needed to fundamentally solve excess capacity and demographic decline, as well as reduction in total factor productivity. A few important long-term measures are elaborated below.

First, as outlined earlier, the demographic structure has a significant effect on aggregate demand and growth. Demographic inter-temporal models suggest that as the population ages, savings will rise, and consumption will reduce meaningfully.<sup>15</sup> Thus, China needs a comprehensive plan to help counter this effect. Demographic transitions require the following long-term changes:

1. Allow immigration to replenish diminishing labor force; and
2. Build a social safety net and welfare system that is proportionate to the increasing needs of an aging population via reforms of pension, health, childcare and access to public services. These measures are particularly necessary in the absence of genuine large-scale immigration.

Second, the property sector needs to find a solution to reduce the drag on overall economic growth and help prevent systemic risk. The following government measures will greatly assist in that regard:

1. Reduce the burden of non-performing assets (NPAs) for banks. For example, mortgage loans currently account for a whopping 17 percent of total bank loans (China International Capital Corporation Limited estimate). Increasing non-performance of these loans due to worsening property sector will likely increase systemic financial risks.
2. Ensure the completion of unfinished, pre-sold projects — provide liquidity/ensure access to refinance by property firms.
3. Encourage state intervention if needed — either provide explicit guarantees of delivery or promote state-owned enterprises buyouts/mergers of real estate companies that could potentially cause systemic issues if they were to collapse.
4. To avoid an asset bubble burst, promulgate purchasing rules adjustments to ensure that asset prices don't plummet (various packages/policies have been encouraged this year to address home purchasing rules, suggesting that policymakers are aware of this risk).

**Jobs can be created, and various industries can thrive off of this demographic trend.**

It is vital that property sector reform be accompanied by broader public finance reform. Historically, China's (defunct) growth model created misaligned incentives at a local government level and increased reliance on the loop of land sales, property development and housing sales.


Only a comprehensive reform of public finance can break this loop such that local government officials have incentives to pursue a new growth model. Other sectors need to step up to serve as alternative engines of growth such as climate transition, high-tech and artificial intelligence.

Third, de-risking of geopolitics is necessary for China to move up the value chain. China currently is still a middle-income country, and access to global markets and integration into global research networks is required for it to propel itself to high-income status like South Korea, Taiwan and Israel did.

While China's dependency on these factors is admittedly less due to its much larger size, the adversarial China-G7 relationship makes scaling up the value chain significantly harder.

While the reforms suggested above should help China dodge a repeat of the disastrous economic challenges faced by Japan, a total avoidance of Japanification may prove difficult, as outlined below.





# China faces complex challenges to avoid Japanification

## **Several structural issues exist in China that make it difficult to find a viable solution. First, the disconnect between local and central government creates barriers that hinder efficacy of policy implementation.**

The regional diversity and the complicated hierarchical nature of Chinese bureaucracy makes it difficult to disentangle.

As promotions of local officials are predicated on their short-term performance, this incentive architecture creates a culture of reduced transparency and myopic policies overshadowing long-term goals.

As highlighted earlier, China faces a much more hostile external environment now than Japan did a few decades ago, especially considering its tense bilateral relationship with the US. There is a clear and gradual pivot from the long-standing strategy on US-China relations engagement and containment to competitiveness. This dynamic has evolved wherein the rise of China poses threats to US dominance and

the values instilled by Western institutions, and represents the classic “Thucydides trap”<sup>16</sup> of a rising power challenging the status quo.

On the macro front, it is difficult to envision significant improvement of the bilateral relationship anytime soon. However, despite the cultural, historical and ideological differences between China and the US, the two largest global economies need to work in a coordinated fashion for mutual benefits. In addition, it is important to increase transparency in communication channels, and establish guard rails to reduce the risk of misperception escalating into a crisis. Ultimately though, it is quite challenging to imagine a complete reversal of the present-day trajectory of the US-China relationship, regardless of the leaders at the top.

## **China faces a much more hostile external environment now than Japan did a few decades ago, especially considering its tense bilateral relationship with the US.**

# Conclusion

China's continued economic disappointments after its re-opening in 2023 have prompted the question: "Is China the next Japan?" In fact, China exhibits a number of characteristics that Japan experienced in 1980s/90s before it entered the "lost decades," namely demographic decline, a high debt level and weak demand coupled with deflation. While China fares better than 1990s Japan in certain aspects — such as higher policy autonomy, stricter capital control, and lower urbanization ratio — the nation has higher policy uncertainty, a more extreme property-sector boom, worse demographic progression, and a more challenging strategic relationship with the US.

Proactive and coordinated policy response on both monetary and fiscal fronts to boost the public expectations of future growth will be critical if China is to avoid Japanification. This proactive policy response needs to be coupled with more long-term structural reforms to combat demographic transition and property sector drag. However, even with successful policy implementation, the disconnect between local and central governments and the tense relationship with the US may render a complete avoidance of Japanification nearly impossible. Regardless of whether China follows or avoids the fate of Japan in the 1980s/90s, the nation tomorrow will be different from the China we have seen in the past two decades, warranting a closer look into its impact on the global economy going forward.

## Acknowledgements

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# Endnotes

1. GDP (current US\$) – China. The World Bank. [GDP \(current US\\$\) - China | Data \(worldbank.org\)](https://data.worldbank.org/ny/gdp/cd?locations=CN).
2. Up until the early 1980s, Japan, for nearly three decades, was one of the world's fastest-growing economies, thanks to its competitive exports supported by the then-extraordinarily strong US dollar (USD) resulting from the Fed's aggressive fight against inflation. However, in September 1985, delegates from the G5 countries gathered in New York and instituted a plan to devalue the USD, which led to a subsequent 37 percent appreciation of the Japanese yen against the USD by the end of 1986. This struck a heavy blow to Japan's exports and GDP growth, prompting authorities to introduce a combination of monetary and fiscal policy responses. Due to monetary and fiscal stimuli introduced in 1987, Japan began to experience not only a boom in output, but also credit growth and asset prices, resulting in the tripling of Japanese stock and real estate market from 1985 to 1989. In January 1990, the music stopped in the form of the stock market bubble bursting, dropping 39 percent in a year that marked the start of the "lost decades."
3. Dependency ratio is the ratio of the number of dependents (aged below 15 and over 64) to the total working-age population in a country or region.
4. The data pertaining to sovereign debt and private debt to GDP for China and Japan has been sourced from Macrobond.
5. China's GDP growth slowed sharply over the past three years (average 4.6 percent year over year), extending a downtrend since 2010. This path parallels what happened in Japan – fast growth during 1956-1973 (+9.2 percent per year), slower pace during 1974-1991 (+4.0 percent per year), and stagnation during 1992-2012 (+0.8 percent per year). Japan entered the crisis with exports constituting less than 15 percent of GDP, whereas the comparable figure for China had been above 20 percent for most of the two decades before the peak in credit.
6. The data pertaining to urbanization ratio for China and Japan has been sourced from Macrobond.
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Erlandsen, Solveig, and Ragnar Nymo. "Consumption and population age structure." Journal of Population Economics 21 (2008): 505-520.
16. The term "Thucydides trap," popularized by American political scientist Graham T. Allison, describes a tendency towards war when an emerging power threatens to displace an existing great power as a regional or international hegemon.





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