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Deflation: Why falling prices in China raise concerns

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By Annabelle Liang & Nick Marsh

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China's economy has slipped into deflation as consumer prices declined in July for the first time in more than two years.

The official consumer price index, a measure of inflation, fell by 0.3% last month from a year earlier.

Analysts said this increases pressure on the government to revive demand in the world's second largest economy.

This follows weak import and export data, which raised questions about the pace of China's post-pandemic recovery.

The country is also tackling ballooning local government debt and challenges in the housing market. Youth unemployment, which is at a record high, is also being closely watched as a record 11.58 million university graduates are expected to enter the Chinese job market this year.

Falling prices make it harder for China to lower its debt - and all the challenges which stem from that, such as a slower rate of growth, analysts said.

"There is no secret sauce that could be applied to lift inflation," says Daniel Murray from investment firm EFG Asset Management. He suggests a "simple mix of more government spending and lower taxes alongside easier monetary policy".

When did prices start falling?

Most developed countries saw a boom in consumer spending after pandemic restrictions ended. People who had saved money were suddenly able and willing to spend, while businesses struggled to keep up with the demand.

The huge increase in demand for goods that were limited in supply - coupled with rising energy costs after Russia's invasion of Ukraine - inflated prices.

But this is not what happened in China, where prices did not soar as the economy emerged from the world's tightest coronavirus rules. Consumer prices last fell in February 2021.

In fact, they have been at the cusp of deflation for months, flatlining earlier this year due to weak demand. The prices charged by China's manufacturers - known as factory gate prices - have also been falling.

"It is worrisome as far as it shows that demand in China is poor while the rest of the world is awakening, especially the West," Alicia Garcia-Herrero, an

adjunct professor at the Hong Kong University of Science and Technology, said.

"Deflation will not help China. Debt will become more heavy. All of this is not good news," she added.

Why is deflation a problem?

China produces a large proportion of the goods sold around the world.

A potential positive impact of an extended period of deflation in the country may be that it helps to curb rising prices in other parts of the world, including the UK.

However, if cut-price Chinese goods flood global markets it could have a negative impact on manufacturers in other countries. That could hit investment by businesses and squeeze employment.

A period of falling prices in China could also hit company profits and consumer spending. This may then lead to higher unemployment.

It could result in a fall in demand from the country - the world's largest marketplace - for energy, raw materials and food, which would hit global exports.

What does this mean for China's economy?

China's economy is already facing other hurdles. For one, it is recovering from the impact of the pandemic at a rate that is slower than expected.

On Tuesday, **official figures showed** that China's exports fell by 14.5% in July compared with a year earlier, while imports dropped 12.4%. The grim trade data reinforces concerns that the country's economic growth could slow further this year.

China is also dealing with an ongoing property market crisis after the near-collapse of its biggest real estate developer Evergrande.

The Chinese government has been sending the message that everything is under control, but has so far avoided any major measures to encourage economic growth.

Building confidence among investors and consumers will be key to China's recovery, Eswar Prasad, a professor of trade policy and economics at Cornell

University, said.

"The real issue is whether the government can get confidence back in the private sector, so households will go out and spend rather than save, and businesses will start investing, which it hasn't accomplished so far," Professor Prasad said.

"I think we're going to have to see some significant stimulus measures (including) tax cuts."

Additional reporting by BBC business reporter Peter Hoskins.

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