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China: Fear of a deflationary spiral

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Falling prices for manufacturers plagued by overcapacity present a problem for Beijing's policy makers

A toy dealer in Yiwu, a centre for the trading of small commodities. Many manufacturers are having to accept reduced prices

The 600,000-square-metre China Commodity City in Yiwu city, often referred to as "Walmart on steroids", is one of the world's largest wholesale markets.

Traders from the Middle East, Russia and Africa come to the market in eastern Zhejiang province to browse a staggering array of products from umbrellas to buttons to refrigerator magnets commemorating every city in the world – many made in one of the small factories dotted around the city's fringe.

But as the holiday season approaches, Guo Wei, factory manager at China Zhongsheng Crafts Co, which makes plastic Christmas trees for export to the US, the UK, Australia and Japan, is struggling to cope. For some products, the company is even selling below cost.

"Sales revenue is holding up OK, but when it comes to prices, customers want them lower and lower. They all say the economy isn't good," said Ms Guo. "Some of our own products aren't profitable any more but we still make them to keep our customers happy."

Cheaper Christmas trees may sound like good news for western consumers. But falling prices in China pose a rising threat to economies across the globe, many of which are grappling with their own issues of weak demand and troublingly low inflation.

After a decade in which rapid growth and investment gobbled up China's enormous output, many of its factories – like those in Yiwu – are finding it difficult to shift stock. Demand at home and abroad has been stalling, leaving many industries with chronic overcapacity, especially in basic commodities like steel, glass and cement. For many, the only answer is to keep cutting prices.

The result is reflected in China's official statistics, which show that so-called producer prices have been in outright deflation for nearly three years. Perhaps even more worrying, consumer prices have dropped to a near five-year low of 1.6 per cent on an annual basis in October. "You think there's a problem in the eurozone? There's a far bigger problem in China," says Albert Edwards, strategist at Société Générale.

China is the world's top exporting nation, and the main trading partner with dozens of countries. As its manufacturers drop prices to increase sales, the impact is being felt across the world, from the factory floor to the shop shelf. With policy makers in many economies

– Europe and Japan especially – worried about falling prices, China's own ability to boost inflation is becoming a key part of the puzzle. As George Magnus, an economic adviser to UBS, puts it: "The rest of us need Chinese deflationary pressures like a hole in the head."

Optimists say China is unlikely to tip into the kind of stubborn deflationary spiral that has dogged neighbouring Japan for two decades and is dominating the policy debate in Europe. Growth, for now at least, remains above 7 per cent a year, making it an important engine of global demand.

But in a possible sign of rising concerns about disinflation, the People's Bank of China cut interest rates in November for the first time since 2012.

"It's a clear indication of how heavy deflationary pressure in China can be these days," said François Perrin, head of China equities at BNP Paribas Investment Partners.

For over a decade, China has faced accusations of exporting deflation. In 2002, Haruhiko Kuroda – then a Japanese finance ministry official, now head of the Bank of Japan – warned in the Financial Times that China's entry into the World Trade Organisation would add a "powerful deflationary force" to the global economy.

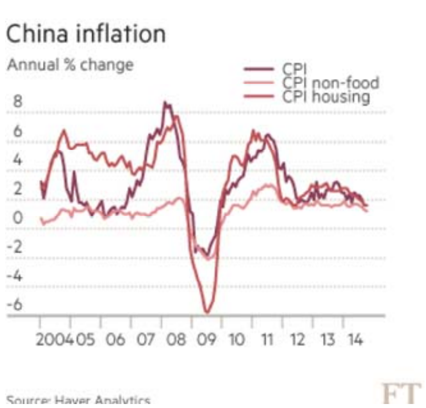
Just over a year later, the US Federal Reserve published a discussion paper entitled: "Is China exporting deflation?", but it concluded that the Chinese economy was "too small" to have an impact. A decade on, China's place in the global economy has been transformed, both as a supplier of goods and a source of demand for raw materials. The Chinese slowdown has been a key factor in falling commodity prices, such as oil, which sank to a four-year low last week.

The drop in global energy costs is feeding through to weaker inflation everywhere, but many see China's current bout of disinflation as a symptom of deeper problems that are unique to the world's second-largest economy: chronic overcapacity, insufficient demand and faltering growth. All are side effects of a top-down system where cosseted state enterprises are reluctant to retrench and local governments are engorged with easy credit.

The country has a long history of excessive development across industries, from solar panels and shipbuilding to steel and chemicals. Many companies in these sectors are now on life support and are increasingly reliant for funding on China's vast shadow banking system, where "non-bank institutions" sell wealth management products that offer high returns on investments regarded – rightly or wrongly – as underwritten by the state. Even the downturn in the housing market can be attributed to the burden of oversupply in many cities.

Last week, government researchers put a figure on wasteful spending. By their calculations, $6.8tn has been squandered on "ineffective investment" – such as needless steel mills, ghost cities and empty stadiums – since the start of the 2009 stimulus launched to buffer China from the global financial crisis.

Overcapacity is largely the result of pressures on local governments. The performance of local officials has long been evaluated based on gross domestic product, creating an incentive to maintain production even at unprofitable factories. Excess capacity has unfortunate consequences: falling prices undermine corporate profitability and lead to stress in the banking system. Local officials lean on banks to relax lending standards for companies that would otherwise be forced to close down. Unprofitable manufacturers pile on ever more debt but avoid bankruptcy and maintain production, adding more downward pressure on prices.



The central government has pledged to stop measuring officials' performance mainly based on GDP, but this change will take years to trickle down to lower levels of government.

Deflation has also fuelled the build-up of risk in the financial system. Cut off from bank finance, companies in oversupplied industries, especially privately owned ones, pay exorbitant interest rates in the shadow banking system. Falling prices at the factory gate make the burden of that growing debt even heavier, raising the risk of defaults.

Overcapacity is not just a local problem: sinking prices for Chinese-made goods affect costs globally. Before the financial crisis, that helped drive a consumer boom in the west. But now excess supply risks worsening the problem of falling prices in developed economies.

Eswar Prasad, economics professor at Cornell University, says: "Disinflation and weak demand growth in China could have adverse spillover effects on other countries grappling with even more severe versions of these two problems."

Deflation inflicts a dual blow on an economy. It increases the burden of debt in real terms, something that China, which Standard Chartered estimates has a debt-to-GDP ratio above 250 per cent, can ill afford.

Falling prices can also hold back consumption, as people delay purchases in expectation of even cheaper prices. But as China tries to shift its economy from credit-fuelled investment towards consumer-driven growth, it needs its citizens to go shopping.

In the scenario of higher spending, China's policy makers could do very little, at least until the prospect of outright deflation becomes a more serious risk.

"Cheaper commodities benefit consuming countries which drive global demand," says Fred Neumann, chief Asia economist at HSBC.

If prices continue to tick down, Beijing has several options for generating demand. But as central bankers in Japan and Europe have found, stirring inflation with monetary policy is no mean feat when dealing with years of excess credit growth. Many analysts expect further rate cuts and more targeted easing measures for some sectors. This could support consumer spending and reduce the debt burden on companies.

But there are questions about the impact of rate cuts on the broader economy. Lower borrowing costs will largely benefit hulking state-backed companies, helping them to keep going even if they are not economically viable.

Rate cuts could also signal the status quo will be preserved, which "might give the market an impression that the new government once again uses credit easing to stimulate growth", said Lu Ting, chief China economist at Bank of America Merrill Lynch.

Under President Xi Jinping and Premier Li Keqiang, China has laid out a path towards comprehensive reform designed to introduce real market forces. But there has been little to show for it. "I think the majority in policy circles still talk about reform in a positive way," says Zhang Zhiwei, economist at Deutsche Bank. "The question is about timing and how to do it."

Until then, China's economic model remains reliant on the trusted drivers of growth – credit-fuelled investment and exports. However, both are under increasing strain. Credit growth has been explosive in recent years since the financial crisis, while weak global growth means that the export engine is stalling, and driving down prices.

The worry is that China decides to take the nuclear option to fan inflation at home: currency devaluation. A sharp drop in the value of the renminbi could boost exports, and help use up excess capacity; it would also offset the drag of weaker commodity prices. But raising import prices would be bad news for Chinese consumers, as would higher input costs for manufacturers.

Analysts say the chances of a devaluation are still slim, but growing. "I don't think this is likely, but the weaker Chinese data gets, the greater the pressure on policy makers to go for the easy option of devaluation," says Mr Neumann. "Should China opt to depreciate its exchange rate, this would be a game changer."

Such a move could prove disastrous for efforts elsewhere, notably Europe and Japan, to fight deflation. China is the world's top exporter to the EU, meaning that a significant drop in the price of its goods would put fresh downward pressure on already very low inflation trends in the eurozone.

But the aggressive expansion of the BoJ's quantitative easing programme has raised the stakes. The yen has tumbled to a record low against the renminbi, while South Korea has put the market on notice that it is watching the Japanese currency closely. If the BoJ sparks a regional currency war, China may not be able to remain neutral.

"If you're trying to crush a credit bubble, which the Chinese are, the last thing you need is a rapid appreciation in the exchange rate," says SocGen's Mr Edwards. "Economically, China doesn't have a lot of choice. It's just an inevitability, and Japan is the straw that broke the camel's back."

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Corporate debt

Historic default fails to clean up financial sector

In March, solar-panel maker Chaori Solar failed to meet an interest payment on its bonds, marking China's first default of the modern era.

Investors expected a wave of corporate bankruptcies and defaults to follow, which would have damaged confidence but would have cleared away some of the excess capacity that has been pushing prices down. Raising the potential for corporate failures was expected to lead to more rational pricing of risk, as investors began to realise not everything was underwritten by the state.

Reality has proved rather different. Fears that injecting too much risk into the system too quickly would close the window for refinancing companies have overridden expectations. Regional authorities were also afraid of playing host to corporate failures.

Instead, local government officials prevented companies from going bust by strong-arming banks into making new loans. Defaults failed to emerge, while non-performing loan rates at large banks – although rising – have remained extremely low.

Chaori bondholders were ultimately bailed out by a state-owned bad bank in October. Huarong, another of China's bad banks, also rescued those invested in "China Credit Equals Gold #1", a trust product that had teetered on the brink of default in January. In both cases, the bailout was largely kept quiet, leading to assumptions of state-directed assistance.

There have been attempts at shaking up the status quo and introducing more market forces into the economy. Many large state-owned enterprises have this year announced restructuring or asset spin-offs. Sinopec recently sold a $17.4bn stake in its gas station business, Citic Group is injecting $37bn of assets into its Hong Kong-listed arm, while China's three mobile operators are exploring a stake sale of their pooled towers business.

But these measures remain piecemeal, and are in many ways simply experiments at the margins of the economy.

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