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China's Producers Struggle to Absorb Free Fall in Prices

By BOB DAVIS and RICHARD SILK

Agence France-Presse/Getty Images

Chinese solar-panel makers are reeling from a collapse in prices.

BEIJING—A sharp fall in factory prices—the 14th straight monthly decline—signals further trouble for a Chinese economy already facing mounting debt and slowing growth, as old-line industries struggle with growing overcapacity.

Producer prices—a measure of prices of goods before they reach consumers—dropped 2.4% in April, the sharpest decline since October, paced by particularly steep falls in the metals and chemicals sectors. That could add to concerns about China's slowdown in growth, say economists, because falling producer prices make it tougher for makers of industrial goods and commodities to make profits, pay off their debts and pay their suppliers on time.

Part of a big surge in Chinese lending has been used to refinance debt or pay off interest of companies burdened by overcapacity, said Barclays BARC.LN -0.59% analyst Jian Chang. "That is helping to prevent companies from going bust."

China continues to be the world's fastest-growing major economy, though the growth rate has slowed from the double-digit gains the country racked up for the past 30 years. In the first quarter, GDP growth fell to 7.7%, year over year, from a 7.9% gain in the fourth quarter of 2012. There is debate among economists about whether the economy will recover the rest of the year to growth of at least 8% or fall further. On Thursday, the People's Bank of China said in a quarterly report on

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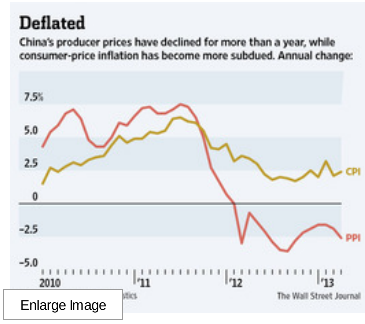
monetary conditions that the fundamentals for stable economic growth aren't yet solid.



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The deflation in the industrial sector reflects overcapacity in a number of major Chinese industries including steel, coal, glass, aluminum, solar panels and cement.

The price declines aren't of the same magnitude as the overall deflation that has gripped Japan, where consumer prices have fallen nearly every year since 1999, sapping profits, investment and consumer spending and dumping a once-highflying economy into a decadelong funk. The decline in factory prices in China also has a silver lining for consumers because it helps keep consumer prices low. Consumer-price inflation hit a high of 6.5% in July 2011 and has since come down to more subdued levels, reaching a nonthreatening 2.4% year over year in April.

But for industries, the effect of falling prices can be severe.

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Aluminum Corp. of China, or Chinalco, which reported a 975 million-yuan ($158 million) loss in the first quarter on a revenue increase of 1.9%, said that more than 90% of the aluminum produced in China is produced at a loss. "China's urbanization will boost aluminum consumption in the long run," said a Chinalco spokesman, "but digesting the inventory many need some time so a price surge is unlikely in the near term."

The cement industry also looks bloated. Huaxin Cement Co. 600801.SH +0.36% President Li Yeqing said in an online news conference last week that cement makers need to shut down old plants to avoid "catastrophe" for the whole industry. Analysts said those firms with government connections, however, are likely to get financial support.

In some sectors, low global commodity prices have been a contributor to falling producer prices. In the past year, crude-oil prices have stayed flat and those for iron ore have fallen about 7.3%. Low input costs partly reflect weak demand in China, the world's largest consumer of commodities, but they also weaken China's industrial prices.

"The lower raw-material cost has washed through into lower selling prices," said Daniel Kang, a JP Morgan JPM +0.63% analyst.

In the solar-panel industry, producers are hemmed in by import duties in the U.S. and similar measures about to be imposed in Europe, cutting their global market, boosting overcapacity and undermining prices and profits. LDK Solar Co. LDK +11.62% has been struggling under the weight of $2.2 billion in debt. After a plan to sell one of its factories fell through, the company was rescued by the Hefei city government, which agreed to acquire the plant. The company said it expects to record a net loss of between $80 million and $90 million on the sale of the factory.

During past episodes of producer-price deflation, China grew its way out of its problems. After China joined the World Trade Organization in 2001, exports soared, boosting demand for manufactured goods and commodities. During the global financial crisis of 2008 and 2009, the government approved a massive stimulus plan that included almost open-ended lending to big, often state-owned firms now seized by falling prices.

But now export demand is light because of financial problems in Europe and Japan and a tepid recovery in the U.S. Domestic demand hasn't been as powerful as some analysts had expected because the government is trying to limit the infrastructure spending that has led to a rapid buildup in debt.

Low inflation and limited public debt means the government still has tools at its disposal to boost growth. Some economists expect big new lending in the first quarter to produce stronger investment, which would buoy demand for industrial products.

But a return to investment spending to boost growth could backfire, said Cornell University China specialist Eswar Prasad. "That would exacerbate underlying economic tensions that are reflected in falling producer prices" by prompting company to gin up production further. Economists say Beijing is likely to try to find some middle ground of slowly cutting industrial capacity and modestly boosting demand.

Shutting factories and laying off workers, which is another way to deal with overcapacity and falling prices, has in the past been largely off-limits in China because of political concerns. China's leaders traditionally have been wary of taking measures that could boost unemployment and lead to what are euphemistically referred to as "mass disturbances." That is particularly a concern in the first year after a leadership change.

Demographic changes in China, which have shrunk the supply of new workers, may temper the need to prop up ailing industries

In the solar industry, a technology director of embattled Suntech Power Holdings Co., STP +1.97% one of the world's largest producer of solar panels, said that after one factory closed, he transferred to another factory where he was given a different job. "I don't worry too much about job security," he said.

—Yajun Zhang and Wayne Ma contributed to this article.

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