Threat of deflation casts pall over China

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GLOBE AND MAIL UPDATE
MARCH 11, 2009 AT 6:00 AM EDT

Only last summer – in what now seems like another epoch – China's leaders were fretting about the perils of inflation. Now they face the opposite problem. The latest figures out of Beijing show that consumer prices fell in February for the first time since 2002, raising the even more frightening prospect of deflation in the world's third-largest economy.

China's National Bureau of Statistics reported that prices fell 1.6 per cent from a year earlier. That was a sharper drop than most economists expected and greater than recent declines in Ireland, Taiwan and Thailand, the Bloomberg news service said. Producer prices fell, too, declining 4.5 per cent, the most in a decade.

Though the statistics bureau said "we can't yet draw the conclusion that deflation has arrived," even the whiff of it is worrying for a country used to rollicking growth and rising prices.

Last year, output and exports were growing so fast that inflation hit its highest rate in a decade, peaking at 8.7 per cent in February.

Now, Beijing finds itself in a race to pump up the sagging economy before deflation takes hold in earnest. With demand for their products falling both at home and abroad, Chinese industries are producing more than they can sell. The inevitable result is downward pressure on prices. That could set off a chain reaction: Consumers delay purchases because they expect prices to fall further and that hesitance indeed causes prices to fall.

"These figures show the risk of a deflationary cycle setting in," said Eswar Prasad, a China specialist at Cornell University in Ithaca, N.Y. "Almost across the board, prices are in decline."

China is particularly keen to avoid such a cycle because its strategy for continued economic health relies on obtaining more growth from domestic consumption, reducing its reliance on exports and investment.

The People's Bank of China warned last month that "the risk of deflation is relatively large" because of falling raw materials prices and rising overcapacity. At a news conference in Beijing yesterday, two Chinese cabinet ministers – Chen Deming of the Commerce Department and Li Yizhong of Industry – said the outlook for manufacturing and exports is "grim."

Another concern is the fall in property prices. According to figures released yesterday, they fell 1.2 per cent in February from a year earlier in 70 main cities, the steepest yearly decline since records began in 2005. In the worst-hit region, the export hub of Shenzhen in southern China, they were down fully 15.7 per cent.

"My concern is that with property values plummeting, people feel poorer and spend less," said Mitchell Bernard, who studies Asian economies at Toronto's York University. "It's all part of the mentality that pushes prices down."

Chinese officials say they are confident they can avoid such a spiral. They argue that last month's price drop looks worse than it is because it was measured against last February, when prices were on a tear.

"The price falls are mainly caused by declines in international commodity prices; they do not mean that the Chinese economy is contracting," People's Bank deputy governor Su Ning told reporters yesterday during the annual meeting of parliament.

Officials argue that China's stimulus package, combined with a surge in new lending, should put a safety net under prices. Banks made more than one trillion yuan ($187-billion) in new loans in February, a fourfold increase from a year earlier, as the government encouraged them to help out troubled companies.

In that respect, China is in much better shape than many Western countries, where faltering banks are hesitating to make loans. "The difference between China and other countries is that, for now, the financial system is working as a conduit to push reserves into the economy, whereas in other countries you don't have credit flowing," Prof. Bernard said.

The downside is that with loans comparatively easy to get, companies will expand production and contribute to the overcapacity problem that helps fuels deflation in the first place, he added.

With files from Reuters and Dow Jones Newswires

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