The Challenge of Deflation: policy choices and their effectiveness

Ligang Song

Challenges of deflation

With an average annual growth rate of about 9 per cent during the past two decades, China has become the seventh largest economy and the eleventh largest trading nation in the world by 1998. It has been one of the largest foreign capital recipients in the world since the mid 1990s. It has the second largest size of international reserves next only to Japan at present (US$151.5 billion by the end of September 1999). Recently, China has weathered the storm of the East Asian crisis erupted in 1997 making an important contribution to the stability and later the recovery of the East Asian economy from this unprecedented crisis in the region.

Domestically, after 20 years of its endeavour on the reform path, China is facing a ‘diminishing return’ to reform after it began to tackle the hardest part of its economic system under the reform program, namely the reform of the state-owned enterprises in relation to restructuring of the state-owned banks. In this process, a new phenomenon has begun to merge in the economy in recent years, that is price deflation, which is partly due to the partially reformed economic system and partly due to the current irrational or imperfect economic structure.

A partially reformed economic system and new reform measures aimed at deepening the reform bring about uncertainties among residents. With uncertainties associated with various reform programs such as housing, pension, health and education, residents continue to increase savings at the expense of consumption. To the extent that the changes in consumption reduce demand for domestic products, domestic prices will tend to fall.

On the other hand, the irrational or imperfect economic structure leads to the continued inefficient production of many unwanted products causing the problems of over-capacities of production and over-supply of goods. The lack of domestic effective demand and over-supply of products in the domestic market are the fundamental causes for the current price deflation.

Other factors, which have contributed the current price deflation, are the implementation of the relatively tight monetary policy in the mid 1990s and the weakening of China’s external economy due to the erosion of the competitiveness of China’s exports by the currency depreciation in other East Asian economies.

It can be argued that a shift from a seller’s market to a buyer’s market taking place in recent years, without at the same time making substantial progress in resolving the institutional and structural problems, will be likely to trigger price deflation, unless the external economy is strong enough to offset the deflationary pressure in the domestic
economy or government expansionary policies are effective to boost domestic investment and demand. Since it takes time for the reform measures to be effective in order to reduce uncertainties, the government has no other choices but to rely on its macroeconomic policy instruments to boost the economy.

Table 1. Macroeconomic indicators, 1995-99

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP (% real change)</td>
<td>10.5</td>
<td>9.5</td>
<td>8.8</td>
<td>7.8</td>
<td>7.4 (1-9)</td>
</tr>
<tr>
<td>Gross industrial output (% real change)</td>
<td>20.3</td>
<td>16.6</td>
<td>13.1</td>
<td>8.9</td>
<td>9.5 (1-5)</td>
</tr>
<tr>
<td>Inflation (retail price % change)</td>
<td>14.8</td>
<td>6.1</td>
<td>0.8</td>
<td>-2.6</td>
<td>-3.0 (1-9)</td>
</tr>
<tr>
<td>Growth of M2 broad money supply (%)</td>
<td>29.5</td>
<td>25.3</td>
<td>19.6</td>
<td>14.8</td>
<td>17.2 (May)</td>
</tr>
<tr>
<td>Exchange rate (RMB/US$)</td>
<td>8.32</td>
<td>8.30</td>
<td>8.28</td>
<td>8.28</td>
<td>8.27 (Sept)</td>
</tr>
<tr>
<td>Fixed asset investment (% nominal change)</td>
<td>13.3</td>
<td>10.6</td>
<td>9.0</td>
<td>14.1</td>
<td>13.5 (1-5)</td>
</tr>
<tr>
<td>Retail sales (% nominal change)</td>
<td>26.8</td>
<td>20.1</td>
<td>10.2</td>
<td>6.8</td>
<td>6.4 (1-9)</td>
</tr>
<tr>
<td>Exports (% changes in $)</td>
<td>23.0</td>
<td>1.5</td>
<td>21.0</td>
<td>0.5</td>
<td>2.1 (1-9)</td>
</tr>
<tr>
<td>Imports (% change in $)</td>
<td>14.2</td>
<td>5.1</td>
<td>2.5</td>
<td>-1.5</td>
<td>19.3 (1-9)</td>
</tr>
<tr>
<td>Merchandise trade balance ($ billion)</td>
<td>16.7</td>
<td>12.2</td>
<td>40.3</td>
<td>43.6</td>
<td>19.4 (1-9)</td>
</tr>
</tbody>
</table>

Note: * Figures for 1999 are from various newly published sources such as the *People’s Daily*.

Sources: State Statistics Bureau, *Chinese Statistical Yearbook 1998* and various other sources for the latest figures.

To implement the expansionary monetary policy, the central bank has reduced interest rates seven times over the past three years, reducing the one-year loan rate from about 10 per cent in 1996 to around 3 per cent in June 1999. The central bank also lowered the bank reserve ratio from 12 to 8 per cent to boost banking lending.

On the fiscal front, the government issued 100 billion yuan (US$12.8 billion) special bonds in the second half of 1998 to invest in infrastructure projects to boost the economy. With domestic demand showing no signs of recovery in the first half of 1999, the government declared it would step up its active policy and issue more treasury bonds of 60 billion yuan (US$7.25 billion) in the second half of this year to offset deflationary pressures. Of the new package, 30 billion yuan (US$3.63 bln) will be included in this year's central government budget, increasing the deficit to 180.3 billion yuan (US$21.80 bln). The other 30 billion yuan (US$3.63 bln) will be raised by the central government on behalf of the local governments, and will not be included in the central budget. The spending will focus on four areas: infrastructure construction, upgrading China's industrial base, improving China's environment and cultural projects.

By September 1999, being unable to generate evident increases in investments by the non-state sector, China still relies heavily on government fiscal policy to sustain the current economic growth. The economy grew at 7.4 per cent annual rate during the first three quarters of 1999, but the expansionary macroeconomic policies failed to fundamentally alter the trend of the general price levels which have slipped into negative growth since October 1997. By September 1999, the retail price index had

---

1 Note that growth fell to 7 per cent during the July-September period from 8.3 per cent in the first quarter and 7.1 per cent in the second quarter.
fallen for 24 consecutive months. It was minor 3 per cent during the first nine months and the broader consumer price index was minor 1.6 per cent during the same period indicating that the government still faces a challenging task in fighting deflation.

It is likely that the current massive increases in government spending will push the growth rate to above 7 per cent in the last quarter of this year, meeting the full year growth target of 7 per cent. But the current price deflation could be prolonged if the government policies, including various credit schemes (such as housing and consumer durables) to boost consumption, imposition of taxes on interests from savings and increases in wages, fail to boost domestic demand and revive the non-state sector’s investment in the next few months.

There were signs of improvement in China’s exports in August and September this year. The customs statistics shows that trade surplus in September was US$3.3 billion with exports rising 20.2 per cent to US$18.6 billion. It was the third successive month exports have risen after falling in the first six months of the year and the first time this year that cumulative exports for the year increased over last year. For the full nine months to September 30, exports rose 2.1 per cent to US$137 billion and imports increased 19.3 per cent to US$117.6 billion leaving a trade surplus of US$19.4 billion.

But, it is still too early to say that the surge of China’s exports in the past couple of months represents a turning point for its exports to pick up from the slowing down triggered by the East Asian crisis during the past year. Given the current exchange rate misalignment vis-à-vis the currencies in other East Asian economies, pressures on China’s export sector will certainly continue especially for its exports in the third markets.

This less optimistic view on the prospects for China’s exports can also be supported by the fact that the inflows of foreign capital continued to decline this year. The total utilised foreign capital reached US$24.75 billion in the first eight month in 1999, a decline of 9.7 per cent over the same period in 1998. The contracted foreign capital was US$25.33 billion during the first eight months, a fall of more than 20 per cent over the same period in 1998. Since FDI sustains almost half of China’s total exports, a declining trend of the inflow of foreign capital will negatively affect its export potential.

Consequently, discussions have been going on with respect to the future orientation of the Chinese economy. That is whether China should turn to its own economy to generate growth or continue to reply heavily on the external economy in its next stage of development. It is argued that as China moves out of the early stages of technological acquisition and adaptation, it may need to make greater domestic efforts to keep the process going.

**Implications**

The price deflation has severe consequences to both the economy and reform program. In particular, deflation has two contractionary effects on the economy. One is that unexpected deflation raises the real value of debts, thereby transferring resources from
debtors to creditors. If debtors have a higher marginal propensity to consume than creditors, this transfer reduces spending on goods and services.

The other contractionary effect of deflation is that expected deflation raises real interest rates for any given nominal rate, thereby reducing investment and other interest-sensitive expenditures. A reduced investment implies a slow growth. It is devastating since China's economy needs to grow at a high speed to create jobs for workers laid off from the restructuring of State-owned enterprises.

Deflation also has the negative effect of delaying consumption. Many Chinese people expect lower prices in goods and services and therefore wait to make a purchase. This can create a dangerous deflationary spiral: Weak demand might lead to more downward pressure on average prices, resulting in further spending delays (Schlevogt 1999).

What happened to the monetary policies?

There has been a clear trend of declining of money supplies in recent years reflecting a weakening of domestic demand for money. The nominal increases in money supplies (M2) from 1995 to 1998 were 29.5, 25.3, 17.3 and 15.3 per cent respectively. It increased 17.8 and 17.7 per cent in the first two quarters in 1999 respectively.

Why the monetary policies did not work effectively?

(1) When prices are falling, cutting nominal interest rates cannot lower real interest enough for the reductions to have stimulating effect on borrowing and investment. In case of China, for example, the falling price level makes the real interest rate at around 6 per cent.

(2) The hardening budget constraints of the commercial banks in recent years have made them very cautious in lending particularly refrained them from making loans to those inefficient enterprises.

(3) There is a mismatch between the financial (lending) structure and the structure of the real economy. The former now consists of both formal and informal systems and the latter consists of both the state and non-state sectors. While the non-state sector has already accounted for a large proportion of the economy, the dominant formal financial sector is still making loans predominantly to the state sector. The informal financial sector has been suppressed and unable to provide sufficient funds to the most dynamic sector of the economy—the non-state sector especially the private sector.

(4) Further reductions in interest rates will be inconsistent with the current policy of holding the RMB exchange rate unchanged since the RMB deposit rates are already lower than the US dollar rates.

Fernald and Babson (1999).
(5) There are time lags associated with monetary policies. It takes approximately one year for an interest rate cut to have an impact on output.

**Constraints to the implementation of the fiscal policy**

There are also some constraints to the implementation of the fiscal policy.

(1) A declining share of the central government’s revenue in total GDP (a fall from 26.7 per cent in 1979 to 11.5 per cent in 1997) imposes ultimate constraints to the expansionary fiscal policy. The current rates of increase in the central government’s budget deficits are not sustainable.

(2) There is a potential risk of fiscal crisis even though the current deficit/GDP ratio is still within the safe range.

(3) The effectiveness of the fiscal expansion has been, to a certain extent, offset by the increases in taxation revenues collected from both households and productive enterprises.

**Conclusions**

China has the potential to grow in the future, but the key to realise such potential lies at the success of its reform particularly in relation to the state-owned sector including state-owned banks. Equally important is to find ways of reviving the investment and growth of the non-state sector providing the opportunities for transferring resources out of the inefficient state-owned sector into the most dynamic non-state sector. A smooth process of such transformation will ensure the social stability and the dynamic gains obtained from such a massive scale resource reallocation will provide a sound basis for a more sustainable growth of the Chinese economy in the future.

**References**
