

Deflation: time to change the medicine

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Both inflation and deflation are bad. They variously rob depositors and borrowers and distort investment and consumption. But which is worse? Asked to choose between China's 1994 inflation and today's deflation, this economist would take the deflation every time.

In 1994, China's economy was growing as fast as 12.6% with the consumer price index at 24%. Today the growth rate is 7% and deflation is between 1% and 2%. In 1994, borrowers – mainly state-owned enterprises – were stealing money on a massive scale from China's depositors (the "inflation tax"). Today, depositors are getting a small "free gift" from borrowers (a "deflation subsidy"). For me, China's growth and price statistics show apparent improvement in the performance of the Chinese economy since 1994. Scholars and policy-makers in China should be much more relaxed than six years ago about China's macro-economic condition.

However, this is only my view, an outsider's perspective not yet widely shared by China's scholars and policy-makers. The insiders worry about today's deflation as much if not more as they did about China's inflation six years ago. Anyone who has been to an economic conference or seminar in China in the last six months (or who is about to go to one), will be familiar with the debate about how to deal with deflation.

Differing deflations

What is special about China's deflation? Few in the debates ask this question yet it is the key for making good policy. Deflation is commonly related to the experiences of the Great Depression in the US and other Western economies during the 1930s, as well as the economic slowdown in Japan in the last decade, and the sharp decline in Hong Kong since the Asian financial crisis in 1997. In each of these cases of deflation, general prices for goods, services and assets declined continuously and the economic growth rate was either negative or close to zero. China's recent experience of quite high economic growth with a low rate of deflation is unique.

In the case of the Great Depression, a credit crunch explained much of the deflation and the policy to deal with this was to increase money supply. Is China's deflation also caused by a credit crunch? Could China eliminate deflation simply by increasing money supply? Many believe the answer is yes. But why? China's efforts in reforming the state-owned banks have tightened up lending to inefficient state-owned enterprises; that was the key to bringing down inflation. No one, including the government, would suggest policies to reverse the tightening of lending to the inefficient SOEs.

On the other hand, the state banks either do not want or do not know how to lend to private enterprises. The managers of the state banks have figured out that lending to private enterprises is a no-win game. If you make a bad loan, everyone thinks you have taken a bribe. Equally it is difficult to make a good loan in current conditions and you wonder whether the effort is worthwhile for the meagre (and fixed) salary you receive. Since the majority of loans are still handled by state banks, if they are not lending then reductions in interest rates (for one-year loans from 8.6% at the end of

How bad is a little deflation?

Why money may not be the answer

1997 to 5.8% at the end of last year) and the growth of money supply (more than 15% annually since 1997 when measured by M2) do not help to expand credit and investment, especially credit and investment for the private sector.

A loose monetary policy, although necessary, is not effective in dealing with deflation in China because of the poor responsiveness of the banking system to changes in monetary policy. The same logic applies to China's expansionary fiscal policy, which is also failing to stimulate private investment. To some extent the situation is similar to recent experience in Japan, a country which fell in to a so-called liquidity trap. People hold cash or deposits and refuse to invest because they do not see good investment opportunities.

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*Unlike Japan, China is
 combining deflation with
 growth*

Nonetheless, I think China is in a much better position than Japan. The fact that the Chinese economy is still growing at more than 7% a year shows investment opportunities exist. Reform and privatisation of the state banks would certainly make the banking system more responsive and make monetary and fiscal policy more effective. But that will take some time.

What can China do now? Most obviously it can open up to foreign and private banks. Let these banks make quality loans to private enterprises. If foreign banks do not have sufficient deposits, let them borrow from state banks directly or through the inter-bank market. State banks are good at taking deposits, given their huge branch networks. Foreign and private banks are good at making quality loans; they are better than the state banks at making profits and controlling risk. True, reform on lending by foreign banks has been going on in Shanghai and Shenzhen. But progress is slow. Foreign banks make less than 3% of total renminbi loans in China. This reform should be accelerated.

Consumption conundrums

What else can China do to stop deflation? Many economists and policy-makers focus on consumption. Some want to promote markets in housing and automobiles for urban residents. Others see potential markets for televisions, refrigerators, washing machines and other consumer goods in rural areas – if only the government would provide electricity, running water and satellite dishes to the hundreds of millions of rural households.

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*No spending when you're
 nervous*

Like monetary and fiscal stimuli, these consumption policies, although helpful to a certain degree, would not have much impact on deflation in China. Why? Because consumption is a private affair, and households are not spending without good reason. Economists and policy-makers will not be able to out-smart consumers if their underlying income prospects are making them too nervous. It is the uncertainty, and for many the decline, of their expected income in the wake of recent reforms and a slowing economy that is the key factor behind weak consumption.

Ten years ago, a worker in a state-owned enterprise could calculate quite accurately how much money and benefits he would receive during his lifetime and also how his income was going to be distributed over time. He would spend half of his wages on food and use two years of savings to buy a television set while keeping only a few months of savings in his bank account. Today, most workers in state-owned enterprises worry about their own jobs and their children's jobs. Few have any reasonable idea about their lifetime income. No wonder people are cautious.

Is there an exchange rate answer?

If monetary, fiscal, and consumption policies are all limited in dealing with deflation, why not try exchange rate policy? Recently, the central bank governor re-affirmed China's policy of maintaining a stable exchange rate. Nonetheless, many people in and outside the country still speculate about a devaluation of the renminbi. Some even argue that the root of China's deflation problem is its fixed exchange rate regime – the same criticism levelled at Hong Kong after the Asian financial crisis. The Hong-Kong-dollar-to-US-dollar peg means the only way for Hong Kong to improve its competitiveness if other economies devalue their currencies is to allow prices of products, services and assets to fall – in other words to deflate.

Most economists would agree that a government-engineered devaluation, if implemented smoothly, could eliminate deflation. However, this has to be weighed against many negative impacts of devaluation, including the possibility of triggering financial panic and capital flight.

A government-engineered devaluation would transfer (or steal) wealth from depositors and hand it to borrowers just like inflation. This is particularly serious for economies with significant foreign trade and investment such as Hong Kong and, to a lesser extent, China. Devaluation would also increase the burden of foreign debt and the costs of imports, both of which are significant for the economies of Hong Kong and China. For China, a large government-engineered devaluation when the country enjoys a trade surplus and rising foreign exchange reserves would likely shake up the Asian currency markets again and create new uncertainties for Asia's recovery. On the other hand, the benefits of devaluation to China's exports might be very limited since the bottleneck for exports is not much related to pricing.

My view is that an exchange rate assault on deflation would be premature at this point. However, the case for a devaluation of the renminbi becomes stronger the longer deflation goes on. In the meantime, the Chinese government would do well to concentrate on structural reforms – such as those in the banking sector – which attack the roots of the problem rather than fiscal and monetary measures which address only the symptoms.

A devaluation might help – if it weren't for the other problems likely to follow in its wake