China Deflates Despite Growth

REDUCTION IN THE overall price level of goods and services—or deflation—has not typified America's economic landscape since the Great Depression. But it has lately become an important and seemingly persistent phenomenon in China, even though the nation's economy continues to grow.

During the early 1990s, inflation accelerated in China. Expansions in industrial capacity became overexpansions. By the mid-1990s, the Chinese government had begun to respond with an austerity program that lowered inflation from more than 20 percent in 1994 to 7 percent by the end of 1996. By the end of 1997, however, the country had moved from slowing inflation to absolute deflation. China's consumer price index for March 1999 was down 1.8 percent, and its retail price index was down 3.2 percent from a year earlier.

Mainly because of past overexpansions, China still has an estimated 40 percent excess manufacturing capacity despite falling prices. Not only have currency devaluations in other Asian countries made export competition more difficult for China, but import competition appears to have intensified. Still wary of purely market solutions to economic problems, China's government has begun to impose narrow price controls, assessing penalties, for example, on television manufacturers who sell below some measures of their costs.

Meanwhile, consumer spending, which accounts for about half of China's gross domestic product (GDP), has been edging down as unemployment moves up—again in the face of measured economic growth. China's ailing state-owned enterprises have been permitted to carry out mass layoffs. In the absence nowadays of any structured social safety net, laid-off workers have little to fall back on except their personal savings. The number of layoffs in urban state-owned enterprises is estimated to reach 7 million for 1999, a million more than last year.

This number may seem small in a country whose population exceeds 1.2 billion; but considering that the urban population is only 30 percent of the total population, that the average labor force participation rate is 60 percent and that the state-owned enterprises employ 60 percent of urban workers, the layoffs' impact will be significant. In addition, more than 100 million people in the hinterland are unemployed. And, in the past, the state bore most of the cost of education, medical care and housing for state workers. Now the burden is being shifted to the individual, further sapping consumer spending power. Russian-style paycheck slowdowns also have begun to lower consumer demand. Beijing's Capital Iron and Steel, which employs 230,000 people, has not paid its workers in more than two months.

In part, China's deflation may be seen as a response to other Asian nations' currency devaluations and associated crises of the last two years. While China has declared that it will not devalue its currency, the nation could adjust to foreign competition indirectly through price deflation. Argentina has allowed its economy to make similar substitutions of deflation for devaluation in the present decade. Despite reductions in prices, foreign demand for Chinese output has begun to slip. In the first quarter of 1999, exports dropped 7.9 percent from a year earlier for the first decline in 15 years, and the trade surplus dropped 59.8 percent. But China did not fall into the red.

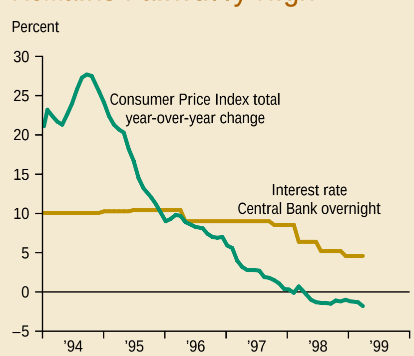
In an effort to strengthen the economy, the government has been attempting to stimulate consumer expenditures by easing credit. However, despite repeated interest rate cuts, consumer demand remains weak. Moreover, with falling prices and positive nominal interest rates, China's real interest rates are still in the 7-percent range (*Chart 1*).

In addition, the government is trying to reflate the economy through a national program for infrastructure construction that began with a $12.5 billion bond issue last August. Largely due to the effect of this infrastructure program and an equivalent amount in mandated lending by state banks, industrial output rose 8.9 percent for 1998 and shot up 10.1 percent in the first quarter of 1999 compared with the same period last year. GDP grew 8.3 percent in the first quarter year over year. At $860 per person, China's output per capita is less than one-fourth Mexico's and is slightly less than that of Bolivia.

China still faces many economic and policy problems. The ability to pursue its fiscally driven infrastructure package is limited by the central government's relatively weak financial condition, which is marked by a high level of national debt service charges. The country suffers serious overcapacity in its unprofitable state sectors—the sectors other nations are rapidly privatizing. Unemployment is on the rise. The social safety net is still in its infancy. But despite these problems and a deflation that analysts typically associate with output decline, China persists in growing.

—Dong Fu

Chart 1
Real Interest Rate in China Remains Painfully High



SOURCES: *Quarterly Statistical Bulletin*, People's Bank of China; *China Monthly Statistics*, China Statistical Information and Consultancy Service Center.