Opinion **Global Insight**

While the world fights inflation, China's problem is deflation

Zero-Covid policy has left the world's second-largest economy out of sync with its peers

THOMAS HALE

Residential buildings under construction in Shanghai. The property market has seen waves of defaults among developers and a fall in transactions © Aly Song/Reuters

Thomas Hale YESTERDAY

From a property crisis to strict Covid controls to its lowest growth target in three decades, the Chinese economy is facing many problems. But inflation is not among them.

Data released last week showed that consumer prices added 2.1 per cent year on year in October — the kind of moderated gain that western policymakers can only dream of. Producer prices, a measure of prices for goods as they leave factory gates, entered negative territory for the first time since 2020.

There are caveats. Producer prices fell against a high base last year, China's National Bureau of Statistics noted, with prices in the metals and coal mining industry falling significantly. But without food and energy, core inflation was 0.6 per cent: consumer prices heavily rely on pork, which makes up a tenth of the basket and whose price rose 52 per cent in October after swine fever-related decimations of herds.

While other big economies have been struggling to tame inflation during the pandemic, China, where Covid-19 still dominates a languid economy and authorities continue to enforce lockdowns and mass testing, is grappling with the threat of deflation. As well as encouraging consumers to delay purchases in the hope of prices falling further, deflation is a problem for borrowers because it increases the real value of their debts, making them harder to repay compared with present-day incomes.

"Deflation is worse than inflation in China for sure because it drives up the cost of borrowing for both consumers and corporates," said Dan Wang, chief China economist at Hang Seng Bank China. Debts for corporates and local governments were still the country's "highest financial risks", she added.

The risk of high debt in China is encapsulated in its property crisis, which has in the past year seen waves of defaults across highly leveraged real estate developers and a fall in transactions. Deflation stood to increase pressure on households' mortgage payments, Wang added, and a slower property market was indirectly putting "downward pressure" on consumption.

"If people don't buy an apartment, there will be pretty much no durable goods consumption."

The future of inflation in China is bound up with its zero-Covid policies. Although cases this week reached a six-month high, the government's approach has for now meant that only a tiny fraction of the population has been infected almost three years after it emerged. The government slightly eased rules for inbound quarantine and contact tracing last week, but the timeline for any reopening remains uncertain.

Erin Xin, an economist for greater China at HSBC, notes that the government has been "fine tuning" its Covid policies and that a potential "gradual consumption recovery" could help with the demand side of inflation.

One of the few signs of inflation in China is food prices in big cities, which Wang suggests may be a result of the higher cost of transporting food between provinces, given strict travel restrictions under zero-Covid.

Otherwise, she notes household savings have been rising rapidly this year. This has a faint echo of what happened in western economies, which in 2020 also grappled with the threat of deflation and saw higher savings, before prices began to rise sharply in 2021.

In China, the government has over the past year sought to gently ease monetary policy rather than unleashing vast stimulus of the kind seen in the US and Europe. But Beijing may be forced to provide such stimulus to its local governments, which shoulder many of the costs for zero-Covid and can no longer rely on land sales to developers.

A rapid reopening in China combined with a shift in the government's approach to stimulus could swing the pendulum on inflation, with profound implications for the world given the country's demand for energy and its production of goods.

But for now, this is not a central scenario. China, under its Covid policy framework, is edging closer to deflation. For the rest of the world, this might provide an unexpected source of relief.