

Excerpt from “Deflation: Determinants, Risks, and Policy Options—Findings of an Interdepartmental Task Force”, Approved by Kenneth Rogoff, April 30, 2003

The full text is available at www.imf.org/external/pubs/ft/def/2003/eng/043003.htm

China

In China, the mild deflation is linked mostly to *transitory* as well as *longer-term supply-related factors*. Transitory factors include lower commodity prices, WTO-related tariff cuts, and restraint in administrative price increases stemming from social concerns. Some of the longer-term factors include productivity gains from strong investment, state-owned enterprise (SOE) reform, and adoption of new technologies—supported by robust increase in foreign direct investment—and stronger market orientation. A less benign structural source of deflation is large excess capacity in some sectors, owing to the loss-making operations of some state-owned enterprises. Large surplus labor in rural areas is also acting to put downward pressure on costs and prices.

Risks of persistent deflation are small. Given the strong pace of activity, deflationary pressures should continue to ease over the course of this year as transitory factors fade (see Box 4.4). Policies are also supportive; the monetary stance is accommodative, with room left to maneuver, and fiscal policy has been expansionary. The recent depreciation of the U.S. dollar has also led to an effective depreciation of the yuan. Expectations of continued strong economic growth are reflected in buoyant private demand and increasing real estate prices. However, some longer-term factors, including continued expansion in capacity and excess labor could continue to press prices down and prevent Balassa-Samuelson effects from taking hold. Further deflationary pressures arising from excess capacity could build if loss-making operations of state-owned enterprises are not closed down in a timely manner. There is also a risk that if the SARS epidemic is not contained quickly, its adverse impact on private spending could create deflationary pressures from the demand side.

China’s Trade Share and Transmission of Deflation

Supply-side factors in China are creating downward price pressures in a number of industrial sectors globally.¹ Cheap and abundant labor and large production capacity have helped China in the last 10 years gain market share in the United States and Japan. By 2002, its share in total U.S. imports reached 11 percent, overtaking Japan as the largest exporter to the United States; its share in total Japanese imports reached 18 percent during the same period (Charts 13a-b). Although *actual* imports from China account for a small proportion of consumption in most countries (in the U.S. imports from China account for 1 percent of GDP), the *potential* imports appear to be a much larger. However, cheaper imports entail terms of trade gains which, through their positive effects on aggregate

¹ In addition to light manufactures including clothing and textiles, and footwear, these include an increasing range of high technology products, such as, digital cameras and camcorders, televisions, electronic and personal computers.

income and demand growth, could mute the direct deflationary effects in individual sectors.

Apart from the direct impact on prices, there may be an indirect impact through activity on some competitor economies. The magnitude of the impact is illustrated by the increase in China's share in the Asian region's total exports to the world from under 15 percent to close to 30 percent over the last ten years. However, this change in market share is not fully at the expense of other countries: there has been a sharp increase in intra-regional trade, with a significant increase in imports by China from many of the regional economies which is likely to help offset the adverse impact on activity and prices in these economies.²

Despite the increase in trade shares, there is insufficient evidence that China is exporting deflation, although there are marked price pressures in particular sectors. A Vector Auto Regression (VAR) analysis on the linkage between prices in China and major trading partners suggests that price fluctuations in China have a moderate impact in a few Asian countries, and discernable but small impact on prices in the United States and Japan (Chart 14). In the region, prices in Taiwan Province of China and Hong Kong SAR are affected the most, owing to their strong links to mainland China, and the price changes appear to be passed through fully in about 2 years. There is some evidence of transmission to Singapore, but in a more limited way. Prices in other economies in the region—Malaysia, Thailand, India, and Indonesia—on the other hand, appear not to be affected at all by changes in prices in China.

Nonetheless, the transmission effects appear to be growing over time. When a similar VAR analysis is undertaken for the late 1970s, the impulse response functions imply weaker links than the ones identified over 1993–2002. This change is not surprising because Chinese external trade began to pick up around 1993, once the government initiatives to increase exports started to take hold. Nonetheless, it does suggest that with the expected continued integration of China into the global economy, the transmission effects could increase further.

² Indeed, over the past three years, the growth in total imports by China has outpaced the growth in its exports.

Box 4.4: China—Recent Deflation Episodes

Prices: The recent deflation episode is the second in the last four years. After peaking at over 25 percent in 1994, CPI inflation declined steadily as macroeconomic policies were tightened to cool the overheated economy. Prices began to fall in 1998 as the economy slowed further in the wake of the Asian crisis, and this lasted until 2000. Deflation resurfaced during late 2001–end-2002, peaking in April 2002 at 1.3 percent. Falling goods prices more than accounted for this decline, as most service prices continued to increase moderately. During the same period, PPI declined also, with PPI deflation exceeding 4 percent in early 2002, but this decline ended by December 2002.

Staff analysis suggests that in the second deflationary episode, both transitory and longer-term supply shocks were at play. In the short-run, lower commodity prices and WTO-related tariff cuts put downward pressure on prices, and led to a mild deflation. Longer-term factors include: productivity gains from reforms to State-Owned Enterprises (SOEs), adoption of new technologies, and greater competition from more open markets. Among the less benign factors is high excess capacity in some sectors owing to difficulties in closing some SOEs.

Monetary and Credit Conditions: Strong foreign exchange inflows pushed the M2 growth rate to 18 ½ percent (year-on-year) in the first quarter of 2003. While overall lending was strong, lending by large state commercial banks remained cautious.

Policy Impediments: Despite improvements, shortcomings remain in China's institutional framework, which reduce the effectiveness of indirect monetary instruments, and China faces medium-term fiscal pressures. Monetary policy faces significant headwinds from an underdeveloped interbank market. Furthermore, while fiscal policy was geared to support domestic demand in 2002, fiscal consolidation is needed in the medium term, in view of the large quasi-fiscal liabilities in the banking system and future costs of pension reform, infrastructure, and other social needs.

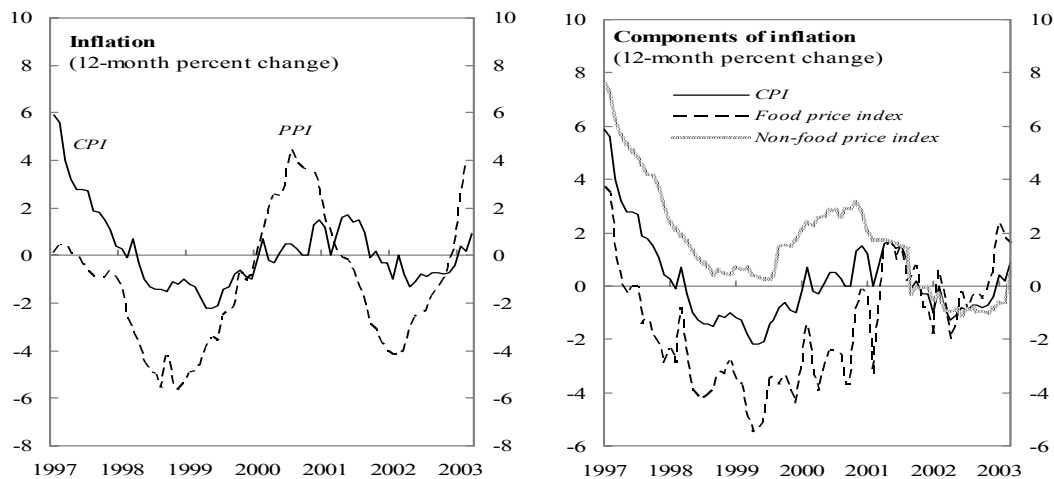


Chart 13a. China's Trade Shares

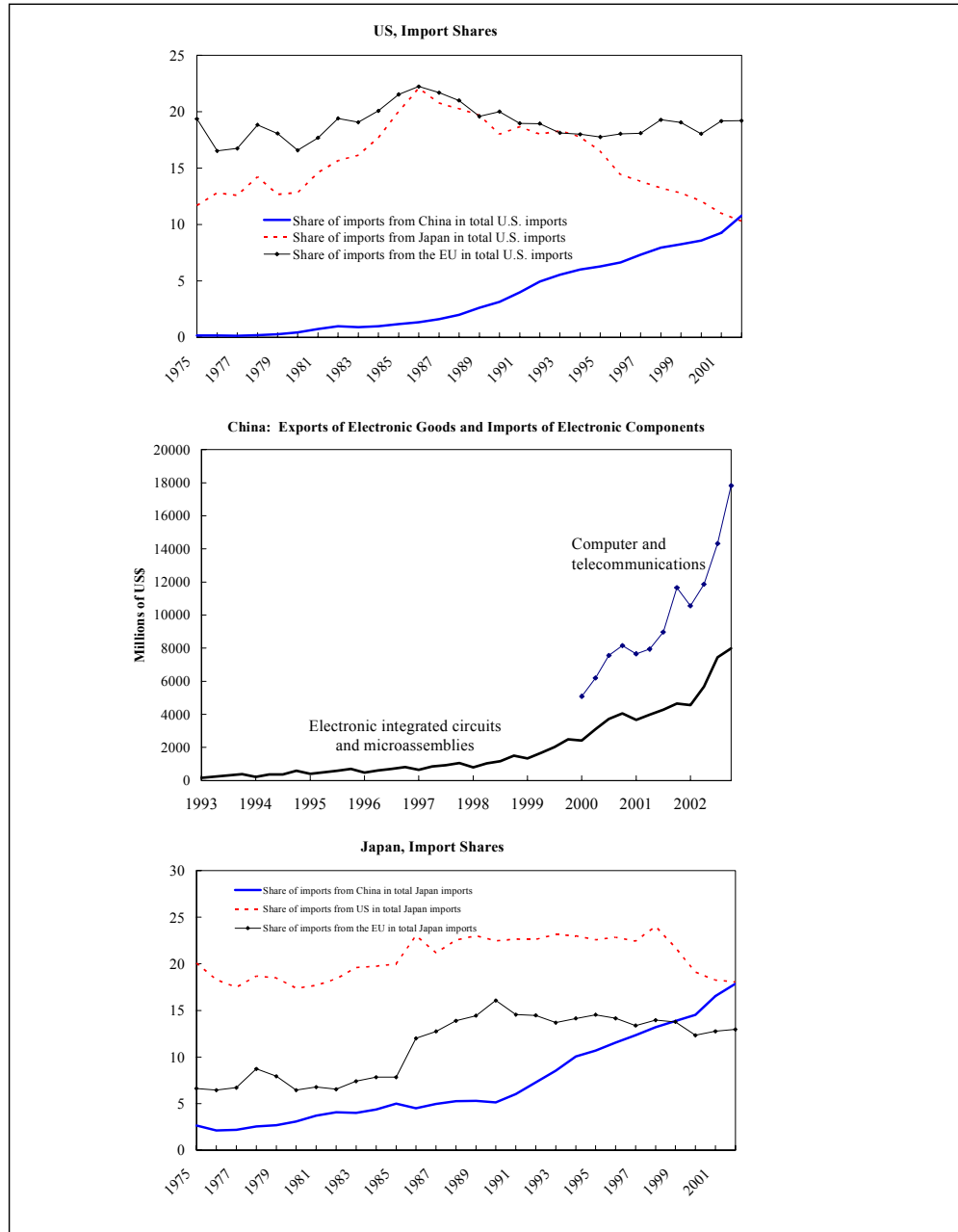


Chart 13b. China-Regional and Global Trade

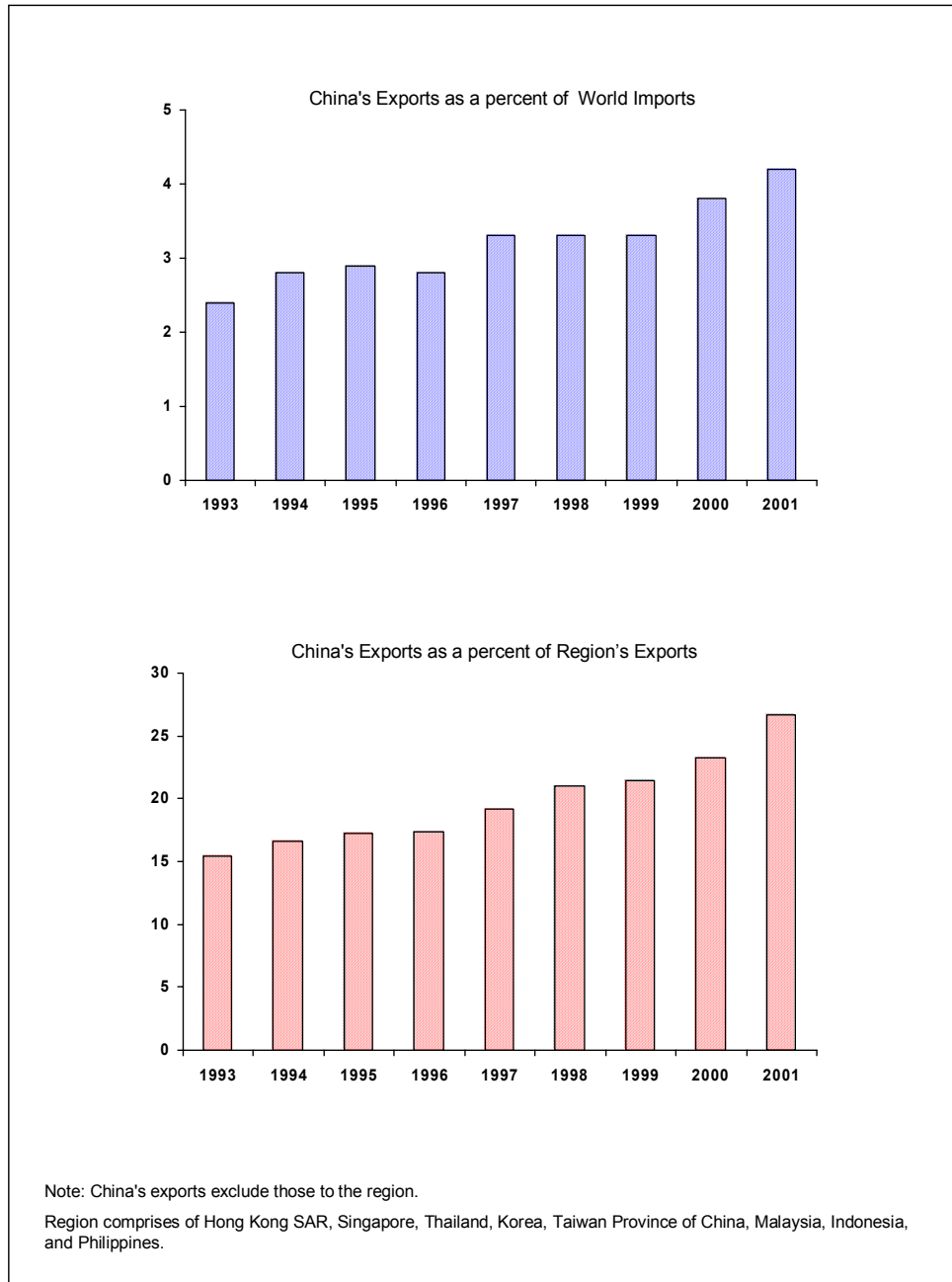


Chart 14. China-Transmission of Deflation

(Change in Inflation in Partner Countries in Response to a 0.7 Percentage Point (One Standard Deviation) Increase in Inflation in China)

