Thornhill Capital

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Will China Follow Japan into Deflation?

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Japan

It wasn't long ago that Japan was the world's economic juggernaut. In the 1960s and 1970s Japan experienced substantial economic growth based upon a rapid expansion of heavy manufacturing in areas such as automobiles, steel, shipbuilding, chemicals, and electronics. Throughout the 1970s it had the world's second largest Gross National Product (GNP), just behind that of the United States, and in 1990 it ranked first among industrialized nations in per capital GNP. [2]

As Japan's economy continued to expand in the 1970s and 1980s, except for a mild-economic slump in the mid 1980s, their economic interests shifted from agriculture, manufacturing, and mining to an information based economy focused on telecommunications, computers, and processing.[2] During this time real estate became extremely over-valued. In 1989, prices in Tokyo's Ginza district reached $1.5 million USD per square meter. Real estate prices were spiraling out of control. Then, in 1992, Japan entered a recessionary and deflationary period, a period where there was a decrease in the price of goods and services due to the inflation rate falling below 0%.

Some would expect deflation to be a good thing, as prices are lower. But deflation is actually bad, as the value of money erodes and consumers receive less and less value per monetary unit. The production of goods and services for businesses also become less profitable and brings businesses a lower overall return. Companies in deflationary periods tend to buy less as they don't know how low the prices from their suppliers will eventually become, as well as how far the price of their own products will actually fall. [9]

The Bank of Japan (BOJ), and the Japanese government, tried to eliminate deflation by lowering interest rates to near zero, but this effort failed. Increasingly, the government realized that their export-led growth model had to be modified to conform to current world market conditions. But these efforts had little effect. In 2008 the Japanese Central Bank still had the lowest interest rates in the developed world, and yet deflation still had not been eliminated.[2,3] Japan's current Prime Minister, Yoshihiko Noda, has vowed to take his country out of this prolonged period of deflation and back to an inflationary growth model. In accomplishing this, Prime Minister Noda is working largely through the BOJ and has set a national goal of a 1% annual inflation rate. The BOJ, for its part, in an attempt to establish inflation, is increasing its purchase of government bonds to try and create an economic and fiscal stimulus. Even given these efforts, the BOJ doesn't believe inflation will return until 2014.[12]

China

The rapid growth in the Chinese economy in many ways mirrors the growth experienced by Japan. It wasn't that long ago that most people felt the Chinese economy was overheating and that inflation had gotten out of control.[4] Even though the Chinese government has, in recent years, been transforming the country from an export-led growth model to an investment-infrastructure approach, many local governments are still not on-board. They continue to cling to manufacturing and exports as the Central Government tries to move towards a consumer-led model where the government plays a smaller role. In a consumer-led model, services play a dominant role to manufacturing.[1]

In this transitional shift to a consumer-led model, banks have been substantially impacted and become less profitable. In previous years, with the meteoric growth in manufacturing, the number of bank loans soared. Between 2006 and 2009, according to International Monetary Fund's Zhu Min, China's loans doubled to almost 200% of Gross Domestic Product (GDP). This is in stark contrast to the situation today where the demand for money has decreased substantially. In May 2012, for example, China's big four banks lent 253 billion yuan, yet only lent 190 billion yuan in June 2012.[3]

One explanation given by the government is that this transitional economic growth has slowed the economy to 6.8% from a rate of 9.2% last year. Export growth and fixed asset investments have also slowed. Output now exceeds sales in a number of industries with a resulting build-up in inventories. The country's industrial sectors are under-utilized and have substantial over-capacity. UBS AG has predicted that the whole-year's GDP growth would be 7.5%, taking into account weakened exports.[11]

With the rapid increase in inventories, according to Albert Edwards from Societe Generale, there's a danger that a flood of excess goods will be unleashed onto the global markets. If this occurs, it could increase deflationary pressures in other areas of the globe. In addition, Chinese consumer prices have been falling for the past three months and producer prices have been falling for the past four months. While deflation is localized, and not yet economy wide, China's aging population, along with its excess industrial capacity, could provide the additional fuel necessary to move the country closer to deflation.[3]

Many expect the government to induce a large stimulus program similar to the $586 billion USD package introduced in 2008 - 2009. [13] This involved funding for both infrastructure and transport, in addition to easing restrictions for first time home buyers. However, the government has so far deferred from such an aggressive stimulus package, partly as a result of the waste and bad debt encountered in the prior program. Instead, its initial response was a more modest investment of $157.48 billion USD, in September of 2012, in infrastructure projects. Furthermore, today's circumstances are different than in 2009. The current Eurozone crisis, along with decreased purchasing from other economically affected world markets, has meant that the demand for Chinese goods has decreased. The only area where the government is likely to react quickly and decisively is unemployment which they directly equate to homeland stability. If employment increases, then the government is likely to act in a more aggressive manner. Realizing that inflation is disappearing and the economy could enter a period of deflation, such as that experienced by Japan, the government is currently watching the various economic indicators before committing additional capital.[1]

There are many, including the World Bank, who believes that China could avoid deflation because of its ability to both cut taxes and boost spending, options not enjoyed by every country. In addition, what many believe to be deflation in China may actually be disinflation. Disinflation is a slow-down in the inflation rate, but is not considered deflation. This was recently exemplified in July of 2012 when the Consumer Price Index (CPI) growth rate, a key gage of inflation, grew to 1.8% and remained above deflationary territory.[11] But to many it felt as if the country had entered into a period of deflation as the country fell from its previous lofty perch of 6.5% in July of 2011, a 37 month high.[14] According to Credit Suisse's China economist Dong Tao, corporations in this economic environment will continue to lose their pricing power as corporate profit margins get squeezed and there is a corresponding decrease in cash flow.

However, consumer prices in China have been known to move sharply and quickly. For example, in February of 2008 China's CPI rose to 8.7% before declining, in the global financial crisis, and recording negative readings for nine consecutive months between February and October 2009.[5] Understanding the reasons for these fluctuations is important when we're evaluating the potential for deflation. In the case of the country's growth in the CPI, food prices account for nearly one-third of the prices used to calculate China's CPI and, during the peak supply season, rain and flooding pushed vegetable prices up by 8% and therefore was the driving force for CPI growth. In addition, according to the National Bureau of Statistics (NBS), during this same period of time pork prices fell 18.7%, dragging down CPI growth by 0.71%. As agricultural production stabilizes, and costs increase, so should the CPI.[14]

Still, many feel that, unlike Japan, China is not likely to enter into a period of deflation. According to Nick Lardy, Chief China specialist at the Peterson Institute of International Economics, deflation in China is not an imminent risk. Instead, what concerns Lardy is China's housing market. Since the property business is 15% of the GDP, the impact of housing tends to be enormous as property impacts 40% of the economy. As one in five households in China owns a second property, this speculative fever could come back and impact the economy. But most feel that the real estate sector probably won't have a significant impact on the economy for at least two years. Instead, the final result is most likely to be an economic slowdown with a reduction in GDP growth.[6] Moreover, Nomura's Zhang Zhiwei expects the People's Bank of China, which has cut the reserve ratio twice in the last two months, to cut the rates twice more before year's end. This would reduce the interest paid by corporations on bank loans. If you couple this with public investment, there should be a discernible increase in industrial production.[7] In addition, lower bank rates will help companies maintain their pricing power. Industries most affected would include consumer staples as well as those that benefit from operational leverage on funding costs. Companies with high working capital requirements would also be positively affected by lower bank rates.[8]

Indeed, a great many experts feel that, although there's a slowdown coming, there's no Armageddon on the horizon for the world's number two economy. After many years of historic growth, most expect, and are not surprised by, an economic stabilization at a more sustainable growth rate. Here's a list from Reuters' Nick Edwards and Kevin Yao, as well as from Global Economic Intersection's John Lounsbury, as to why many experts feel that China will slow down and not go into deflation:[10,17]

- The CPI is positive;
- Food inflation is still very high at 6.4%, although a lower agricultural Producer Price Index (PPI), a main gage of inflation at the wholesale level, could result in lower food inflation in the coming months;
- Interest rates are still high by global standards, so there is room for monetary price adjustment;
- GDP growth was 7.6% in Q2, although a growth reduction is needed in order to balance an overheated economy;
- Fixed asset investment, a key driver for economic expansion in China for the past decade is at 20.4% versus 20.1% forecast in the benchmark Reuters poll.

This is down from 25% as the government wants to reduce this contribution to growth as it rebalances the economy;

- Retail sales in June 2012 were up 13.7% from a year ago versus May's 13.8%.

The Chinese economy has historically shown a remarkable tendency to adapt to current world market conditions. Moreover, its historical growth has been nothing short of phenomenal. From 2000 – 2010, the Chinese economy grew at average rate of 10.4%, and it's expected to average 8% in the decade from 2010 – 2020. According to new research from Barclays, their economy will further slow to an annualized rate of 6% the following decade, 2020 – 2030 as the government exercises more caution in letting the country's expansion settle to a new growth rate.[19] Still, China is on track to become the world's largest economy around 2023, depending on which economic projections one reads.[16]

In addition, the economy seems ready to bounce back quickly as the growth in the money supply is high while the development of the economy is slowing. This often leads to excess liquidity. In addition, in the first six months of 2012, the nation's broad money supply, M2, grew at 13.6%, according to the NBS. This would indicate that the economy is not headed for a deflationary period, but is still growing, but at a slower rate, with a decrease in industrial production and a corresponding decline in profits that was to be expected. [11]

Not everything is in China's control as declining overseas demand, a decrease in government support policies, and increased property (real estate) restrictions, have had an impact on the industrial sector. Couple this with the increased cost of labor, which leads to increased global competitiveness, and these are the challenges facing modern-day China as it transforms itself from a manufacturing and export, to a consumer-led economy.[11]

In addition to the government's infrastructure investment and two recent interest rate cuts, the government has liberalized banking rules and allowed banks to discount borrowing costs by a further 30%. Unlike the sudden collapse in 2008, the current economic slowdown is more gradual and any major government policy changes may lead to an escalation in property sales and prices, something the government has worked hard for two years to

control.

Reuters, in their April consensus poll, projected China's 2012 growth rate would be 8.4%. The Asian Development Bank, cut growth expectations for 2012, but nevertheless forecasted in July 2012 that China's full year growth for 2012 would be 8.2%, slightly higher than the 8% forecast by the International Monetary Fund. The Chinese government has pared its original growth target from 8%, a goal they've had in place since 2005, to 7.5%. [17,19]

China is also having local and provincial governments come in line with national goals. According to Michael Buchanan, chief Asia-Pacific economist at Goldman Sachs Group Inc. in Hong Kong: [18]

The growth target indicates the lowest level that the government is comfortable with and is also a signal to local officials that they shouldn't solely focus on the rate of expansion. China's trend growth rate is coming down but it's still higher than this – more like around 9 percent.

China is in the process of transforming itself from reliance on exports and capital spending in favor of consumption. In a state-of-the-nation speech given by Premier Wen Jiabao, the Premier indicated that the nation needed to shift to a more sustainable and efficient economic model and achieve higher-quality development over a longer period of time. In addition, he reiterated that the government will maintain a proactive fiscal and a prudent monetary policy. The government's proactive role in fiscal and monetary policy can best be seen by their five interest-rate increases from October 2010 to July 2011, aimed at slowing inflation, and later followed by their 2012 lowering of banks' reserve requirements for the second time in three months to boost lending and sustain growth. [18]

Unlike Japan, China has addressed this issue early enough to avoid entering a deflationary period. No matter what the current projections indicate, it would seem that with a stabilization of economic growth, most economists believe that the Chinese economy will stabilize at a more sustainable rate going forward and that the likelihood of deflation will disappear.[11,17] Unlike Japan, China has more economic tools at its disposal, seems better able to address current economic issues and take effective corrective actions, and ultimately achieve a sustainable level of growth as it proceeds towards becoming the world's number one economy.

Endnotes:

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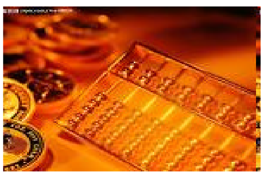

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