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Prices Won't Stop Falling in China, and Beijing Is Grasping for Solutions

Companies are pumping out goods amid falling prices, creating vicious cycle that is eroding confidence

By Hannah Miao Follow

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A potential trade war with the U.S. could worsen China's deflationary problem. PHOTO: KEVIN FRAYER/GETTY IMAGES

The country that invented paper is making way too much of it.

So Shandong Chenming Paper, one of China's biggest paper manufacturers, did what any company faced with overcapacity would do: It cut prices to unload more supply while it tried to ride out the storm.

Instead, its losses mounted. Last month, the company said it had racked up around $250 million in overdue debts. Creditors sued and some of the manufacturer's bank accounts were frozen, it said.

The papermaker's troubles are only the latest sign of the havoc caused by falling prices in China, as factories struggle to cope with overcapacity and weak demand.

Chinese leaders this week pledged to do more to stimulate the economy, including by cutting interest rates and boosting government borrowing. But pressure is building on Beijing to take even more forceful action to prevent a downward spiral of deflation that becomes self-reinforcing, potentially landing China in a longer-term recession.

Prices for goods leaving Chinese factories have fallen year-over-year for 26 consecutive months, dropping 2.5% in November from a year earlier, and there is little sign of them turning up again soon. China's gross domestic product deflator, a broader gauge of price levels across the economy, has been in negative territory for six consecutive quarters, the longest stretch since the late 1990s.

While there are signs that China's economy is regaining some momentum, prices so far remain subdued. PHOTO: HECTOR RETAMAL/AGENCE FRANCE-PRESSE/GETTY IMAGES

A potential new trade war with President-elect Donald Trump could worsen the problem, by making it harder for China to unload excess factory production on the U.S., leaving it with more goods it can't absorb at home.

The fear is that deflation is becoming ingrained in China. As falling prices sap profitability, companies could postpone investments or shed workers, leading more people to cut back on spending. Others might put off purchases because they think prices will drop even more.

“It becomes a vicious cycle,” said Penelope Prime, founding director of the China Research Center, an Atlanta-based think tank.

China’s consumer-price index is still above zero—but only barely, gaining just 0.2% in November from a year earlier, compared with a 2.7% increase in the U.S. The Chinese rate is well below the roughly 2% level that most central banks consider healthy for their economies.

Many economists are watching China’s producer-price inflation data—which captures factory-level prices—especially closely, given the country’s reliance on manufacturing as a driver of growth.

Chinese leaders have already taken a number of steps in recent months to put a floor under the economy, which has struggled with a real-estate market bust and rising debt loads in many cities. Authorities have cut interest rates, and last month, policymakers approved a $1.4 trillion debt swap plan in an effort to shore up local government finances.

This week, China's 24-man Politburo said it would implement more proactive fiscal policy and adopt a "moderately loose" monetary policy next year—the first introduction of such language since 2008. The leaders also vowed to boost domestic demand and stabilize the housing market, which some economists have said is needed to reignite inflation.

While there have been signs that China's economy is regaining some momentum, the policies so far don't seem to be putting a fire under prices. One reason is that the policies have mainly focused on fending off immediate financial risks rather than triggering a sustained increase in consumer spending.

Another is that Beijing has been extending loans and subsidies to Chinese factories. That supports growth, but it also exacerbates the problem of excess supply, adding to downward pressure on prices.

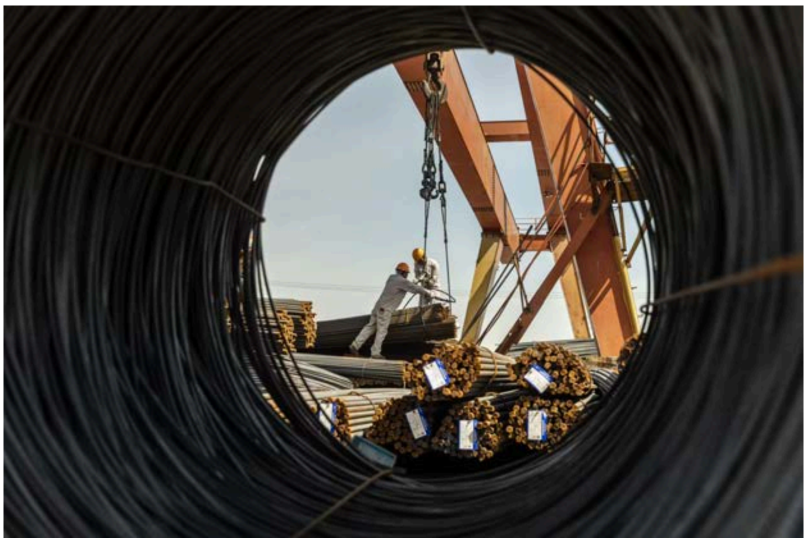
At Shandong Chenming Paper bosses wound up shutting down nearly three-quarters of the manufacturer's production capacity. The company didn't respond to a request for comment.

Other companies have kept cranking out more. China's output of paper and paperboard year to date through October is up about 10% from the same period last year, according to China's National Bureau of Statistics. Prices for paper products leaving Chinese factories have been dropping year-over-year since October 2022.

Other industries have followed a similar pattern. William Li, chief executive of Chinese electric-car company NIO, said on a call with analysts in September that makers of internal-combustion-engine vehicles in China have entered an "unsustainable cycle or a vicious cycle" of price cutting, hurting profits. Vehicle production in China continues to rise.

Some economists expect producer prices to continue in negative territory at least through next year, with Nomura expecting China’s producer-price index to be down 1.2% while Macquarie estimates a 1% fall in 2025. Bank of America and Goldman Sachs are forecasting producer prices to be flat in 2025.

The problem is that once expectations for lower prices become entrenched, it is hard to turn them around. Japan found that out the hard way in the 1990s when the bursting of real estate and stock market bubbles left consumers and businesses focused on paying down debt rather than spending or investing, even though policymakers cut interest rates to virtually zero. That led to about three decades of weak growth and persistent deflation. Unfavorable demographics didn’t help.



Prices for goods leaving Chinese factories have fallen year-over-year for 26 consecutive months.
PHOTO: QILAI SHEN/BLOOMBERG NEWS

Richard Koo, an economist at the research arm of Japanese investment bank Nomura Securities, coined the term “balance sheet recession” to describe what happened in Japan, and says China is facing one today.

In a sign of how seriously investors are viewing China’s deflation problem, 30-year Chinese bond yields recently slid below Japan’s for the first time since 2006, according to FactSet. Falling long-term bond yields, which move inversely to prices, signal that investors think China’s economy is shaky, leading them to seek the safety of bonds rather than investments such as stocks.

"The longer deflation lasts, it becomes entrenched into people's expectations about future economic prospects," said Eswar Prasad, professor of trade policy at Cornell University and a former head of the International Monetary Fund's China division. "It becomes harder and harder to use macroeconomic stimulus."

During past periods of deflation, China took more dramatic action. In the aftermath of the Asian financial crisis in the late 1990s, when producer prices fell for 31 months straight, China launched a painful process of reining in overcapacity. Under then-Premier Zhu Rongji, many state enterprises closed or downsized, leading to massive layoffs.

Factory-gate prices also fell for about four years straight between 2012 and 2016, spurred again by overproduction in products such as tires and solar panels. Chinese leaders shut down unneeded steel mills and other factories.

This time, Xi appears to be committed to boosting growth through more manufacturing. He views U.S.-style consumption-driven growth as wasteful, people familiar with decision-making in Beijing have said.

China's Ministry of Finance didn't respond to a request for comment.

A key difference today is that China's economy is expanding at a slower pace than before. The country's GDP grew at an annual rate of about 7% in 2015 and 2016. In the third quarter of this year, China's economy expanded by 4.6% from a year earlier and many economists think growth will be slower next year.

Lisa Wang, a salesperson at a textile manufacturer in China's Zhejiang province, said new tariffs under Trump could add more pressure. Her factory has already had to cut prices to compete with the many other factories that make similar bedding products, eating into profits and forcing it to cut its workforce from about 600 people before the Covid-19 pandemic to about 400 today.

She said her company is trying to develop new products in categories that aren't as saturated, such as a blanket using a fabric that feels cool to the touch, to try to attract more clients, including new Chinese buyers. Her current customers are mostly foreign.

With Trump's potential tariffs still up in the air, she said the company is taking it one step at a time.

"It will be very hard for us," she said.

Residents gather near flower blossoms at a park in Beijing. PHOTO: ANDY WONG/ASSOCIATED PRESS

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