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GLOBAL

Rising Prices Are Bad, but Plummeting Prices Are Worse

Americans may envy China's deflation. They shouldn't.

By Michael Schuman



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LIVING IN CHINA IS getting cheaper. Because rents in my neighborhood in central Beijing are dropping, my wife and I pressed our landlord to reduce ours by \$140 a month in a new lease that we signed last month. He wasn't too happy about it, but he's lucky that we didn't move out. Given the desperation of local landlords, we probably could've saved another \$500 a month had we switched to a comparable apartment nearby.

To Americans pinched by rising prices, such declines might seem enviable. The high cost of living in the United States has become a serious political headache for President Donald Trump, who entered office with promises to bring prices down but has seen them only rise. Falling prices in China may then seem like yet more evidence that Beijing is getting things right.

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But plummeting prices are a problem too. Deflation in China is a result of the most basic of market principles: too much supply and too little demand. China's government has spent decades promoting investments in housing, factories, and infrastructure—investments that enabled China's rapid growth but that have also left the economy burdened by apartments and assembly lines that well exceed demand. This mismatch explains why prices for Chinese-made goods have been falling for more than three years.

A proliferation of bargains may be great for shoppers and renters, but it poses an existential threat to the economy. Deflation often stymies growth by discouraging consumption. Why buy a car or dishwasher today when they will become cheaper tomorrow?

Chinese leaders have tried to tackle the problem by meddling with the markets. The Chinese Communist Party's powerful politburo signaled over the summer that it would crack down on price-cutting. China's president, Xi Jinping, declared in comments published in September that aggressive price competition must be "effectively managed"—in other words, stopped by the state. Regulators have tightened oversight of how businesses set prices. Like Trump, Xi seems to believe that he can solve complex economic problems by addressing the symptoms, not the root causes. But Xi can't simply regulate falling prices and expect them to stabilize.

Chinese leaders have resisted economic reforms to scale back supply and juice demand. Although Xi has suggested that the government should do more to strip out excess factory capacity—calling in September for an “orderly exit” from outdated manufacturing, for instance—local officials often prop up loss-making companies to preserve jobs. The government could also entice households to save less and spend more by building out a more comprehensive social safety net, but Xi has expressed fear that extensive welfare programs promote laziness.

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China is now paying for this economic mismanagement. Companies in crowded, competitive markets are slashing prices in a mad scramble for customers. We recently bought a cup of fresh yogurt from a nearby restaurant for 68 cents; in September it was \$1.10. A friend recently tried out a new gym where a promotion cut the price of exercise classes to 40 cents a session, a

bargain compared with the \$10 she usually spends. Vicious competition among desperate automakers has depressed car prices to nearly unsustainable levels. BYD, China's largest electric-vehicle maker, startled the industry earlier this year with steep discounts on many of its models. The company cut the price of its Seal hybrid sedan by 34 percent, bringing it to about \$14,500.

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Despite the deals, Chinese people are reluctant to shop. Worried about their jobs in a sagging economy, many have grown even more cautious than usual. Retail-sales growth has been slowing for months.

The government has tried to spur spending by subsidizing purchases of new appliances, smartphones, and other products. My wife and I recently bought a Sealy king-size mattress at half-price thanks to a retailer's discount and a state handout. But declining prices also create strong incentives for shoppers to wait. A local real-estate agent told me that our landlord could have sold the two-bedroom apartment where we live for \$2.25 million three years ago. Now, she estimated, he'd be lucky to get \$2 million, assuming he could find a buyer. Because apartment hunters expect property prices to fall further, many are holding off for better deals that might come in a year or two.

That patience will likely pay off. Leah Fahy, an economist at the London-based research firm Capital Economics, expects deflation to persist through at least the end of 2026. She told me that in the absence of structural reforms, "it looks pretty likely that supply will continue to outpace demand."

The risk is that China tumbles into a long-term deflationary spiral that saps growth, much like the one that contributed to Japan's "lost decades," starting in the 1990s. To avoid that fate, policy makers need to reform China's economy to encourage more consumption than investment and let market forces cull bloated industries. "It is going to be challenging for China to escape deflation unless it is willing to take the measures needed to shift its growth model," Eswar Prasad, an economist at Cornell University, told me.

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But China's leaders do not seem ready to pursue these changes. Instead, the Communist Party's latest five-year plan, a draft of which was drawn up at a party conference in October, seems to promise yet more state-led investment in manufacturing and technology, ensuring the supply glut may well persist for years to come.

What's bad for China, however, isn't all bad for the rest of the world, because China is exporting its lower prices abroad. There is some irony in the fact that China's deflation problems could be a boon for Americans seeking cheaper goods—if only Trump hadn't offset those potential savings with hefty tariffs. The lesson for both Beijing and Washington is pretty clear: Policy makers are often better off letting the market do its job.

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