

## Should we worry about deflation?

**Vicky Pryce**

With the focus of most governments and central bankers being on fighting inflation, how do we cope with the sudden re-emergence of deflation? It isn't new- Japan has struggled with that for decades, certainly since the collapse of its property markets back in the 90s. And it is only now enjoying a return to inflation, partly due to higher energy prices which have finally done what years of monetary injection and zero interest rate policy had failed to do. Japanese inflation has stayed sustainably above zero for the last two years and is currently at 3.3%.<sup>ii</sup>

True some other things have also happened. Japanese companies have raised prices to at least partly cover those rising costs ' something generally frowned upon in Japan. And wages have also been allowed to follow upwards. But the Japanese interest rate regime remains accommodating although there has been some upward adjustment to its until now zero interest rate policy.

But it is China that is under the deflation spotlight at present ! After a real slowdown in the rate of inflation in recent months, prices fell in July by 0.3% year-on- year though core inflation was still 0.8% up.<sup>iii</sup>

What has been going on? Well, it is of course energy prices and food prices with pork, a major staple down 30% over July 2022. But lots of other goods prices are also falling such as cars and motorbikes and also smartphones and furniture and household appliances.

So what is going on? It is mainly that growth is way below what China has been used to in the last few decades. Construction output has suffered since the clampdown by the Chinese authorities on overindebted property companies in 2020/21.<sup>iv</sup> There is also increasing evidence that jobs for new graduates are becoming difficult to find. Imports and exports are slowing down indicating a weakening economy. Add to this the latest tightening of investment and export restrictions to China for US tech and venture capital firms in the areas of AI, quantum computing and chips just announced by President Biden- and the picture looks even bleaker. The People's Bank of China has intervened to lower some rates in a bid to stimulate the economy.

Deflation is of course a bad thing as it stifles investment and growth. We haven't seen that since the beginning of the Covid crisis and before that during the Eurozone crisis that followed the financial sector crash in 2008. It has always been at the bank of central banks minds fearful of overreacting when prices started rising when Covid restrictions were being lifted.

But do we need to worry now? Truth is that Western consumer inflation expectations for the next few years are still high and are now anchored in spending and wage decisions in many countries according to ING research.<sup>v</sup> Consumers in eight European countries they surveyed in fact thought that that inflation would stay high over the next the years- and worryingly they expected those goods, like energy and food , which have seen the largest increases to continue rising. Even over a 5 year horizon inflationary expectations remained elevated..

They may have a point. And central banks will tell you that it is still inflation rather than deflation we should be concerned about despite some predictions that falling Chinese inflation could soon be reflected in lower prices for Chinese exports which should benefit us all. Indeed there are signs that oil and international food prices may be heading upwards again, partly due to OPEC production cuts and Russia's new restrictions on grain exports from Ukraine .

Maybe they are right. But the surprise turnaround in China suggests that as growth stalls in the Western world the deflationary risk after years of low underlying growth and now sharply high interest rates should not be underestimated<sup>vi</sup>. Witness the impact already on UK house prices which have now fallen again for the fourth month running and the slowly but steadily rising unemployment rate<sup>vii</sup>.

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i <https://www.investopedia.com/articles/economics/08/japan-1990s-credit-crunch-liquidity-trap.asp#:~:text=Japan's%20%22Lost%20Decade%22%20was%20a,down%20the%20real%20estate%20market>. ii Japan Inflation Rate 1960-2023 | MacroTrends iii China tips into deflation as efforts to stoke recovery falter | Reuters iv China walks a tightrope on property clampdown | Reuters v Inflation's here to stay, say European consumers | Article | ING Think vi The economic headache caused by deflation in China – and the worldwide effects | Business News | Sky News vii <https://www.theguardian.com/money/2023/aug/07/uk-house-prices-drop-again-as-halifax-says-first-time-buyers-are-switching-to-smaller-homes>