Is China Facing *a* Deflationary Trap?

The problems are mounting.

By Patrick Bolton and Haizhou Huang

About two years ago, in the aftermath of the Covid-19 pandemic, China's economy hit a roadblock. As all sectors underwent deleveraging, economic growth slowed, household savings rates increased, and businesses scaled back their investments and accumulated savings. Many now wonder whether consumers and companies are stuck in a self-reinforcing cycle of declining spending and falling prices, which would have the pernicious effect of increasing the real value of debt.

For a long time, the government did not move forcefully to counter these trends. On the contrary, as falling property prices and stalling land sales, together with slower growth, squeezed local governments' budgets, the central government maintained a prudent fiscal stance. Now, China is teetering on the edge of a deflationary trap: the consumer price index has been hovering near zero for sixteen months, and the producer price index has been in negative territory for twenty-four months.

Japan remained ensnared in such a trap for three decades. Economic growth, inflation, and interest rates stagnated around zero, resulting in a

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long-term relative decline in GDP per capita, from a peak of 150 percent of the level in the United States in 1995 to just 41 percent of the U.S. level in 2023. With China potentially on a similar trajectory—in 2021–2023, its GDP fell from 76 percent of the U.S. level to 67 percent, and today, its GDP per capita is only 15 percent of the U.S. level—how to avoid Japan's fate has become an urgent question.

Answering it requires, first, changing the way we think about money. The conventional macroeconomic wisdom is that central banks and governments manage price and liquidity pressures through interest rates and fiscal policy. But if we recognize that money is, ultimately, a country's equity capital, money issuance can—and should—be thought of in similar terms to equity issuance. And as equity issuers, central banks can play an important role in stabilizing financial markets, recapitalizing banks, and avoiding a liquidity trap.

Just as a company might issue equity to recapitalize or fund productive capital expenditures, a central bank can issue money to retire debt and boost financing of investment, thereby reducing leverage across the economy and countering deflationary forces. (Conversely, when an economy is overheating, and inflation is rising, policymakers can shrink the monetary base, much as corporations repurchase stock to increase share value.)

By using equity issuance productively to mobilize an idle workforce with high human capital, China could increase both economic activity and consumption.

Moreover, if banks are lending less because they have accumulated too many non-performing loans, the central bank can recapitalize them through debt-equity swaps, with banks exchanging their liabilities (debt) for money (equity) from the central bank. At the same time, central banks can support an asset-relief program involving the removal of non-performing loans from banks' balance sheets.

This way of thinking about money should inform China's effort to fight deflation. Fortunately, the government's newly announced stimulus package suggests that this may well be happening. Some of its features are conventional. For example, the People's Bank of China has lowered its key policy rate—the seven-day reverse repo rate—20 basis points, from 1.7 percent to 1.5 percent. This will drive the medium-term lending-facility rate down by about 30 basis points. The loan-market quotation rate and the deposit rate will probably also be lowered, most likely by 20–25 basis points.

Moreover, the People's Bank of China is encouraging commercial banks to lower their mortgage interest rates to align more closely with the rate for newly issued loans—an average reduction of about 0.5 percentage points. The stimulus also includes a 0.5-percentage-point reduction in financial institutions' mandatory reserve ratio, which frees up about CN¥1 trillion ($140 billion) in long-term liquidity.

But China's stimulus program also includes two new PBOC tools, designed to support the capital market. The first is a swap facility—initially valued at CN¥500 billion, though it will probably be expanded—to make it easier for securities firms, fund companies, and insurers to finance stock purchases. The second is the provision of up to CN¥300 billion (to start) in cheap loans to commercial banks, to be used to help other entities increase their share purchases and buybacks. With these policies, the People's Bank of China is effectively issuing equity to stabilize prices and asset values, thereby reducing economy-wide leverage.

Capital markets responded positively to the stimulus announcement, with China's A-share market index rising by more than 20 percent in less than a week. But more must be done to restore long-term investor confidence. While the list of necessary policies is long, three priorities stand out.

First, China's fiscal authorities should increase spending in order to support economic growth, which is vital to address property-sector and local-government debts. Their current stance, which has had the central government's budget deficit running only slightly above 3 percent of GDP for the last four years, is too prudent.

Second, the government should do more to support the private sector, which has contributed 60 percent of GDP, 70 percent of innovations, and 80 percent of employment to the Chinese economy roughly over the past five years. Specifically, it should fast-track its draft private-economy promotion law, aimed at fostering private-sector development, and actively promote investment with financial support, tax incentives, and expanded market access.

Finally, policymakers should support job creation for recent college graduates, migrant workers, and other groups exposed to rising unemployment. By using equity issuance productively to mobilize an idle workforce with high human capital, China could increase both economic activity and consumption.

With its latest stimulus plan, China's government is on the right track. But to escape deflation, it must go further. ◆