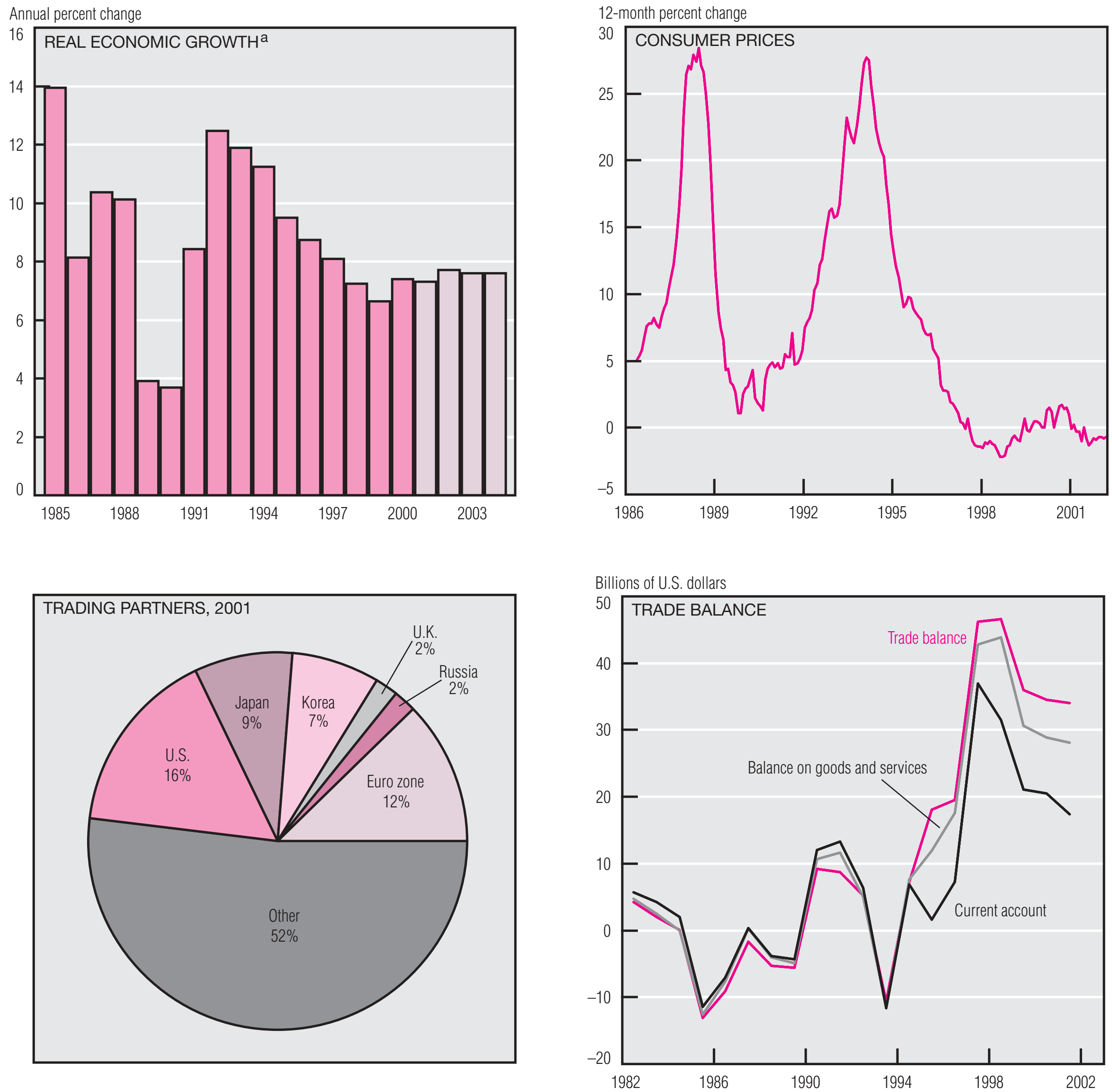
China's Deflation



a. Data for 2001–04 are Blue Chip forecasts.
SOURCES: International Monetary Fund, *Direction of Trade Statistics*; and Bloomberg Financial Information Services.

Those who think deflation is always and everywhere a bad thing must have overlooked the People's Republic of China, whose economy is growing by leaps and bounds despite a falling price level. Why?

As prices fall, the real return on holding money balances rises, enticing people to hold cash. If the real return on money balances exceeds the real return on capital, deflation will destroy incentives to invest; economic growth will slow and unemployment will rise.

In emerging markets, capital is relatively scarce and the return on investment promises to be fairly high. China's rapid growth—despite deflation—and a substantial inflow of direct investment capital suggest that the real return on capital there is high and offers an attractive alternative to holding cash.

Falling prices may also help China compete in global markets where the rest of the world is not hoarding cash. In 2001, the country's rapidly growing current account surplus topped $17 billion, or 1.5% of GDP. The People's Republic of China is the fifth-largest trading partner of the U.S., accounting for 7% of our total trade (exports plus imports). And we are the single biggest trading partner of the People's Republic, accounting for 16% of their total trade.