Editorial

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Great China's deflation boom and doom

By Chi Lo

Deflation has created an economic puzzle in the Greater China economy. The Mainland is enjoying an economic boom on the back of pricing power erosion. But Hong Kong is suffering from severe economic pains, as deflation has taken its toll in economic growth (Chart). How can the Mainland enjoy a deflationary boom while the SAR suffers an economic doom under the same deflationary environment? What are the implications for their respective asset markets?

Deflation has exerted a tremendous stress on Hong Kong but not China because the Mainland is a source of deflation while Hong Kong is a recipient of it. Both Hong Kong and China have been stuck in price deflation for over 4 years. Hong Kong's price level started declining after the 1997/1998 Asian crisis, while China's deflationary pressures started to build since 1996 when the central government started its anti-inflation campaign.

Deflation has not hurt China, as seen in two important economic indicators that underscore robust GDP growth. One is bank lending. China's bank credit has been growing at an average annual rate of 14%, despite deflation. But Hong Kong's bank credit has been contracting since the Asian crisis. Credit expansion is crucial because bank loans are a crucial leading indicator for investment spending and consumer demand. China's swift credit growth has supported economic expansion, despite large amount of bad loans in the banking system. This also means that fears about the financial risk in China were exaggerated.
On the other hand, despite Hong Kong's stronger banking system, the territory does not enjoy the same benefit, due to the loss of public confidence in the local economy. Deflation and its resulting wealth destruction have only deepened this confidence crisis. While contraction in the SAR's bank lending has moderated recently, chronic deflation has dimmed the outlook for a significant pick-up in the medium-term. Given the low odds of a robust global economic recovery, Hong Kong's pricing environment is expected to remain deflationary. Such is hardly a conducive environment for lending and asset price growth.

The other indicator is China's corporate profit growth, which is recovering after a sharp fall in 2000. This is in sharp contrast to Hong Kong, whose profits have been squeezed since the Asian crisis. The fact that Chinese companies can manage a recovery in profits under deflation suggests that structural reforms in the Mainland had improved corporate efficiency. This benefit has spilled over to rising demand, which is likely to last in the medium-term given China's reform momentum. On the other hand, Hong Kong is still in the middle of a post-crisis adjustment. This has created uncertainty and capped profit growth, limiting Hong Kong's demand growth.

Thus, China is experiencing a mini-boom, which was initially concentrated in the property sector. The boom has spread to other parts of the economy, with investment and industrial output rising strongly along with export growth, consumption growing at close to 10% annual rate and foreign direct investment flowing in rapidly. Hong Kong has had an exactly opposite experience, with output and consumer spending falling, local investment declining and foreign investment flowing out.

The economic divergence is echoed by the asset, notably property, market performance when we compare Hong Kong with Shanghai, the economic dragon-head of China. Both property prices and rentals in Hong Kong have fallen sharply since the Asian crisis, while those of Shanghai's have retained an upward bias. To a large extent, stock market performance has seen similar divergence between Hong Kong and Shanghai in recent years.

However, despite Hong Kong's 60% property price drop from the peak in 1998, its property yield is still less attractive than Shanghai's. For example, Hong Kong's rental yield averages 4.6% for premium offices and 5.3% for luxury residential properties, compared with over 6% for both segments in Shanghai. Political risk is not likely a big factor for China's higher yield. China's Fourth generation leaders are coming to power with high confidence and support. Coupled with economic reform, China's political risk is not excessive. This suggests that unless Hong Kong's property prices could turnaround and rise fast to justify the lower yields, its property market would remain less attractive than Shanghai's in the medium-term.

The root cause of Hong Kong's deflation is the combination of its currency peg and the powerful deflationary impact of the Chinese economy. To see this, consider China's deflationary boom. The Mainland's productivity gains are the ultimate source of price deflation. Normally, productivity gains should lead to a rise in wages because firms tend to pay productive workers more. But labour supply in China is so abundant that this is not happening. Instead, as each worker produces more with the same amount of inputs, supply increases faster than demand so that prices fall. Price deflation, in turn, pulls down costs. As a source of deflation, China can thus have price decline co-existing with economic and profit recovery.

On the other hand, Hong Kong is on the recipient side of deflation. Given its small and open
economic nature, it is a price taker in the world market. So, when China emits deflation and
the Hong Kong dollar cannot fall to adjust, local prices (including asset prices) have to drop
to cope with the fall in international prices. So, as long as the dollar peg stands, the stress on
the SAR's asset prices will remain until a robust recovery in external demand emerges to
provide relief for Hong Kong.

In a nutshell, the difference in the nature of deflation between China and Hong Kong will
last for a while. This implies that Hong Kong's assets, especially property, would continue to
under-perform Shanghai's in the medium-term.

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