Spreading deflation across East Asia threatens fresh debt crisis

By [Ambrose Evans-Pritchard](), International Business Editor

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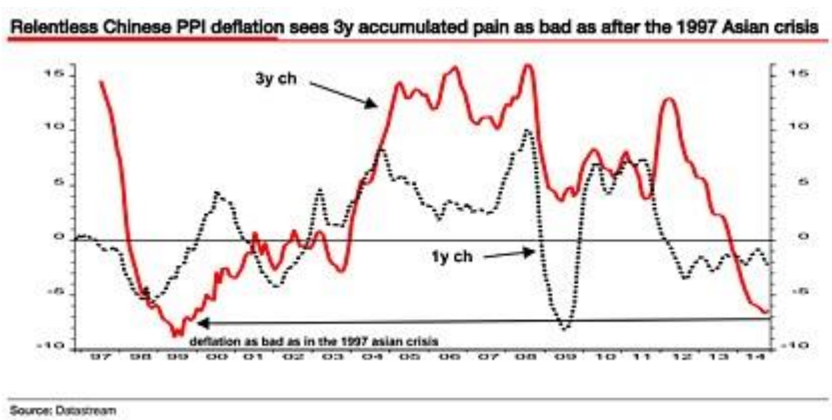
Deflation is becoming lodged in all the economic strongholds of East Asia. It is happening faster and going deeper than almost anybody expected just months ago, and is likely to find its way to Europe through currency warfare in short order.

Factory gate prices are falling in China, Korea, Thailand, the Philippines, Taiwan and Singapore. Some 82pc of the items in the producer price basket are deflating in China. The figures is 90pc in Thailand, and 97pc in Singapore. These include machinery, telecommunications, and electrical equipment, as well as commodities.

Chetan Ahya from Morgan Stanley says deflationary forces are “getting entrenched” across much of Asia. This risks a “rapid worsening of the debt dynamic” for a string of countries that allowed their debt ratios to reach record highs during the era of Fed largesse. Debt levels for the region as a whole (ex-Japan) have jumped from 147pc to 207pc of GDP in six years.

These countries face a Sisyphean Task. They are trying to deleverage, but the slowdown in nominal GDP caused by falling inflation is always one step ahead of them. “Debt to GDP has risen despite these efforts,” he said. If this sounds familiar, it should be. It is exactly what is happening in Italy, France, the Netherlands, and much of the eurozone.

Data from Nomura show that the composite PPI index for the whole of emerging Asia – including India – turned negative in September. This was before the Bank of Japan sent a further deflationary impulse through the region by driving down the yen, and before the latest downward lurch in Brent crude prices.



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The Japanese know what it is like to be on the receiving end. A recent study by Naohisa Hirakata and Yuto Iwasaki from the Bank of Japan suggests that China’s weak-yuan policy - a polite way of saying currency manipulation to gain export share – was the chief cause of Japan’s deflation crisis over its two Lost Decades.

The tables are now turned. China itself is now one shock away from a deflation trap. Chinese PPI has been negative for 32 months as the economy grapples with overcapacity in everything from steel, cement, glass, chemicals, and shipbuilding, to solar panels. It dropped to minus 2.2pc in October.

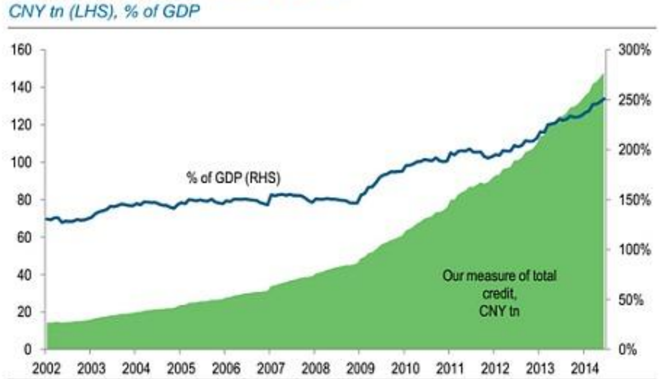
The sheer scale of over-investment is epic. The country funnelled $5 trillion into new plant and fixed capital last year - as much as Europe and the US combined - even after the Communist Party vowed to clear away excess capacity in its Third Plenum reforms. Old habits die hard.

Consumer prices are starting to track factory prices with a long delay. Headline inflation dropped to 1.6pc in October. This is so far below the 3.5pc target of the People’s Bank of China that it looks increasingly like a policy mistake. Core inflation is down to 1.4pc.

China has flirted with deflation before: during its banking crisis in the late 1990s, and again during the West’s dotcom recession from 2001-2002. Both episodes proved manageable.

This time the level of debt greater by orders of magnitude, with a large chunk in trusts, wealth product, and other parts of the shadow banking nexus, and a further $1.2 trillion in “carry trade” loans from Hong Kong. Standard Chartered thinks total debt has reached 250pc of GDP. This is roughly $26 trillion, the same size as the US and Japanese commercial banking systems put together, and therefore a headache for us all.

Figure 1: Total credit continues to grow…
CNY tn (LHS), % of GDP



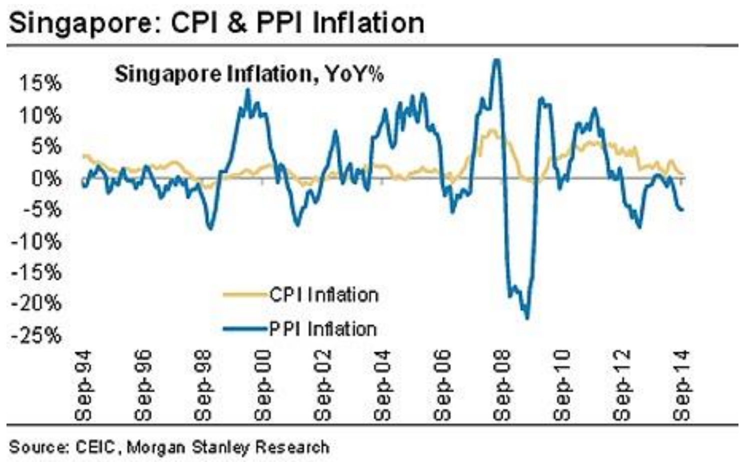
Source: CEIC, Standard Chartered Research

Larry Brainard from Trusted Sources says China is sliding towards a European debt-compound trap. “It’s arithmetic. Deflation will kill you if you’re leveraged. It is just a question of how quickly. We don’t know how big the problem is because China is playing a game of three-card Monte and moving the debt to different buckets,” he said.

“The bottom line is that PPI deflation increases the cost of leverage across the board. The risk is that it sets off a self-reinforcing cycle of debt defaults and rising non-performing loans that runs out of the control of the authorities. China will have to cut rates,” he said.

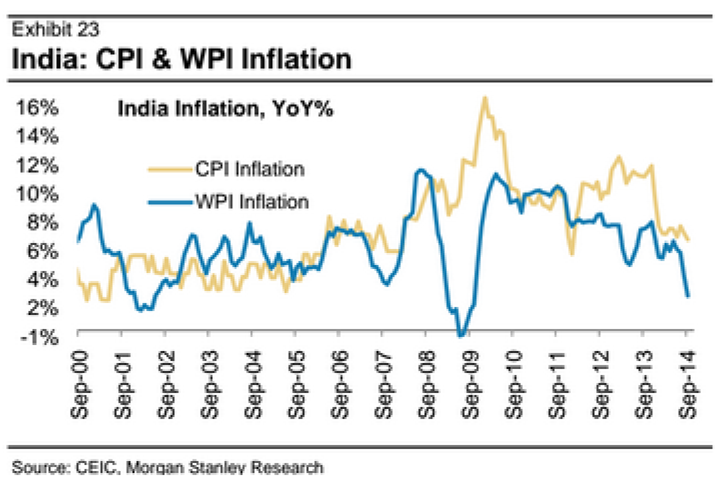
Asia is not yet in a full-blown currency war, but no country can stand idly by as neighbours dump toxic deflationary waste on their front lawn. Korea has threatened to force down the won, pari passu with the yen. The central bank of Taiwan has been intervening.

These skirmishes are happening in a region of festering grievances and territorial disputes, with no Nato-style security structure - or for that matter EU-style soft governance - to damp down fires. The spokes of the diplomatic wheel connect by a perverse geography to Washington, a city retreating from Pax Americana.



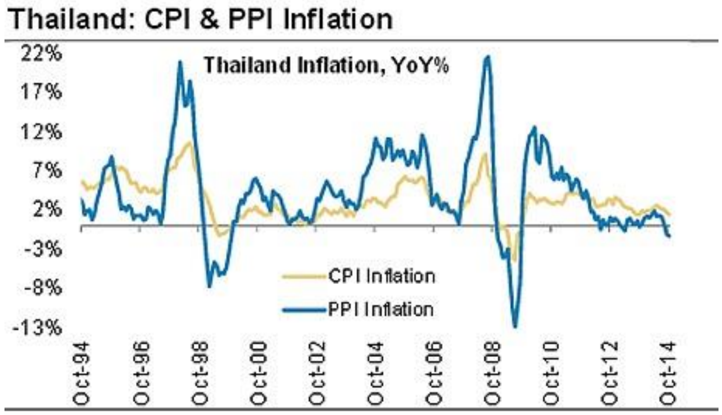
The Asia-Pacific Economic Cooperation summit this week feigned concord, but was in reality more like the Great Power dances of the late 1930s. China's Xi Jinping shook nationalist hands with Japan's Shinzo Abe, even as both sides rearm, and their warships threaten each other daily in Senkaku waters. In such a world - mercantilist by temperament in any case - attempts to export deflation to neighbours take on a sharper edge.

China has so far held its nerve under premier Li Keqiang, a man determined to wean his country off credit and an obsolete development model before it lurches into the middle income trap. It has not resorted to another blitz of stimulus - beyond short-term liquidity shots - even though house prices have been falling for five months and growth has fizzled. Fathom's momentum tracker suggests that underlying GDP growth has dropped to 5pc.



The benchmark one-year lending rate is still 6pc. The reserve requirement ratio for banks is still 20pc. Money is getting tighter and tighter.

Nor has China intervened to hold down the yuan. Purchases of foreign bonds have dropped to zero, down from $35bn a month at the start of the year. The yuan has appreciated 22pc against the yen since June, and 50pc since mid-2012. It is up 12pc against the euro since the early summer.



Source: CEIC, Morgan Stanley Research

China is in effect strapped to the rocketing dollar through its quasi-peg, increasingly a torture machine. George Magnus from UBS says this cannot continue. “What is happening in the property market is the tip of the iceberg for the whole economy. China will have to resort to monetary reflation over the winter, and I think this will include a lower yuan. We are heading into a currency war,” he said.

This looks all too like a replay the East Asia storm of 1998, when a tumbling yen triggered a Chinese banking bust and pushed Beijing to the brink of devaluation. Washington defused the crisis by stabilizing the yen, and by promising China membership of the World Trade Organisation.

It will be harder to repeat that trick in these deflationary times. The clear danger is that China will feel compelled to defend itself, throwing its huge weight into a beggar-thy-neighbour battle across East Asia.

Should that happen, the mother of all deflationary shocks will roll over Europe before the EU authorities have even got out of bed.