

**The Diffusion and Dynamics of Producer Prices,
Deflationary Pressure Across Asian Countries,
and the Role of China**

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Summary

Producer prices across Asia have been on an unrelenting downward trajectory in recent times, and this entrenched deflationary trend has now become an important macro concern for Asian economic policymakers. The weakness in aggregate demand has resulted in a feedback loop which has exacerbated the mounting deflationary pressures. China is at the heart of the region's deflation challenge. Overall, up to June 2016, China's producer prices are down a cumulative 12.7 per cent from their peak in 2011. The speed at which prices are falling is a cause for alarm.

The recent synchronous and protracted of producer price deflation in Asian economies may be due to spillovers within the region or the common factors and

similar development of the local factors. This paper, therefore, applies a spillover index proposed by Diebold and Yilmaz (2009) to measure the spillover among the Asian economies, and investigates the possible determinants of the Asian producer price deflation using a dynamic panel model.

The empirical results using the dynamic panel model suggest that common factors like a sharp drop commodity prices and spillover effects from China are important determinants of recent Asian PPI deflation. Furthermore, the results confirm that spillovers from China exist. Overall, the results confirm that China is at the heart of the region's PPI deflation challenge.

The three fundamental problems of China, declining corporate profit, overcapacity and heavy debt burden could increase the risk of worsening PPI deflation and eventually lead to CPI deflation, which in turn makes all three problems worse. These three fundamental problems are more serious for state-owned enterprises. Therefore, besides fiscal and monetary policies, supply side reforms such as tightening the overall credit growth, converting corporate debt into equity, and closing down non-profitable zombie firms, or any combination of these measures to reduce overcapacity and debt level, and improve the efficiency and profitability of state-owned enterprises are required to avert a deflationary spiral.

As CPI inflation has been consistently positive and quite stable and China's PPI deflation has lessened over the past six consecutive months, the threat of huge deflationary pressures is not immediate. Nevertheless, a comprehensive supply-side reform package combined with moderately expansionary demand policies is still needed to help China to avoid a hard landing, and prevent the threat of further deflation in other Asian economies.