

China Economy

Deflation continues with gradual improvement ahead

China's CPI narrowed its YoY decline in December as fresh food, some durables and healthcare service prices rebounded. Pork and energy prices continued to decline in sequential terms. Consumer demand remained weak as core CPI stayed flat at 0.6% YoY with a MoM increase of 0.1%. PPI also narrowed its YoY decline thanks to the base effect as overcapacity pressure and tough competition remained in most industries. A deflation trend would harm the economy by increasing debt burden, postponing durables consumption and reducing business earnings, in our view. As China's experience in 1998-2002 and Japan's experience in the two lost decades indicates, it is not easy to step out of the deflation shadow as both strong macro policies and brave structural reforms are needed. Looking forward, we expect China's CPI and PPI to mildly improve with their YoY growth respectively up from 0.2% and -3% in 2023 to 1% and 0.2% in 2024. Deflation pressure may alleviate yet should remain in most sectors. The PBOC may further cut LPRs, deposit rates and RRR by once or twice in 2024 to defy the deflation pressure and stabilize economic growth.

- CPI improved thanks to the modest rebound in prices of fresh food, some durables and healthcare service.** CPI narrowed its YoY decline from 0.5% in Nov to 0.3% in Dec. In sequential terms, CPI bounced back to 0.1% growth after dropping 0.5%. Specifically, food CPI grew 0.9% MoM with most contribution from fresh vegetables and fruits as cold weather influenced their supply. Pork price dropped 1% MoM in Dec after decreasing 3% in Nov. Pork price may continue to cause deflationary effect on CPI in 1H24 as the de-capacity process in the live pig sector seems more slow than expected. CPI in telecom equipment and home appliances respectively picked up 3.1% and 0.6% MoM in Dec after dropping 1.8% and -1.1% MoM in Nov as demand may have improved and inventory may have declined in the two sectors. However, CPI in vehicles further declined 0.7% MoM after dropping 0.3% MoM as the price war continued in the auto sector. CPI in healthcare service rose 0.2% MoM, while that in vehicle fuel dropped 4.5% in Dec. MoM growth of tourism rebounded to 0.1% from 5.9% in Nov while other services like rent, telecom, postal and education services stayed unchanged. Core CPI growth stayed flat at 0.6% YoY while its MoM growth mildly picked up to 0.1% from -0.3%.
- PPI continued its weakness with mild narrowing of its YoY decline.** PPI declined 2.7% YoY in Dec after decreasing 3% YoY in Nov, which has been in contraction for 15 months. The MoM growth of PPI stayed at -0.3% in Dec. Energy price continued to decline as PPI in oil & gas mining and coal mining fell 16.5% YoY and 1.6% YoY respectively in Dec. PPI in non-ferrous dropped 1.9% YoY while ferrous metals moderated to 0.4%. From the MoM perspective, the slump of international crude oil price continued to weigh on the MoM PPI growth of crude oil & gas and petroleum, with notable 6.6% and 3% declines after dropping 2.8% and 2.5%. Prices of crude oil-related industries like chemical materials & products also saw a MoM decline of 0.7%. PPI in durables and capital goods remained weak with slight improvement.
- PBOC may further loosen monetary policy in face of deflation pressure.** China's CPI growth slowed down from 2% in 2022 to 0.2% in 2023, with 3 months of decline in 4Q23. Deflation expectation may lead the economy into the dangerous "deflation-spiral" as it would increase debt burden, restrain

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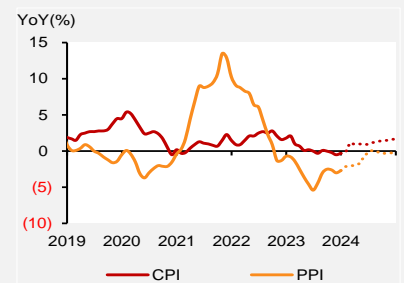
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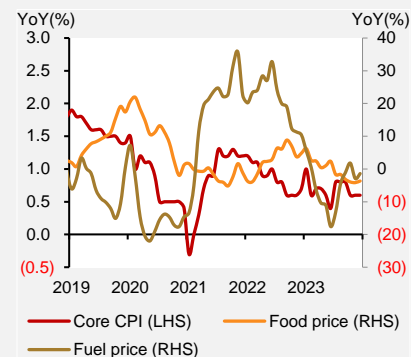
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Forecast numbers from Aug 2023

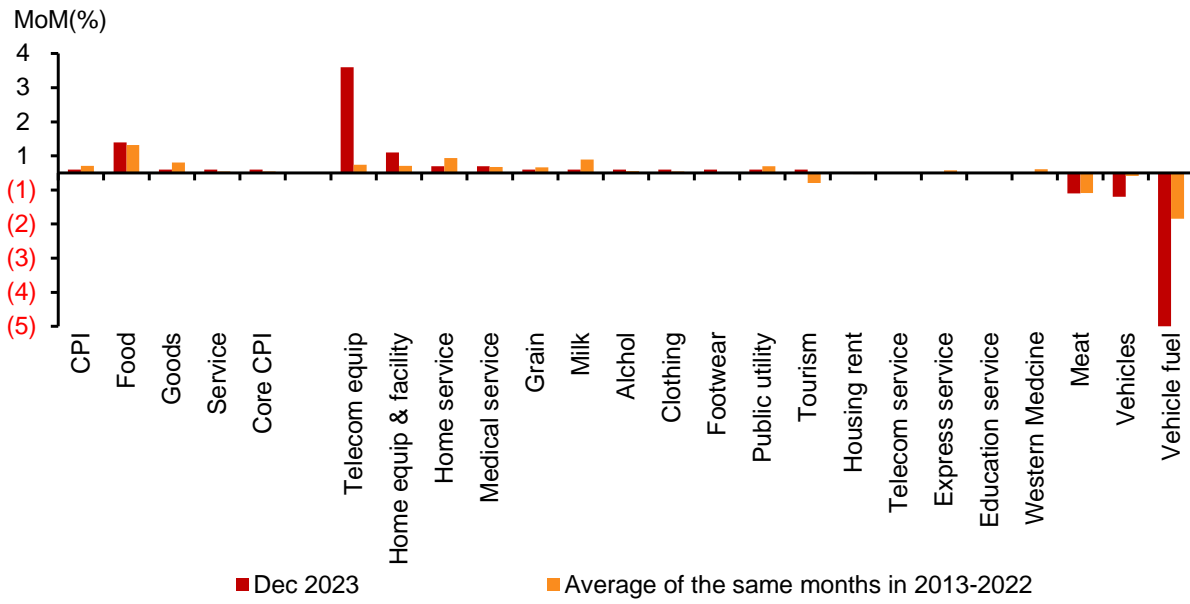
Source: Wind, CMBIGM



Source: Wind, CMBIGM

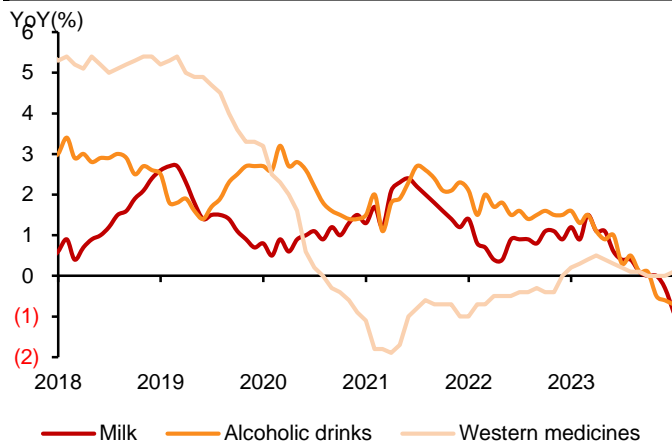
capex and durables consumption and hurt business earnings. As China's experience in 1998-2002 and Japan's experience in the two lost decades indicates, it is not easy to step out of the deflation shadow as both strong macro policies and brave structural reforms are needed. We expect the PBOC to maintain accommodative liquidity and credit policy with possible 50bps of RRR cuts, 10bps of 1-Y LPR cut and 20bps of 5-Y LPR cut cuts in 2024. The central bank is also expected to commit RMB1-1.5trn PSL loans for "three major projects". The fiscal policy will be more expansionary with expected broad fiscal deficit ratio at over 7.5% in 2024. We expect CPI and PPI growth rates to rise from 0.2% and -3% in 2023 to 1% and 0.2% in 2024.

Figure 1: MoM Changes of China CPI in Dec



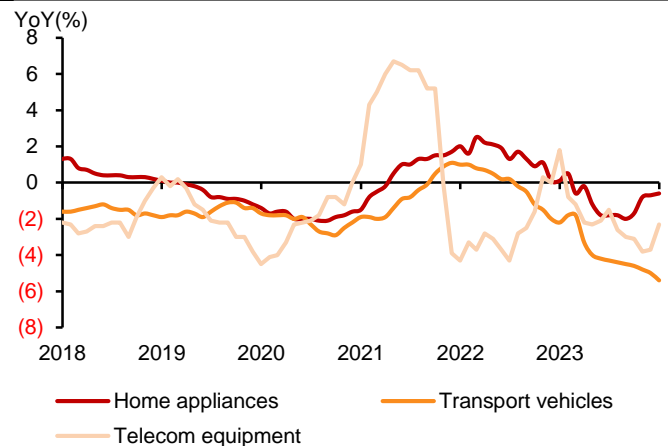
Source: Wind, CMBIGM

Figure 2: China CPI Growth in Staples



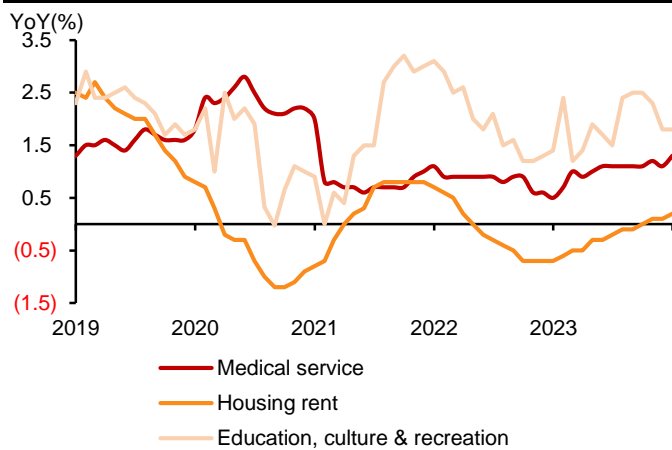
Source: Wind, CMBIGM

Figure 3: China CPI Growth in Durables



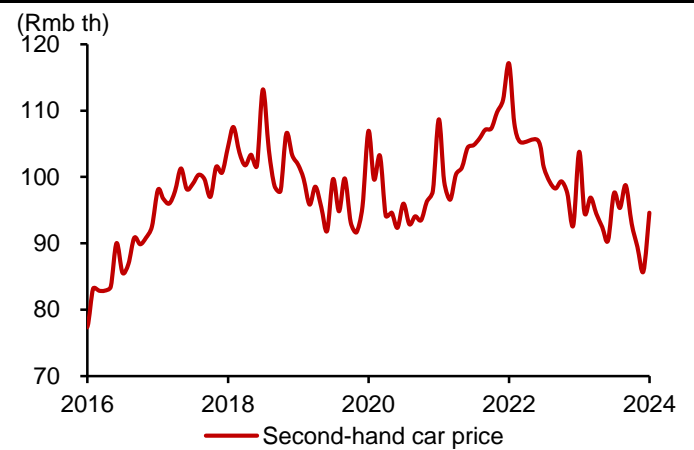
Source: Wind, CMBIGM

Figure 4: China CPI Growth in Services



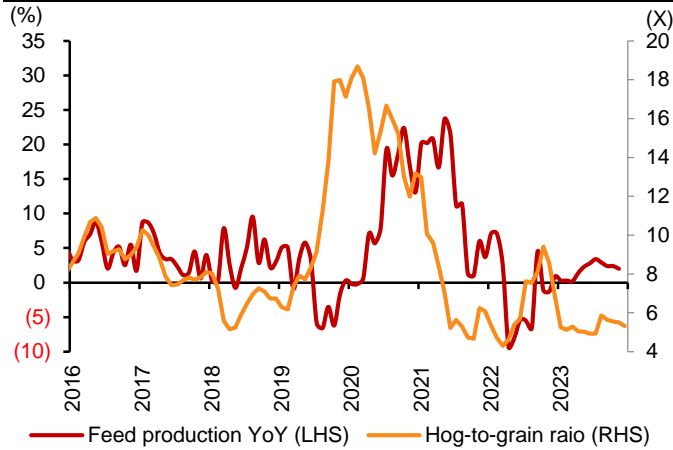
Source: Wind, CMBIGM

Figure 5: Second-hand Car Price in Shanghai



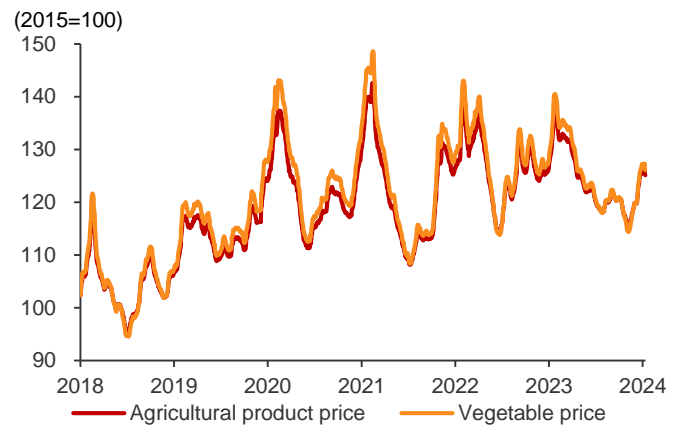
Source: Wind, CMBIGM

Figure 6: Feed Production & Hog-to-Grain Ratio



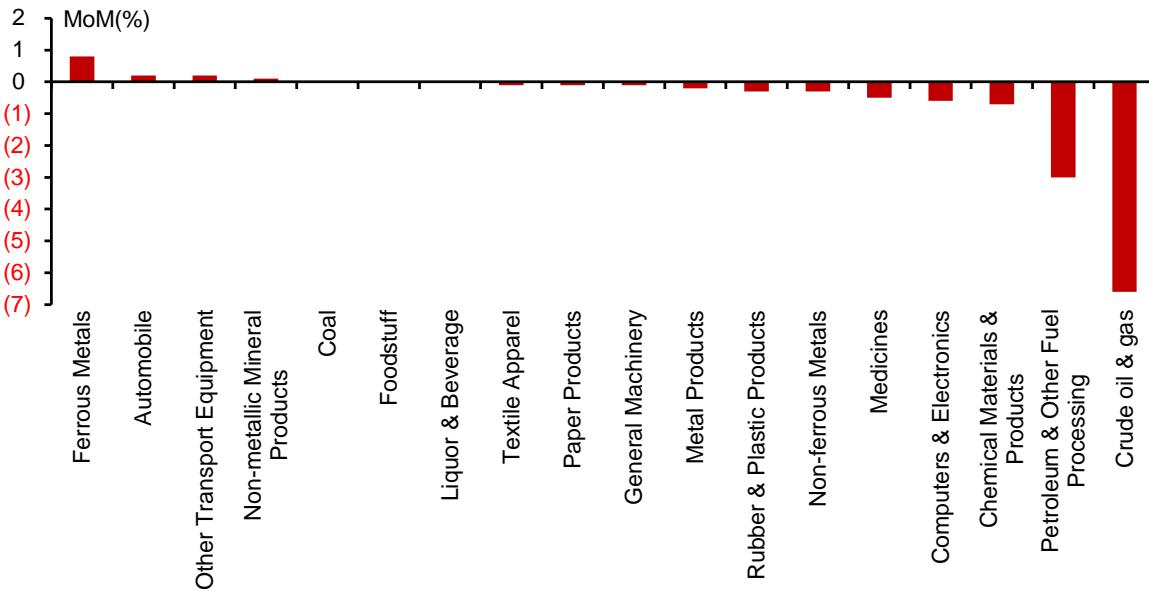
Source: Wind, CMBIGM

Figure 7: Agricultural and Vegetable Price



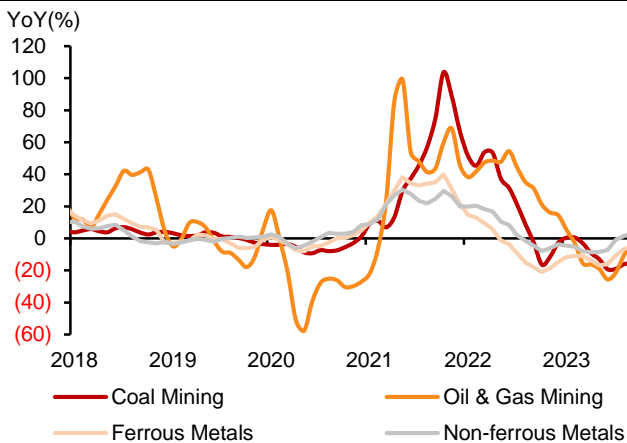
Source: Wind, CMBIGM

Figure 8: MoM Changes of China PPI in Dec



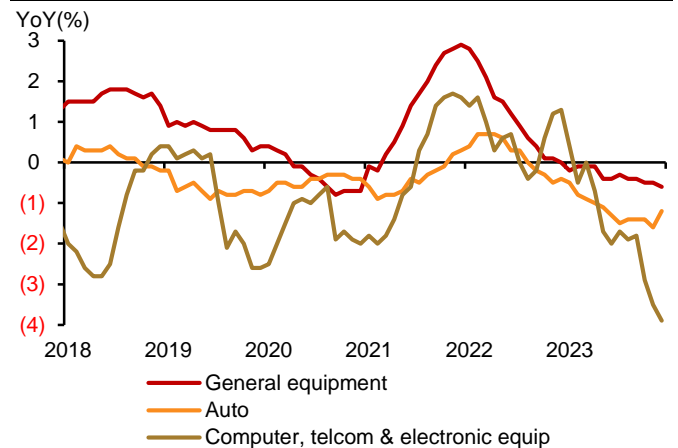
Source: Wind, CMBIGM

Figure 9: China PPI in Energy & Metals



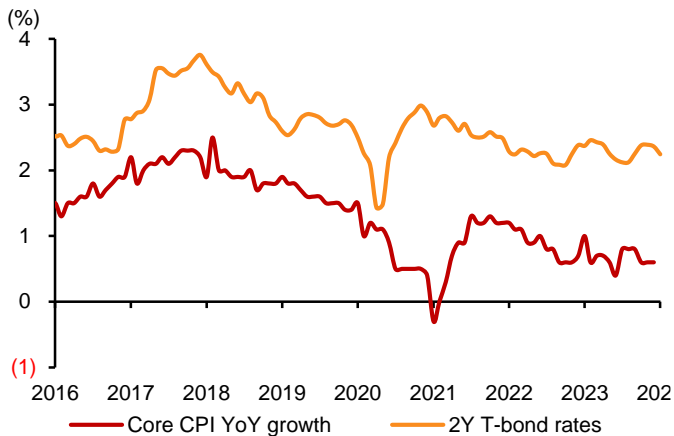
Source: Wind, CMBIGM

Figure 10: China PPI in Equipment



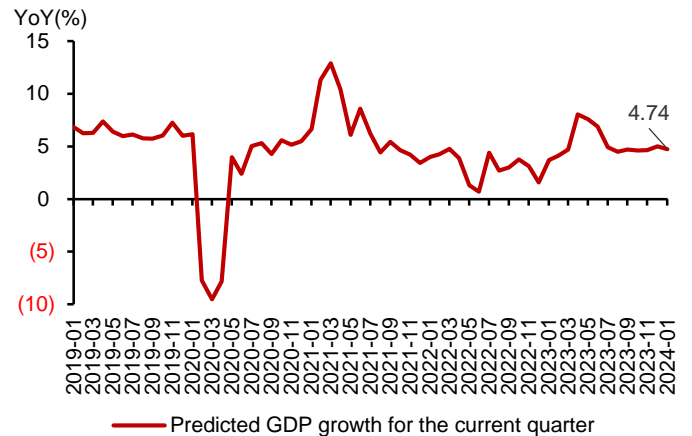
Source: Wind, CMBIGM

Figure 11: China Core CPI Growth & 2Y T-bond Rates



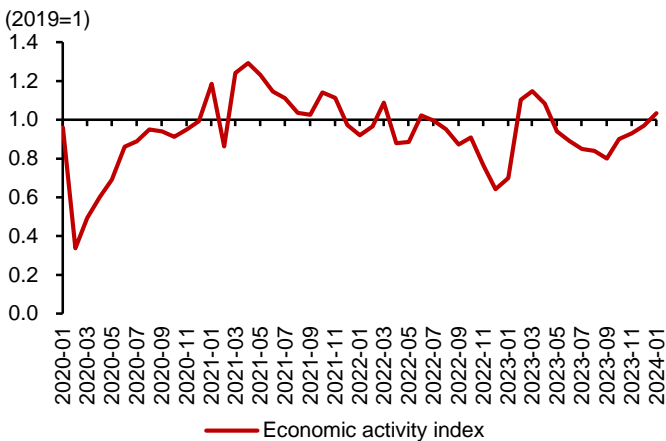
Source: Wind, CMBIGM

Figure 12: China Predicted GDP Growth



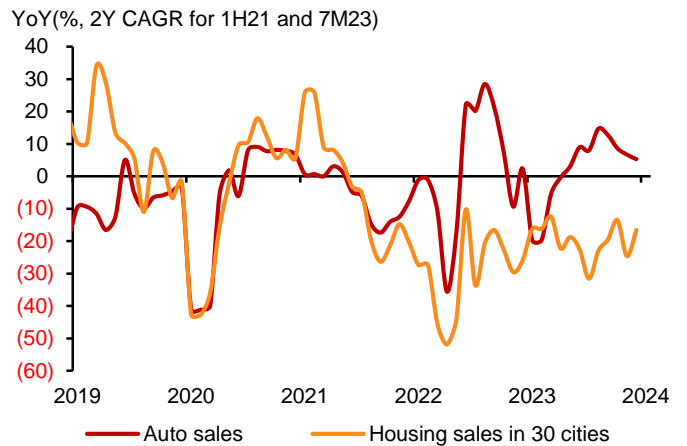
Source: Wind, CMBIGM estimates

Figure 13: China Economic Activity Index



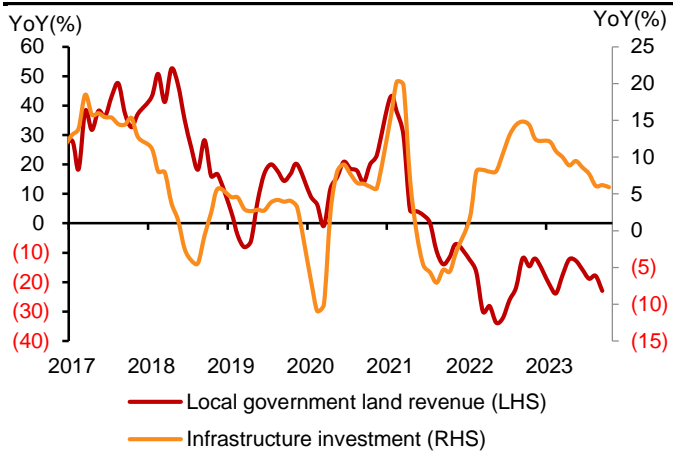
Source: Wind, CMBIGM

Figure 14: China Auto & Housing Sales



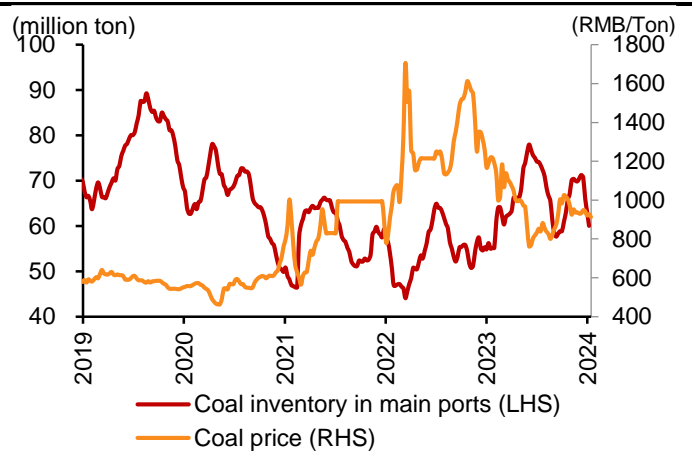
Source: Bloomberg, CMBIGM

Figure 15: Infrastructure Investment in China



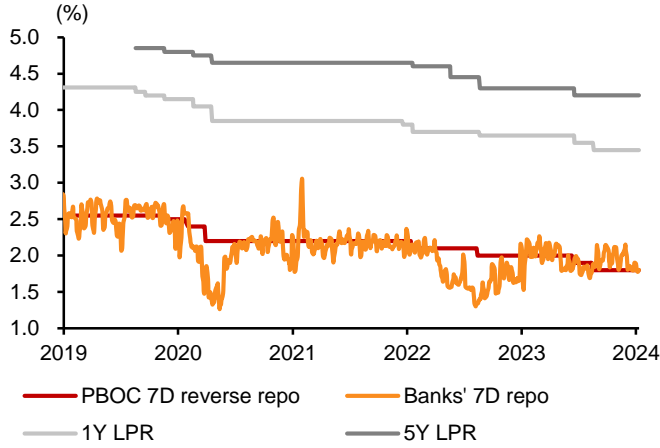
Source: Bloomberg, CMBIGM

Figure 16: China Coal Inventory & Price



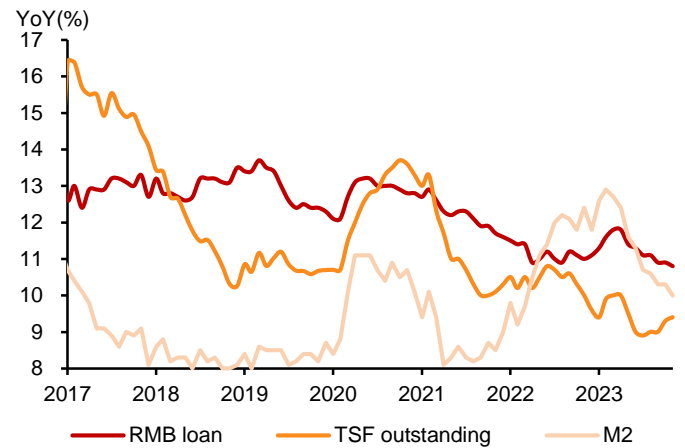
Source: Wind, CMBIGM

Figure 17: PBOC Policy Rates & Liquidity Condition



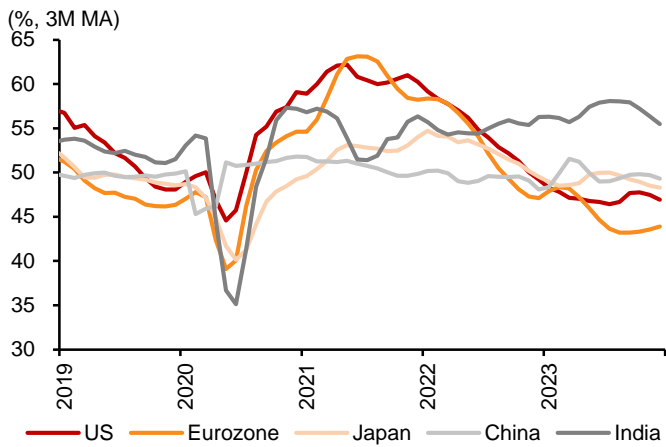
Source: Bloomberg, CMBIGM

Figure 18: China Credit Growth



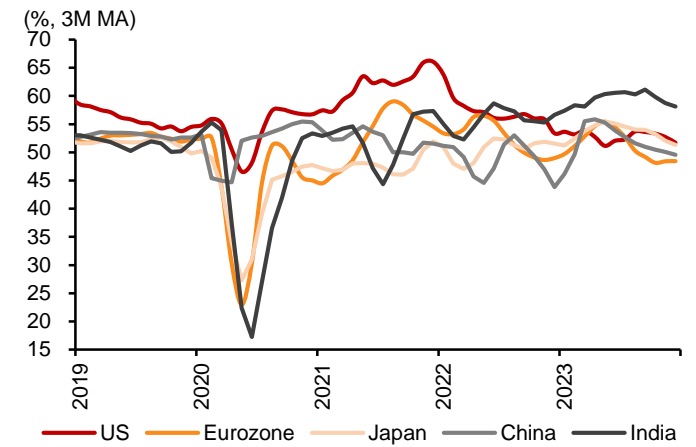
Source: Wind, CMBIGM

Figure 19: Manufacturing PMI of Major Economies



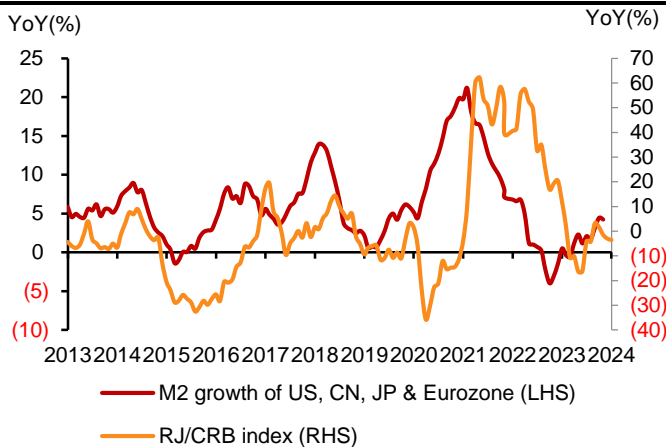
Source: Bloomberg, CMBIGM

Figure 20: Service PMI of Major Economies



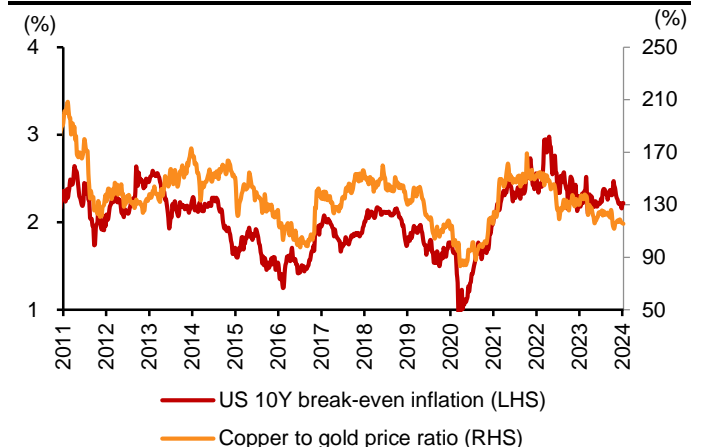
Source: Wind, CMBIGM

Figure 21: M2 Growth & Commodity Inflation



Source: Bloomberg, CMBIGM

Figure 22: Copper-to-gold Ratio



Source: Wind, CMBIGM

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