

# China Economy

## Deflation lingered amid weak consumption

China's CPI growth notably dipped to 0.2% in June against market expectation of 0.4%, as food price further declined even though pork price has rebounded markedly. Non-pork food items including vegetables, fruits, and beef became the major headwinds. Core CPI still stuck in a quagmire as consumer demand remained weak. Price of durable goods including vehicles and home equipment plunged amid intense supply-side competition. PPI continued to recover mainly driven by lower base. As the prolonged deflation has led to the formation of deflationary expectations, household consumption could be further impeded leading to a downward spiral in price. Looking forward, the PBOC may cautiously seek a balance between multiple targets in 2H24 with possible mild cuts in RRR, deposit rates and LPRs once possible Fed cuts in 2H24 grant more policy autonomy for PBOC. We expect CPI and PPI may rise from 0.2% and -3% in 2023 to 0.5% and -1% in 2024.

■ **CPI dropped unexpectedly dragged by weak food price.** CPI YoY came in below expectations at 0.2% in June compared to 0.3% in May, against market expectation of 0.4%. In sequential terms, CPI further dipped 0.2% after dropping 0.1% in May. Food price dipped 0.6% in June while its YoY declined to -2.1% from -2% even though pork price has significantly rebounded, while non-food price stayed flat at 0.8%. Pork prices have finally come out of woods with 11.4% MoM growth in June while its YoY growth accelerated to 18.1% from 4.6%. Pork price may continue to rebound in upcoming months indicated by pork wholesale price, as supply side continued to cut overcapacity. However, non-pork food items became the major headwinds as prices of vegetables and fruits markedly dropped 7.3% and 3.8% MoM in June, while beef price saw a 13.4% YoY decline with -2.5% MoM growth. Vehicle fuel price moderated from 6.3% to 5.6% YoY as its MoM growth notably declined 2% in June compared to -0.8% growth in May. Surprisingly, MoM change of public utility has been 0 since Feb, considering recent news of increasing electricity and water bills.

■ **Core CPI mired in mud as durable goods remained sluggish.** Core CPI remained flat at 0.6%. Its MoM growth further dipped by 0.1% in June after dropping 0.2%. For the first time since Mar 20, it has declined for two consecutive months, as a sign of extremely weak domestic demand. Durable goods consumption was still subdued amid elevated real interest rate and price cut expectations. Vehicles notably plunged by 1% MoM in June, the largest drop in last 15 months, with still no signs of price war ending. Even more concerning was the price drop in new vehicles has transmitted to used car market, with second-hand cars notably declined by 12.5% in early July. Home equipment dropped 1.2% MoM after dipping 1.1%, one of the largest drops in history, partly due to mid-year promotion on e-commerce platform. Telecom equip rebounded by 0.8% MoM following five months of decline. Price of clothing and footwear also declined by 0.2% and 0.4% MoM, broadly in-line with historic seasonality. Service sector registered 0% MoM growth in June as tourism notably declined by 0.8% while rent, home service and medical service saw 0.1% growth. Other services price including telecom, express and education remained unchanged in June. Looking forward, core CPI growth may remain restrained in the near term resulted from deterioration in household income and balance sheet, elevated real interest rate and fierce producer competition, but the trade-in policy could be a potential game-changer.

■ **PPI continued to recover mainly driven by low base effect.** PPI continued to narrow its contraction from -1.4% YoY to -0.8% in June, in line with market expectation. The MoM growth of PPI dropped by 0.2% after rising 0.2% in May. For mining industries, PPI of non-ferrous metals continued its rally rising

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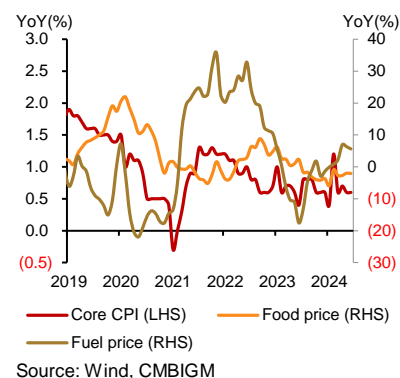
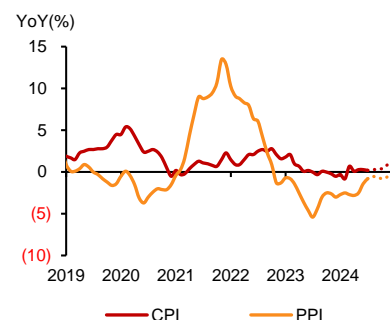
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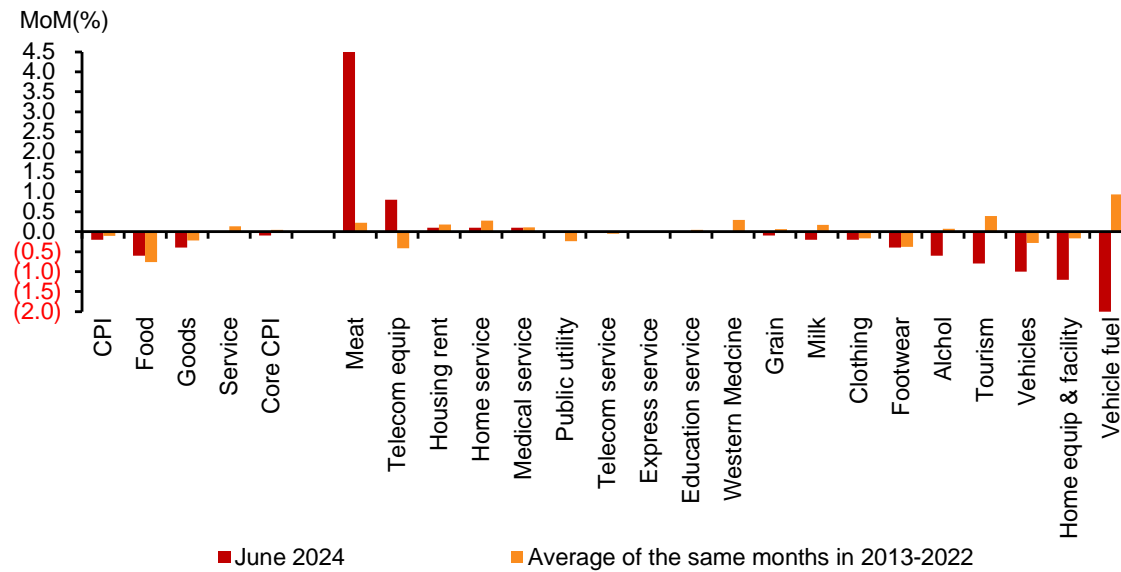
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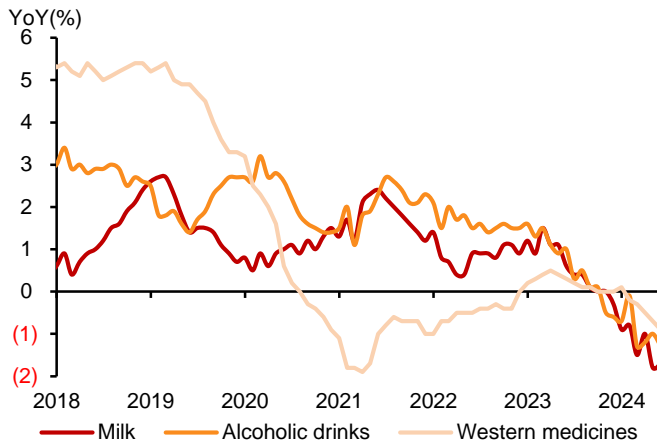


11.5% YoY from 8.9% in May. Oil and gas mining moderated to 8% from 9.4% YoY albeit much lower base last year due to declining crude oil price. Coal mining and ferrous metals both narrowed their decline from -3.7% and -9% YoY to -2.1% and -1.6%. For mid-stream industries, PPI in intermediate goods such as rubber & plastics and metal products saw no change while general machinery dropped 0.1% MoM. Final goods such as auto manufacturing endured higher deflation pressure, dropping 0.7% MoM in June, the largest decline in history as a sign of weak domestic demand and persisted supply-side competition. Looking forward, we expect MoM growth to remain muted due to weak domestic demand while its YoY decline gradually closing in on 0 thanks to lower-base effect and rising raw material cost.

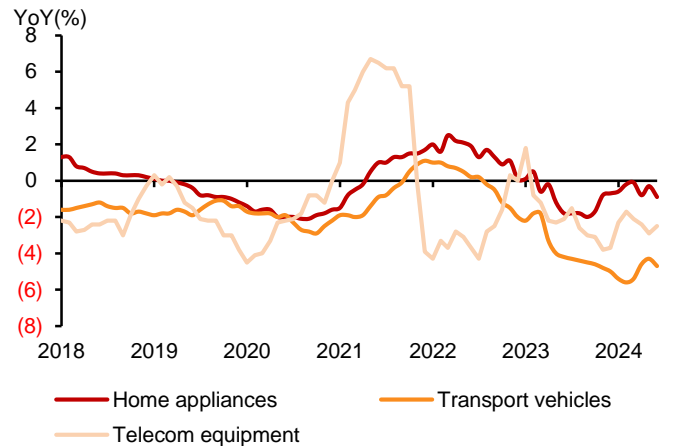
- **The self-reinforcing deflationary expectations could hinder economic recovery.** As we have seen in the auto industry, as a result of overcapacity, diminishing consumer demand and fierce price cuts, once the prolonged deflation has led to the formation of deflationary expectations, the consumption could be further impeded as consumers would just simply sit and wait in exchange for larger purchasing power. Instead of focusing on managing long-term yields, the PBOC should act more aggressively to cut shorter-term policy rates to lower real interest rates, boost consumer demand and defy deflation pressure. We do not expect significant policy stimulus at the Third Plenary Session of the Party's Central Committee in July. A gradual policy easing in the next two quarters would be more likely as possible Fed cut in 2H24 would enable more policy autonomy for the PBOC, since RMB exchange rate stability was a key focus for the PBOC. The central bank may cautiously seek a balance between multiple targets in 2H24 with possible mild cuts in RRR, deposit rates and LPRs.

**Figure 1: MoM changes of China CPI in June**

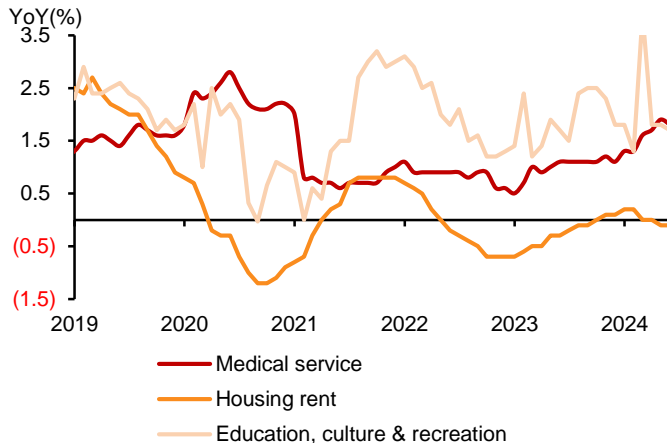
Source: Wind, CMBIGM

**Figure 2: China CPI growth in staples**

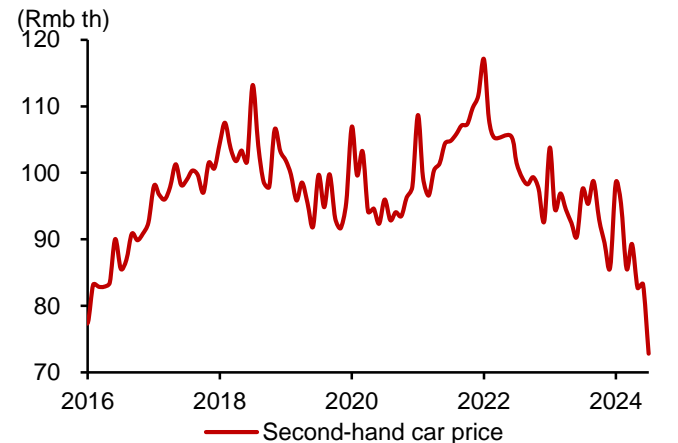
Source: Wind, CMBIGM

**Figure 3: China CPI growth in durables**

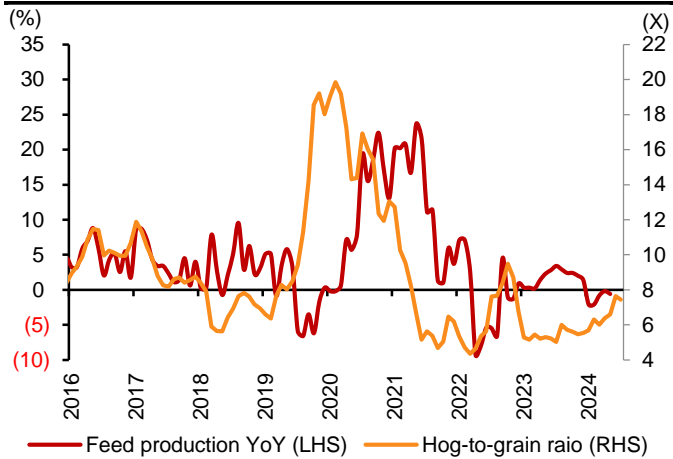
Source: Wind, CMBIGM

**Figure 4: China CPI growth in services**

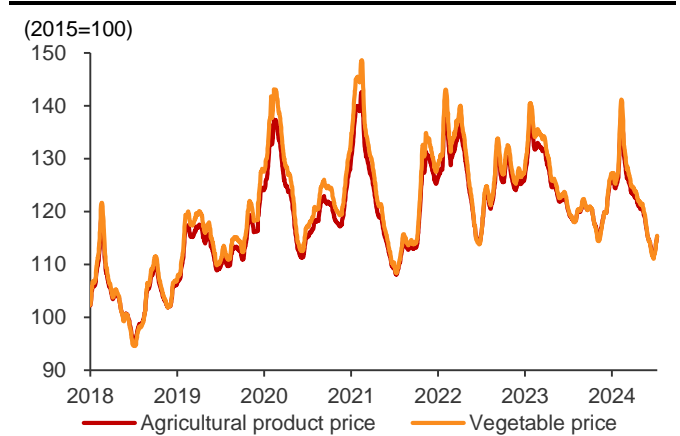
Source: Wind, CMBIGM

**Figure 5: Second-hand car price in Shanghai**

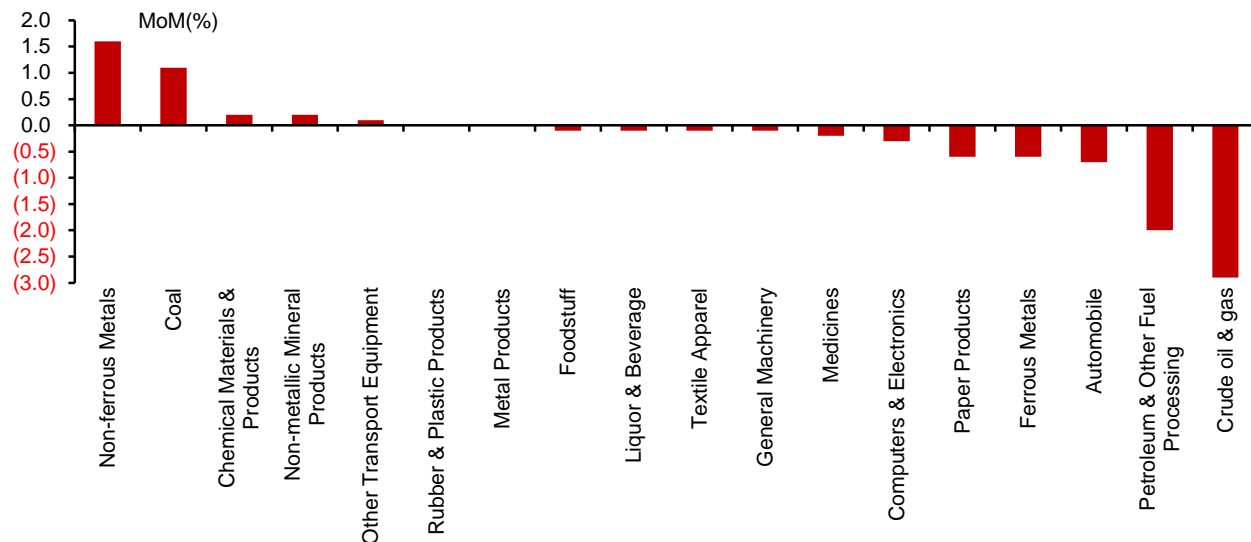
Source: Wind, CMBIGM

**Figure 6: Feed production & hog-to-grain ratio**

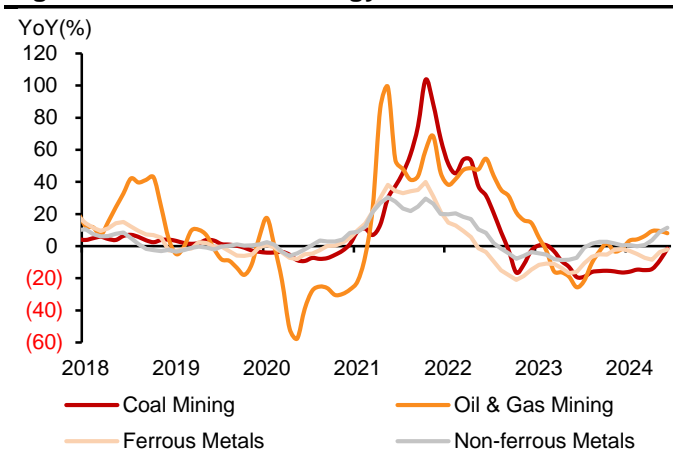
Source: Wind, CMBIGM

**Figure 7: Agricultural and vegetable price**

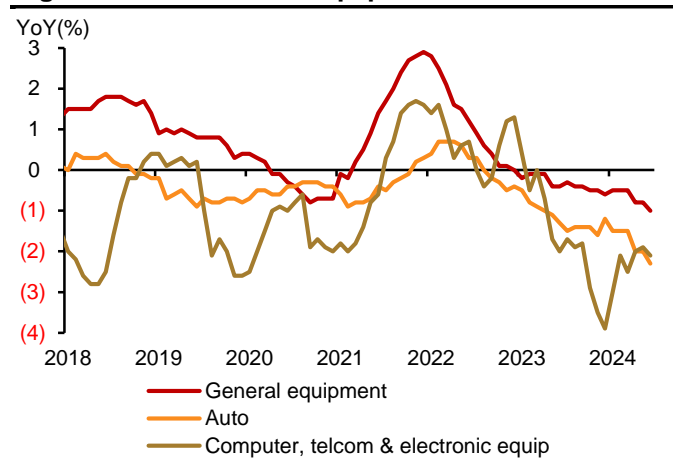
Source: Wind, CMBIGM

**Figure 8: MoM changes of China PPI in June**

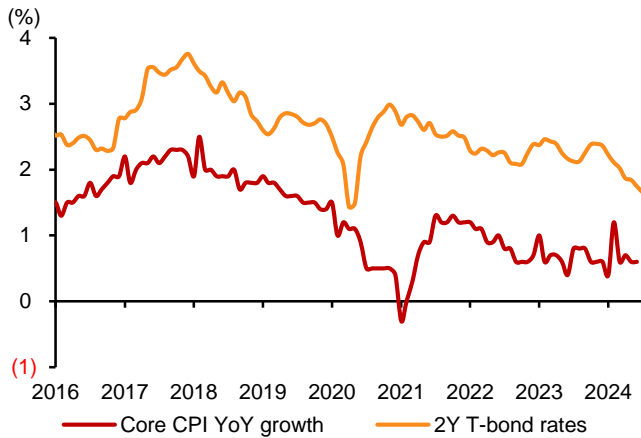
Source: Wind, CMBIGM

**Figure 9: China PPI in energy & metals**

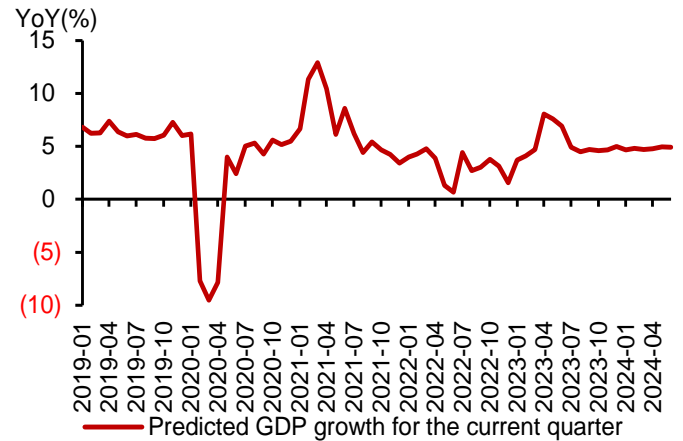
Source: Wind, CMBIGM

**Figure 10: China PPI in equipment**

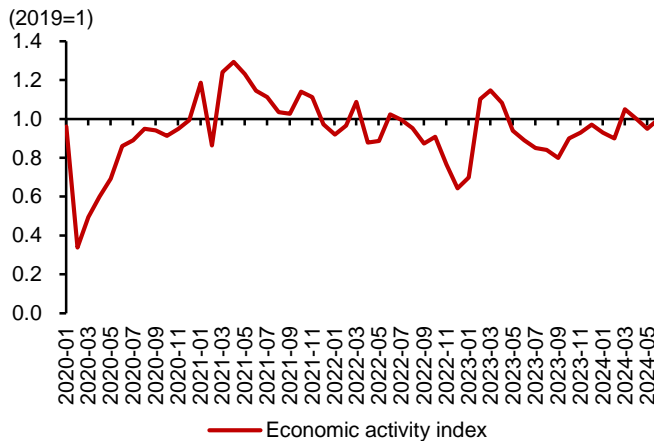
Source: Wind, CMBIGM

**Figure 11: China core CPI growth & 2Y T-bond rates**

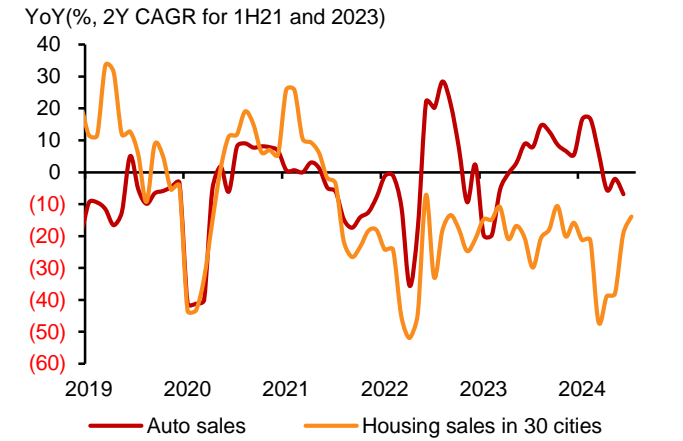
Source: Wind, CMBIGM

**Figure 12: GDP growth predicted by AI**

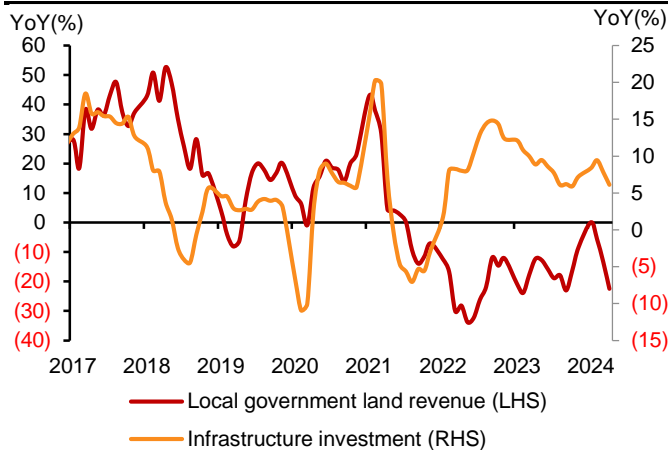
Source: Wind, CMBIGM estimates

**Figure 13: China Economic Activity Index**

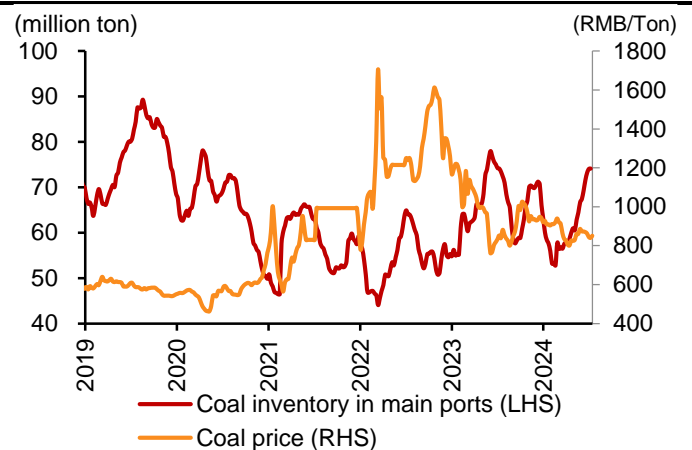
Source: Wind, CMBIGM

**Figure 14: China auto & housing sales**

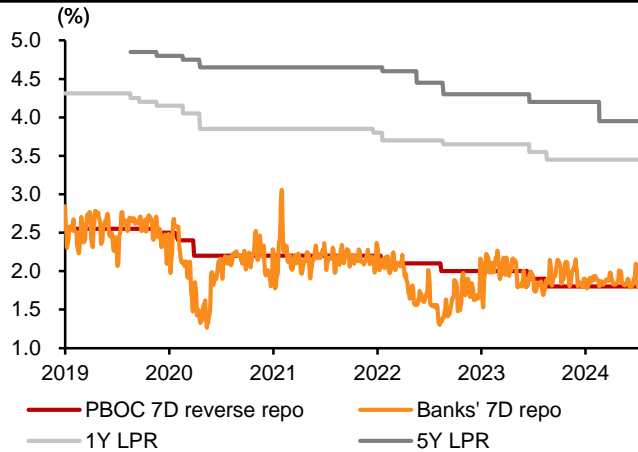
Source: Bloomberg, CMBIGM

**Figure 15: Infrastructure investment in China**

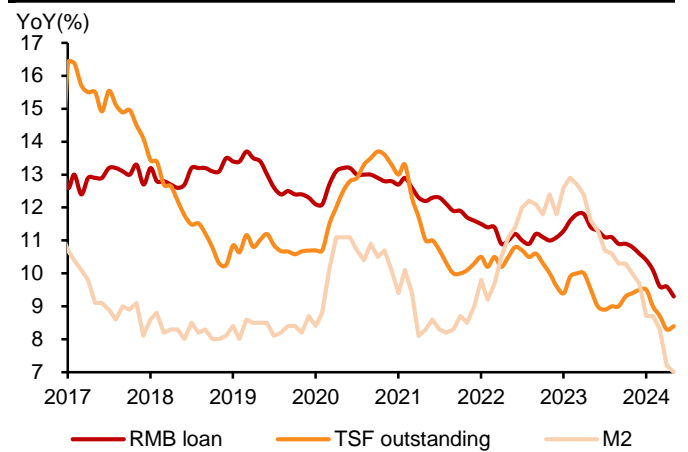
Source: Bloomberg, CMBIGM

**Figure 16: China coal inventory & price**

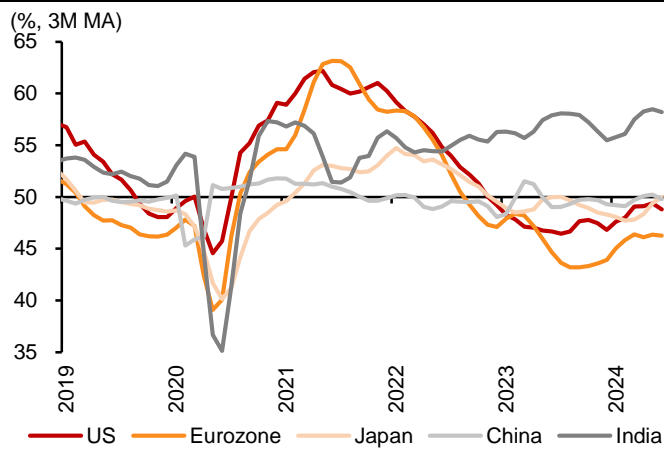
Source: Wind, CMBIGM

**Figure 17: PBOC policy rates & liquidity condition**

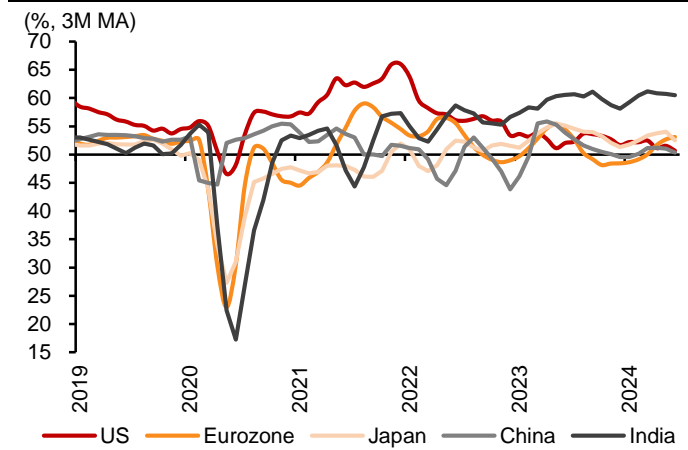
Source: Bloomberg, CMBIGM

**Figure 18: China credit growth**

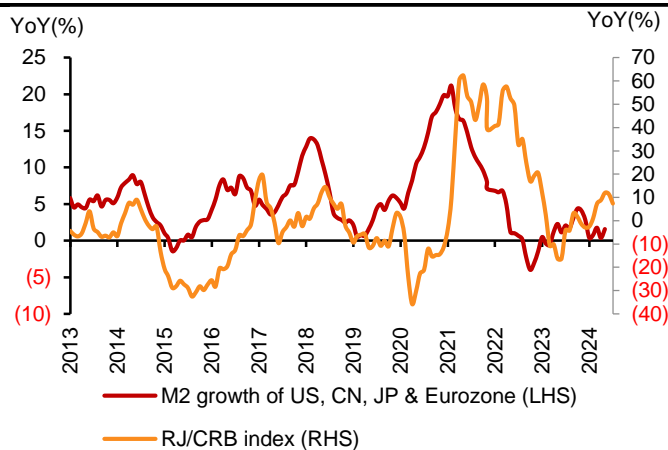
Source: Wind, CMBIGM

**Figure 19: Manufacturing PMI of major economies**

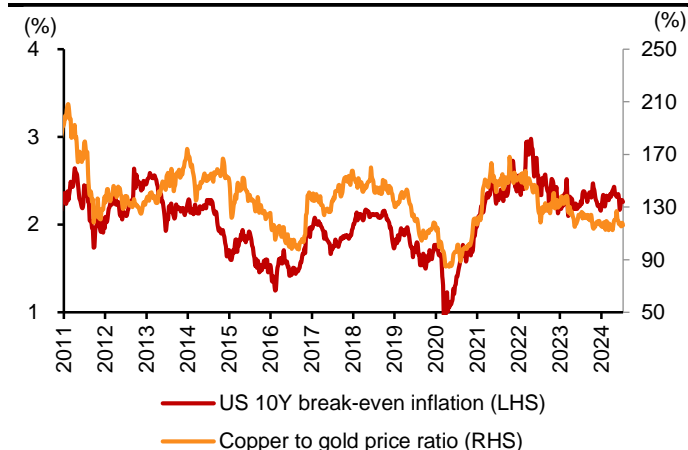
Source: Bloomberg, CMBIGM

**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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