

China Economy

Deflation bottomed with possible mild reflation

China's CPI growth dropped further in July to -0.3% as consumer demand remained sluggish and food & energy prices dropped sharply. Core CPI mildly picked up as demand in service sector especially in travel, medical service and home service continued to recover. China's PPI narrowed its YoY declines thanks to base effect and MoM increases in some raw materials. Looking forward, the deflation may have been in the bottom as domestic demand gradually restores and overseas commodity prices rebound in 2H23. We maintain forecast on CPI growth at 0.6% for 2023 and 2% for 2024. The PPI is expected to drop 2.7% in 2023 and rise 1.3% in 2024. The deflation will increase debt burden and hurt durable consumption and capex demand. China is likely to further loosen credit policy and property policy in future.

- CPI growth dipped into contraction as consumer demand was sluggish and food & energy prices dropped sharply.** CPI dropped 0.3% YoY in July from 0% growth in June. The negative CPI is mainly driven by the food and energy sector. Food CPI declined 1.7% YoY in July after rising 2.3% in June as pork price dropped notably at 26% YoY in July from a 7.2% YoY decline in June. Fuel CPI slowed down on deflation trend and declined 13.2% YoY in July after dropping 17.6% YoY in June. Core CPI growth marginally increased to 0.8% YoY in July from 0.4% YoY led by a robust service sector reflation. Breaking down by sectors, CPI in transport vehicles, home appliances and telecom equipment further declined as durable demand remained weak and supply competition was tough. But CPI YoY growth in travel saw its biggest climb in years thanks to the release of pent-up demand in the first summer holiday following the pandemic. Employment condition especially for the youth remained challenging as housing rent continued to decline in July. Medicines, medical service, home service, recreational services and apparel experienced a mild reflation as demand in these sectors continued to recover.
- PPI narrowed its declines due to base effect and restored demand in a number of raw materials.** PPI declined 4.4% YoY in July after dropping 5.4% YoY in June, largely resulted from price rebound in a few raw materials. The decline of PPI in coal mining, oil & gas mining, ferrous metal and non-ferrous metal respectively slowed down to 19.1%, 21.5%, 10.6%, and 1% after dropping 19.3%, 25.6%, 16%, and 7.2% YoY in June. From the MoM perspective, PPI's drop narrowed to 0.2% in July after dipping 0.8% in June. Prices of crude oil & gas and non-ferrous metals increased 0.6% and 0.4% MoM in July. However, prices of non-metallic mineral products, coal, chemical materials & products, and paper products declined by 2%, 2%, 1.2% and 1.1% MoM in July.
- Deflation pressure could be around the bottom as domestic demand gradually recovered from the trough in 2Q23.** The July politburo meeting indicates a more pro-growth policy stance in the second half year. The policymakers changed the optimistic view on the economic outlook and signaled more active policy easing ahead. The weak private confidence is likely to restore gradually in 2H23 with the policies starting to work, which is positive for the recovery of goods and service consumption. Meanwhile, overseas commodity prices continued to rally in recent months as oil and metals price showed an upward momentum. Therefore, the reflation should

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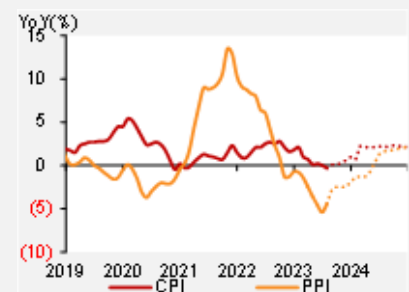
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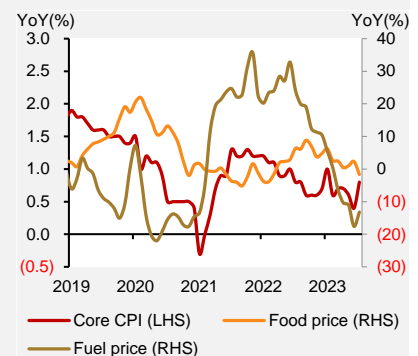
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Source: Wind, CMBIGM

Forecast numbers from Aug 2023

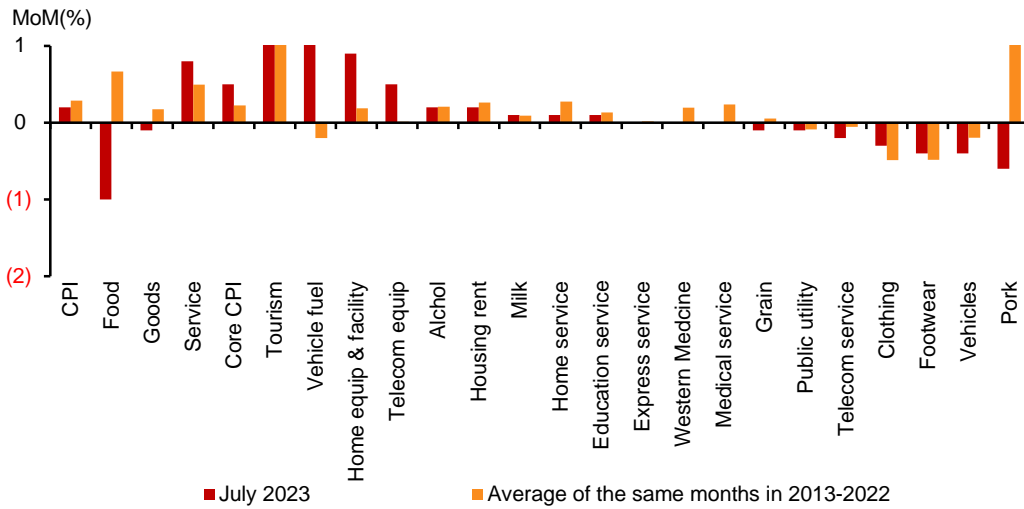


Source: Wind, CMBIGM

be quite mild in China as we maintain the forecast for CPI growth in 2023 at 0.8% and lower than that in 2024 from 2.4% to 2.1%. We cut the forecast for PPI growth in 2023 and 2024 from -2.3% and 1.7% to -2.7% and 1.3%, respectively.

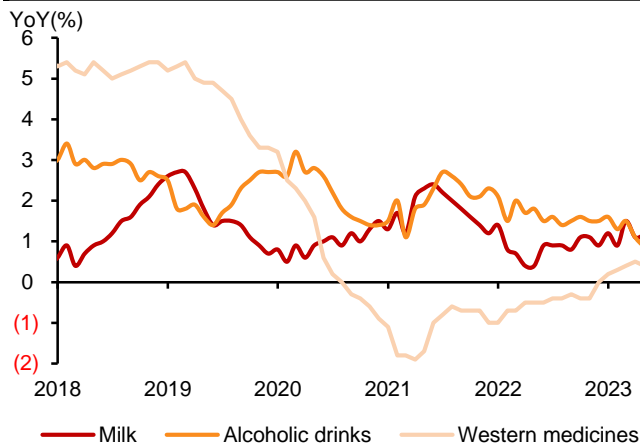
- **China may further loosen economic policies to boost growth momentum.** The deflation will hurt durable consumption and capex and increase debt burden for borrowers. The PBOC may further cut RRR, deposit rates and LPRs and guide banks to increase credit supply to real sector and to roll over the debts of property developers and local government financing vehicles. Meanwhile, more cities will loosen property policies with removal of home purchase restrictions and reduction in down-payment ratios & mortgage rates for first-home and second-home buyers. We expect the YoY growth of total social financing balance to reach the bottom in 3Q23.

Figure 1: MoM Changes of China CPI in May



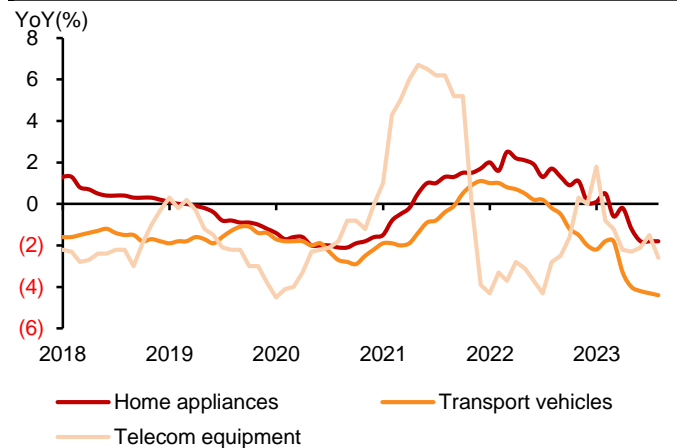
Source: Wind, CMBIGM estimates

Figure 2: China CPI Growth in Staples



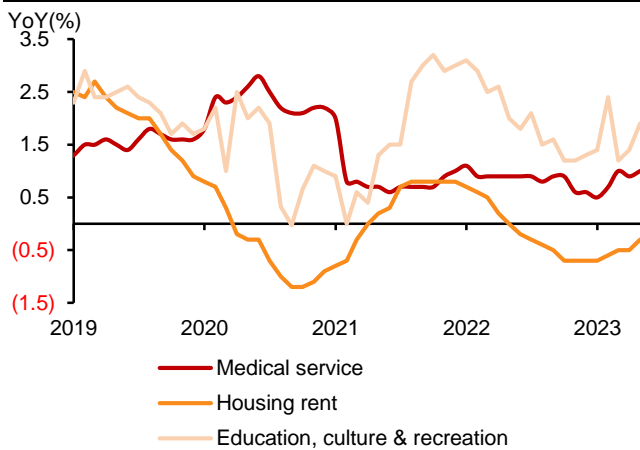
Source: Wind, CMBIGM

Figure 3: China CPI Growth in Durables



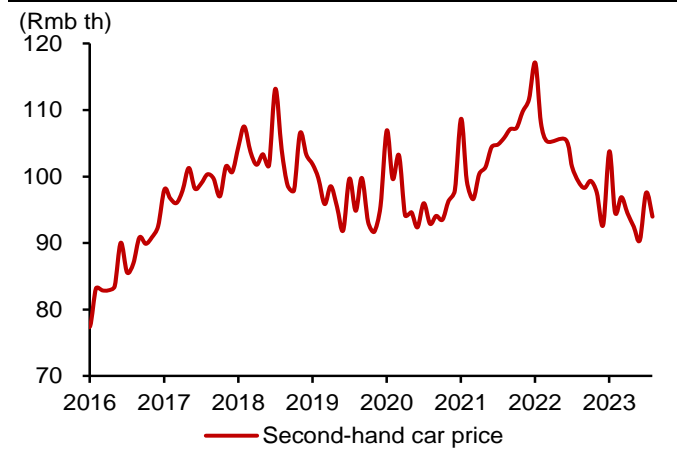
Source: Wind, CMBIGM

Figure 4: China CPI Growth in Services



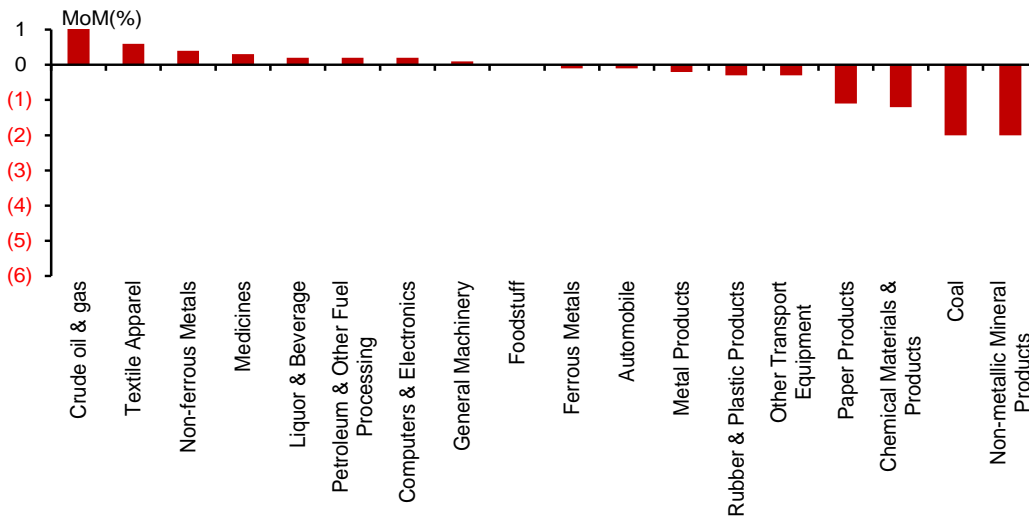
Source: Wind, CMBIGM

Figure 5: Second-hand Car Price in Shanghai



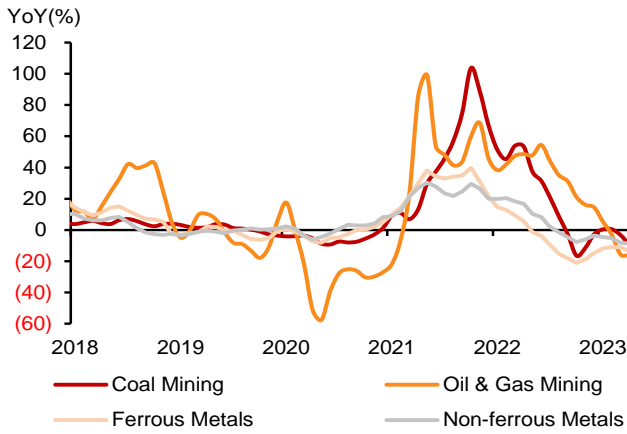
Source: Wind, CMBIGM

Figure 6: MoM Changes of China PPI in May



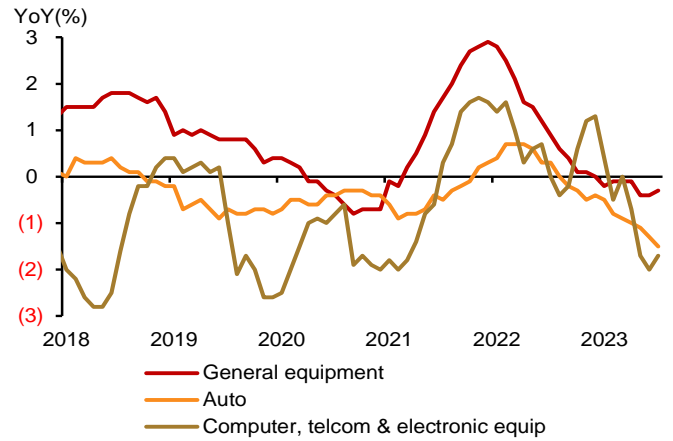
Source: Wind, CMBIGM estimates

Figure 7: China PPI in Energy & Metal



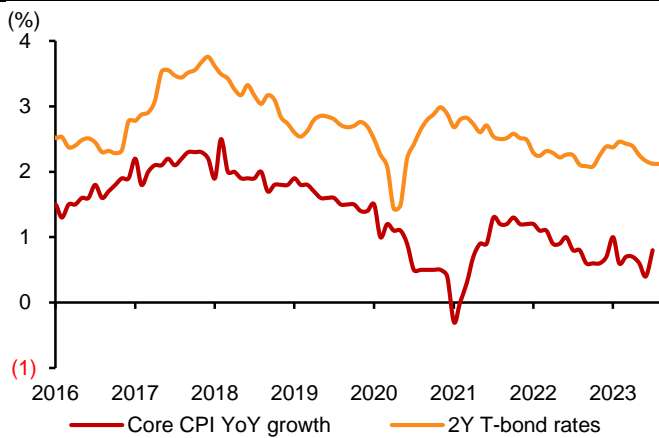
Source: Wind, CMBIGM

Figure 8: China PPI in Equipment



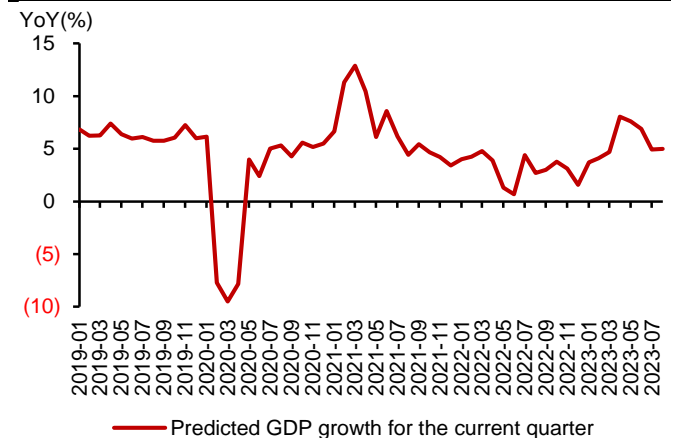
Source: Wind, CMBIGM

Figure 9: China Core CPI Growth & 2Y T-bond Rates



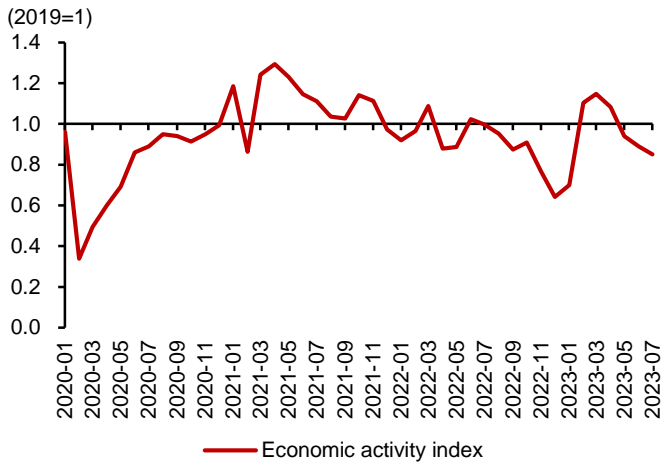
Source: Wind, CMBIGM

Figure 10: China Predicted GDP Growth



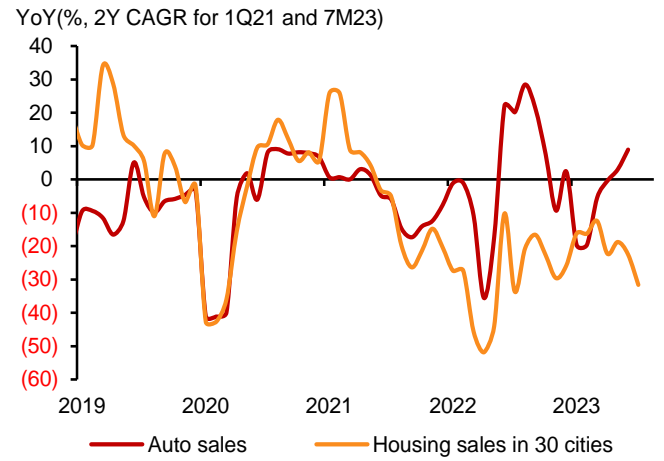
Source: Wind, CMBIGM

Figure 11: China Economic Activity Index



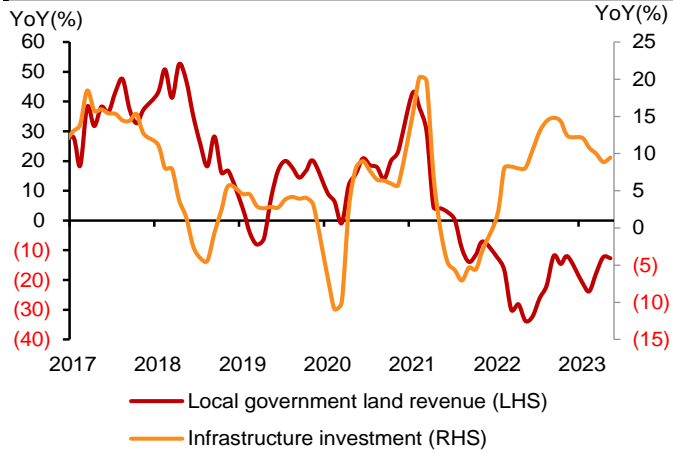
Source: Wind, CMBIGM

Figure 12: China Auto & Housing Sales



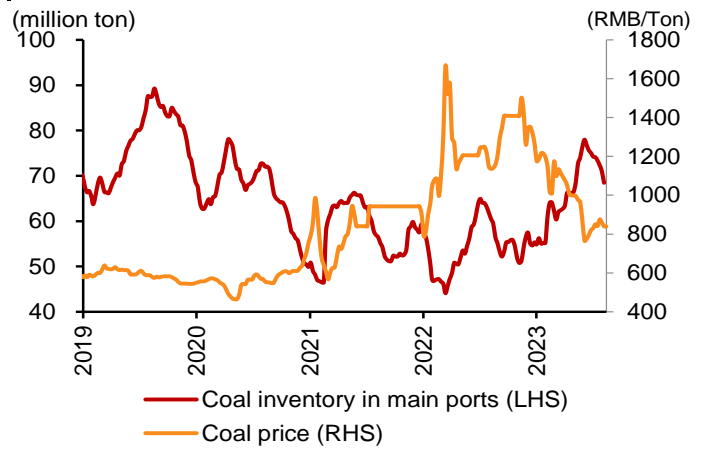
Source: Bloomberg, CMBIGM

Figure 13: Infrastructure Investment in China



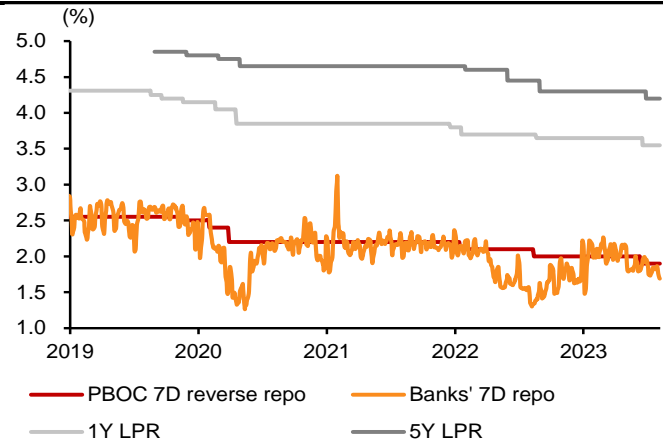
Source: Bloomberg, CMBIGM

Figure 14: China Coal Inventory & Price



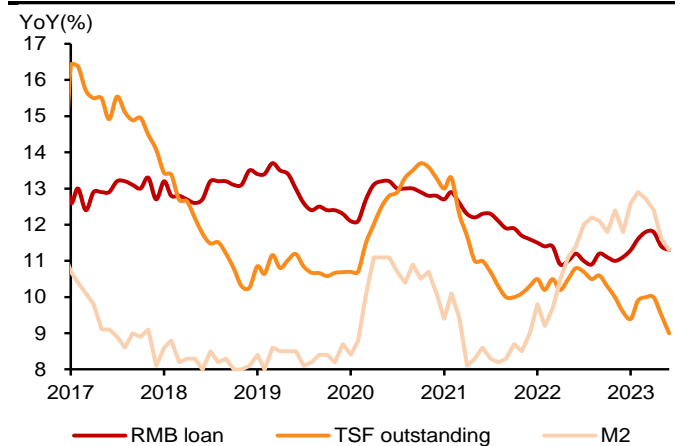
Source: Wind, CMBIGM

Figure 15: PBOC Policy Rates & Liquidity Condition



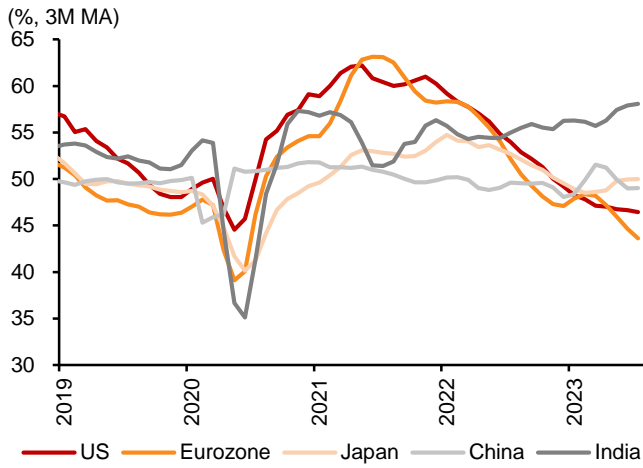
Source: Bloomberg, CMBIGM

Figure 16: China Credit Growth



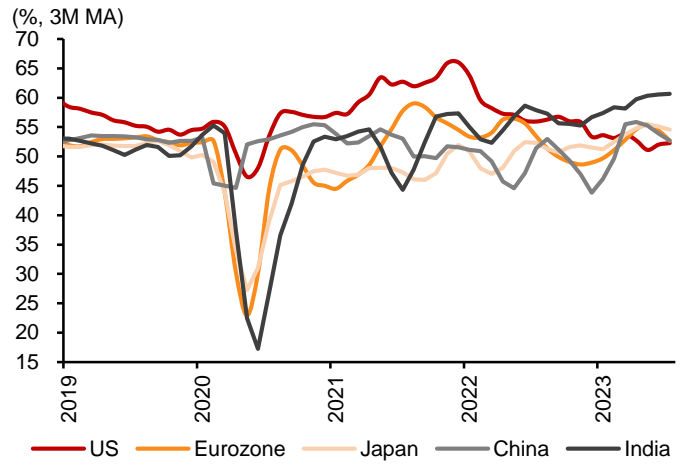
Source: Wind, CMBIGM

Figure 17: Manufacturing PMI of Major Economies



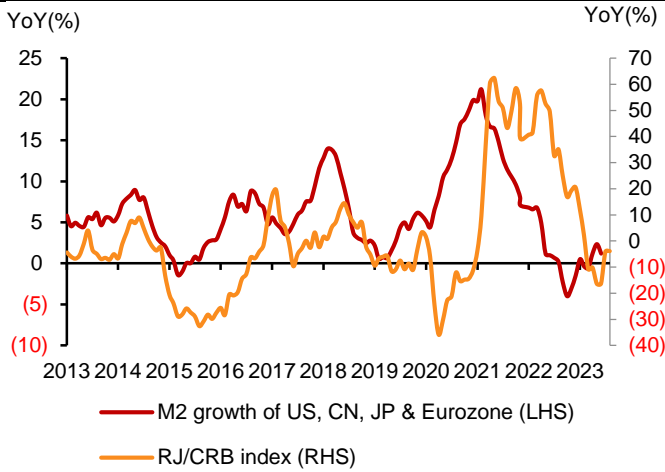
Source: Bloomberg, CMBIGM

Figure 18: Service PMI of Major Economies



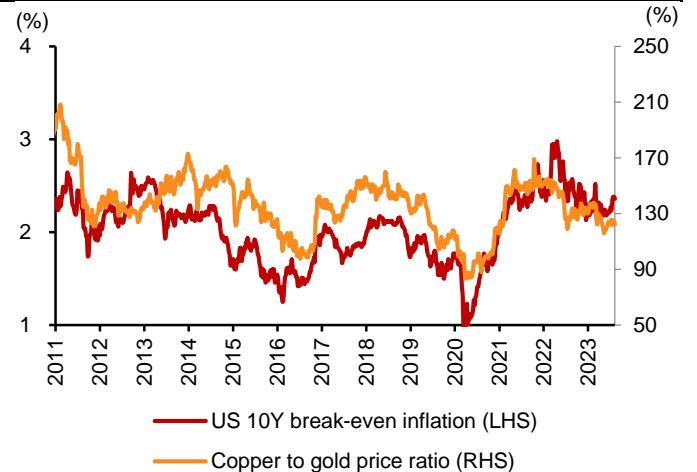
Source: Wind, CMBIGM

Figure 19: M2 Growth & Commodity Inflation



Source: Bloomberg, CMBIGM

Figure 20: Copper-to-gold Ratio



Source: Wind, CMBIGM

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