

# CHINA ECONOMICS UPDATE

## Deflation likely temporary but slowdown isn't

- **Consumer price inflation slipped into negative territory in July. But this probably won't last more than a quarter or two and has less to do with the health of domestic demand than many think. Inflation in services, the part of the CPI basket most influenced by domestic conditions, has picked up. That makes it harder to blame cyclical headwinds for the current weakness, reinforcing our view that structural factors are playing a bigger role and that most of the slowdown since the start of the pandemic can't be reversed by policy stimulus.**
- At the start of this year, after China abandoned its zero-COVID policy and its economy began to recover, many wondered whether it would follow the path of other countries and experience a post-reopening jump in inflation. At the time, [we argued](#) that any pick-up in Chinese inflation would be modest compared to elsewhere. But none of the economists surveyed by the major polling companies, including us, had anticipated that CPI would rise by less than 1.0% in 2023 – it has averaged just 0.5% so far this year.
- **The blame has been widely pinned on the disappointing recovery in domestic demand.** This certainly helps explain why inflation hasn't picked up following reopening. **But it isn't the reason for the decline in inflation.** Instead, the main culprit is simply lower food and energy prices, upon which domestic economic conditions have limited bearing. Admittedly, oil prices are partly driven by Chinese demand. But their trajectory since the start of last year mostly reflects global factors, especially the Ukraine war. And when it comes to food prices, much depends on weather conditions and the idiosyncrasies of China's pork cycle.
- Core inflation, a better guide to underlying price pressures, has not declined nearly as much – it has averaged 0.7% so far this year, down from 0.9% in 2022. (See Chart 1.) What's more, **the drag on core inflation has come from the recent pullback in foreign demand rather than domestic weakness.**
- One way to see this is to compare inflation in services, which are mostly non-tradeable and therefore dependent on domestic conditions, with inflation in core goods, where foreign demand plays a greater role. **Services inflation has ticked up this year**, reflecting the fact that although recent growth in domestic demand has been underwhelming, it still marks an improvement relative to last year. **In contrast, core goods inflation has slumped amid a growing excess supply of goods.** (See Chart 2.)

Chart 1: Consumer Prices (% y/y)

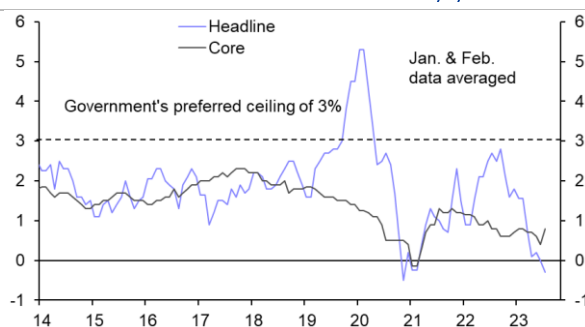
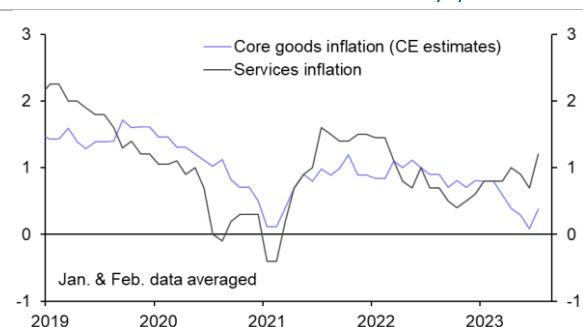


Chart 2: Consumer Prices (% y/y)

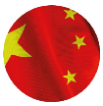


Sources: CEIC, Capital Economics

- **The origins of this excess goods supply lie with the surge in global goods demand during the pandemic.** To meet the sudden increase in demand, Chinese factories invested heavily in expanding capacity. But now that consumption patterns are returning to normal and fiscal support in developed economies has been pared back, global goods demand is dropping back. In response, Chinese firms are slashing their export

Julian Evans-Pritchard, Head of China Economics, [julian.evans-pritchard@capitaleconomics.com](mailto:julian.evans-pritchard@capitaleconomics.com)

Zichun Huang, China Economist, [zichun.huang@capitaleconomics.com](mailto:zichun.huang@capitaleconomics.com)



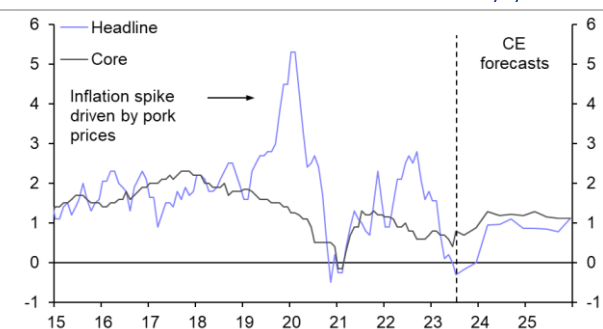
prices (see Chart 3), which is having a knock-on effect on domestic prices for the same goods given that the recovery in domestic demand has been too modest to absorb the additional capacity created by the decline in foreign demand.

- There are a number of takeaways from all of this. The first is that, **contrary to what many believe, China's inflation data doesn't point to a major cyclical downturn in domestic demand** – the cleanest measure of domestic prices pressures, services inflation, has picked up.
- Second, **deflation is likely to be temporary** – base effects mean that food and energy inflation look set to turn positive again around the turn of the year, alleviating the main drag on headline CPI. And if we are right that policy support will drive a modest reacceleration in economic activity over the remainder of this year, then services inflation should continue to edge up too.
- **To be sure, any rebound in Chinese inflation over the coming year is likely to be modest.** Policymakers still have a preference for investment-led stimulus over handouts to consumers. The former is less inflationary because it also boosts the supply-side of the economy. Meanwhile, the current excess supply of manufactured consumer goods is likely to persist for an extended period. The recent pullback in foreign demand isn't a typical cyclical downturn that will be easily reversed, even once developed central banks pivot back to looser monetary policy. Instead, it is a return to normality following a period of unusually strong demand caused by a one-off shock that (hopefully) won't be repeated anytime soon. Assuming Chinese exports return to their pre-pandemic trend, it could take years before they regain their 2022 highs.
- All told, **we think consumer price inflation will return to positive territory by year-end and average around 1.0% in 2024 and 2025.** (See Chart 4.) That's low by international standards but within historic norms for China – the country's investment-intensive growth model often leads to periods of low inflation, especially amid pullbacks in foreign demand.
- While that might sound reassuring, **our relatively sanguine view on inflation still lends itself to a troubling conclusion for the growth outlook.** If underlying price pressures outside of the export sector aren't as weak as they look, then it suggests that the bulk of the slowdown in domestic demand growth since the start of the pandemic is **structural in nature** rather than cyclical. As a result, we think policy stimulus will struggle to lift growth significantly above current levels, at least on a sustained basis.

Chart 3: Export Price Index (\$, 100 = 2010)



Chart 4: Consumer Price Inflation (% y/y)



Sources: CEIC, Refinitiv, Capital Economics



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