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China's fragile economic condition raises concern that deflationary pressure may persist, despite signs of stabilisation

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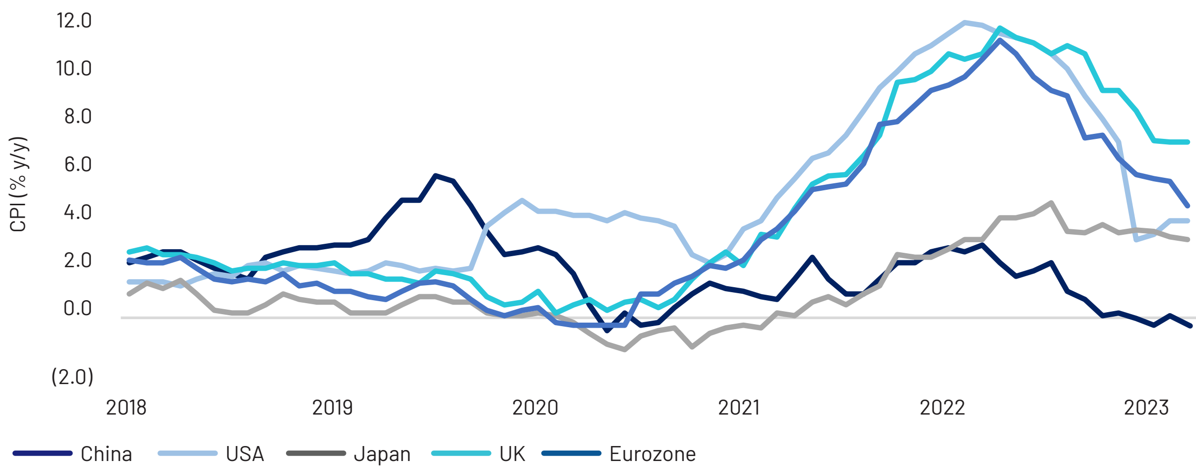
While most major economies continue to struggle with stagflation, with low growth coupled with high inflation, China, the world's second-largest economy, slipped into deflation in July. Deflationary pressure moderated in August, with the Consumer Price Index (CPI) rebounding from negative territory.

However, the CPI remained flat in September, despite signs of an economic rebound, indicating that the economy remains fragile and raising concerns that deflationary pressure may persist given weak consumer demand and the property slump.

Inflation in key economies

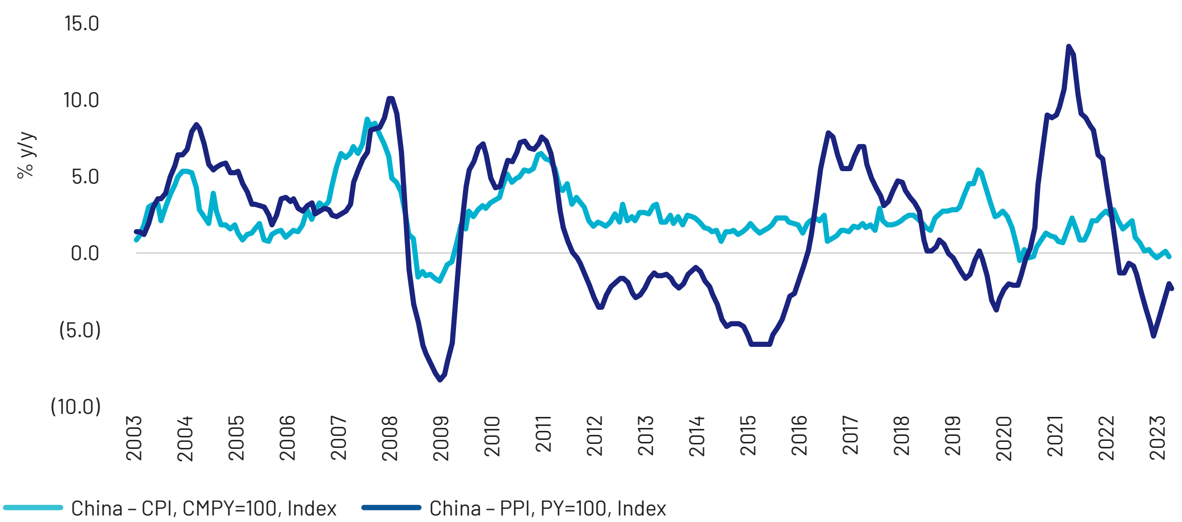


Source: FactSet, Eurostat

Most key economic indicators show signs of a recovery, but deflationary risk persists

Recent data on overall economic activity shows signs of economic stabilisation. However, still-weak economic indicators signal underlying issues, increasing risk of deflationary pressure.

CPI and PPI in China



Source: FactSet

The CPI was flat y/y in September, vs 0.1% y/y growth in August, following the 0.3% y/y drop in July. The CPI rose by 0.4% y/y for 9M23, far below Beijing's annual control target of 3.0% y/y.

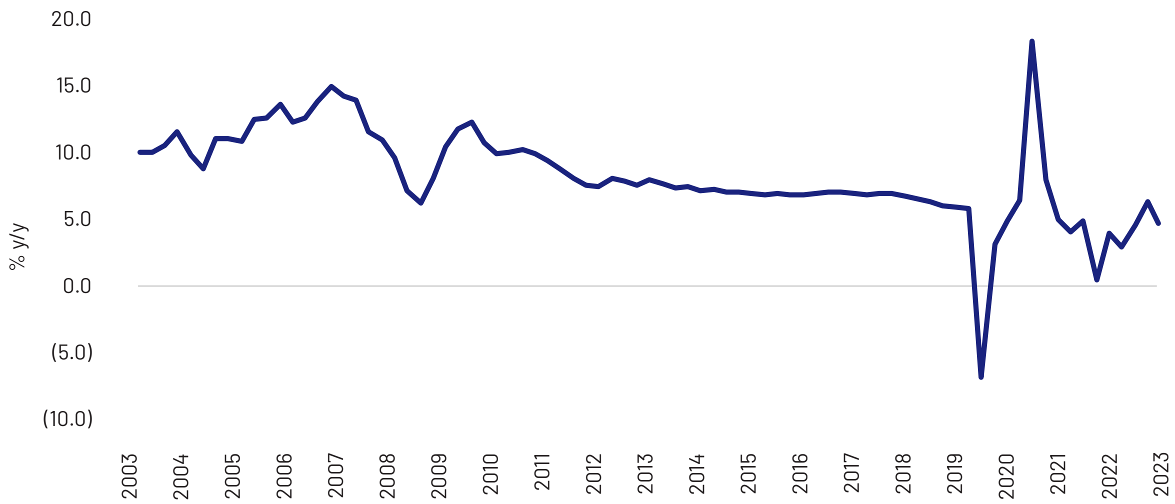
» The CPI measures the change in prices of goods and services consumed by households and reflects the change in price levels
» Food prices declined 3.2% y/y in September (vs -1.7% y/y in August and July), driven primarily by the steep decline in the price of pork, the most widely consumed meat in the country, by 22.0% y/y (vs -17.9% y/y in August and -26.0% y/y in July). This contraction was driven further by the drop in prices of livestock and meat (-12.8% y/y) and fresh vegetables (-6.4% y/y)
» Non-food inflation continued to grow, at 0.7% y/y (vs 0.5% in August and 0.0% in July), on the back of services prices, which climbed by 1.3% y/y
» Core inflation, excluding food and energy prices, remained steady and rose by 0.8% y/y in September, August and July

The Producer Price Index (PPI) dropped by 2.5% y/y, for a 12th consecutive month in September, underlining continuing weakness in the industrial sector. However, factory-gate price deflation has shown a narrowing trend since July (-3.0% y/y in August vs -4.4% y/y in July vs -5.4% y/y in June), with the recovery in domestic raw material prices on the back of rising global commodity prices.

» The PPI measures the cost of goods leaving factories (factory-gate prices) charged to wholesalers and provides an overview of the health of an economy

GDP growth: China's 3Q23 economic growth was 4.9% y/y (vs 6.3% y/y in 2Q23 and 4.5% y/y in 1Q23), suggesting that it is on track to achieve Beijing's growth target of 5.0% this year.

Real GDP growth in China by quarter



Source: FactSet

Retail sales, an indicator of household spending, rose by 5.5% y/y in September vs 4.6% y/y in August and 2.5% y/y in July.

Industrial output was up by 4.5% y/y in September and August vs 3.7% y/y in July.

China's official **manufacturing Purchasing Managers' Index (PMI)** was reported at 49.5 in October vs 50.2 in September and 49.7 in August. A reading below 50.0 marks a contraction vs the previous month.

China's **PMI for non-manufacturing sectors**, including services and construction activity, fell to 50.6 in October, the lowest for the year so far, vs 51.7 in September and 51.0 in August.

Profits at China's industrial firms climbed 11.9% y/y vs 17.2% y/y in August, -6.7% y/y in July and -8.3% y/y in June.

However, **property investment** continued to deteriorate, by 18.7% y/y in September, for a 19th consecutive month vs -19.1% y/y in August and -17.8% y/y in July. For 9M23, property investment declined by 9.1% y/y vs an 8.8% y/y drop for 8M23.

Fixed asset investment continued to grow, by 3.1% y/y over 9M23 vs 3.2% y/y over 8M23, 3.4% y/y over 7M23 and 3.8% y/y over 1H23. **Fixed asset investment by private firms** fell 0.6% y/y during 9M23, highlighting weak private-sector confidence.

The urban unemployment rate eased to 5.0% in September vs 5.2% in August and 5.3% in July. However, China suspended publishing youth unemployment data, which was at a record high of 21.3% in June, citing the need to refine assessment standards of the labour market.

What is deflation?

Deflation is a general decline in the price levels of goods and services in an economy.

Causes of deflation

Deflation generally stems from the following:

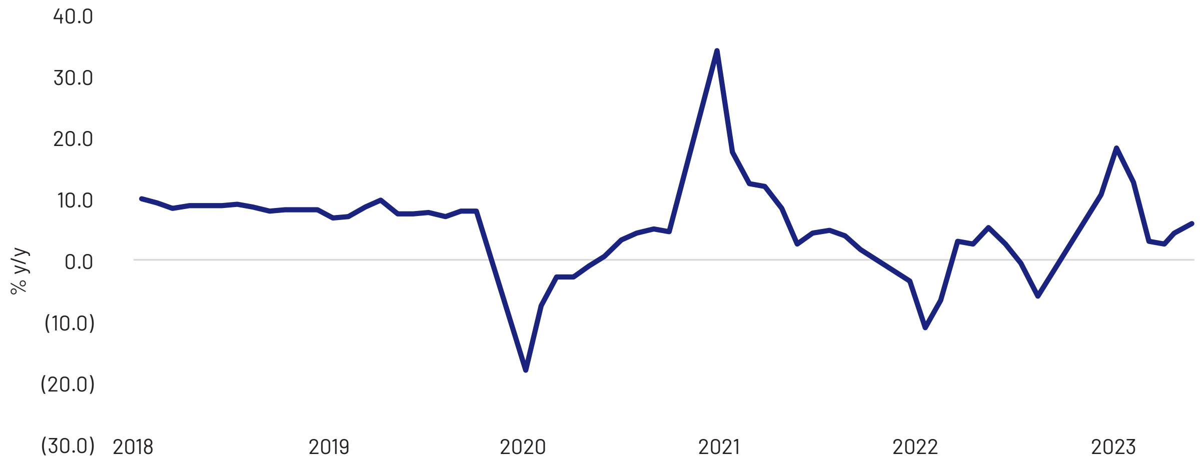
- Reduced consumer demand: Consumers are less likely to spend due to low confidence in the economy
- Oversupply of goods: This occurs when businesses produce more goods and services at a lower cost, sometimes due to technological innovation
- Decrease in money supply: Central banks reduce money supply in the economy by raising interest rates, raising banks' reserve requirements and selling government bonds

Drivers of China's deflationary pressure

Weak consumer spending, with a high level of precautionary saving

China's consumer spending has improved, with a gradual recovery in retail sales – growth of 5.5% y/y in September vs 4.6% y/y in August and 2.5% y/y in July. However, consumer spending remains weak due to low consumer confidence, with growth below the pre-pandemic level (c.8% y/y in 2019).

Retail sales in China



Source: FactSet

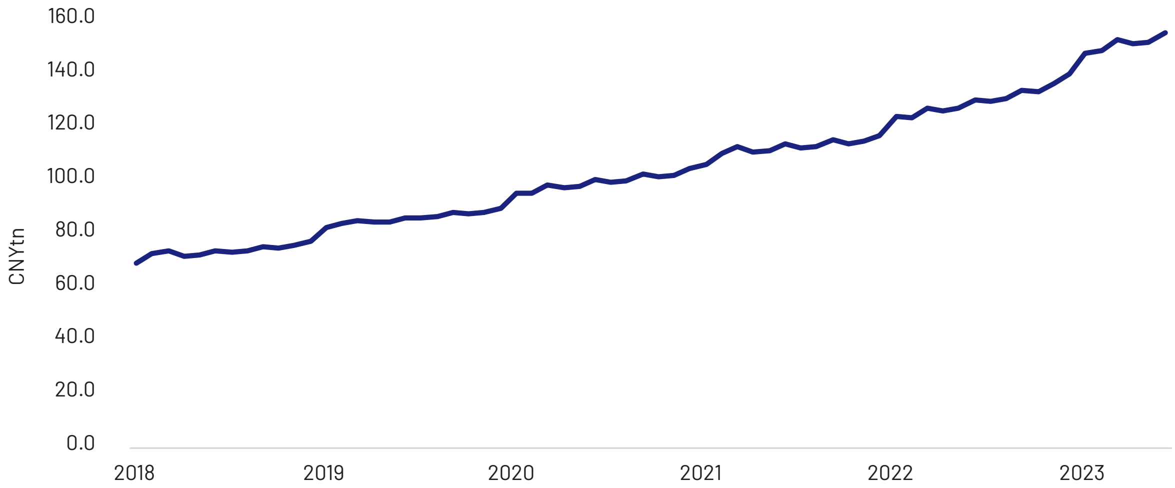
The Golden Week holiday, which fell on the eight days to 6 October, saw a lacklustre recovery in consumption, with travel and spending data only slightly better than during the pre-pandemic Golden Week holiday in 2019, which lasted seven days. Data for 2023 also missed official projections.

» Domestic tourism revenue for the holiday period amounted to CNY753.0bn, up by 129.5% y/y and 1.5% higher vs 2019 (vs projected: CNY782.5bn)
» 826m trips were reported within mainland China, up by 71.3% y/y and 4.1% higher vs 2019 (vs projected: 900m trips)
» Average spending per trip was CNY911.6 vs CNY830.8 in 2019 and CNY680.6 in 2022

Tepid domestic demand was due to government policies aimed at supporting production and investment more than consumption, and high unemployment.

Amid low consumer confidence, the Chinese have been maintaining high levels of precautionary saving due to the economic uncertainty, leading to weak consumer spending and demand. Despite the policy measures to maintain low interest rates to stimulate demand, the household savings rate continued to grow, with the personal deposit base reaching CNY135.6tn in September, on a continued increase from CNY132.3tn in July.

Personal deposits



Source: The People's Bank of China (PBoC)

Real estate slump weighs heavily on the economy

The real estate market – one of China's main growth drivers, estimated to account for c.30% of GDP[1] – has been in crisis since 2021. The government's crackdown on over-leveraging resulted in limited access to financing for property developers, leading to the failure of highly indebted developers. The situation worsened amid the global economic slowdown. Construction and development had to be halted on a large scale due to the lack of financing, resulting in buyers not receiving homes even after hefty down-payments. Concern about not receiving their homes in time has led to a reduction in new-home sales and a sharp decline in property prices.

The sector faces structural issues, reducing housing demand further.

- Lower demand for housing in tier 2 and 3 cities[2] , with a slowdown in the rate of urbanisation
- Lower demand for newer and bigger homes given plummeting marriage and birth rates
- An ageing population – the government projects that 400m of its people will be aged 60 and above by 2035, representing c.30% of the population, vs 280m at the end of 2022 (19.8% of the population)
- Reduced demand, with most youth choosing to stay with their parents for longer due to high youth unemployment (latest disclosed rate of youth unemployment: 21.3% in June)

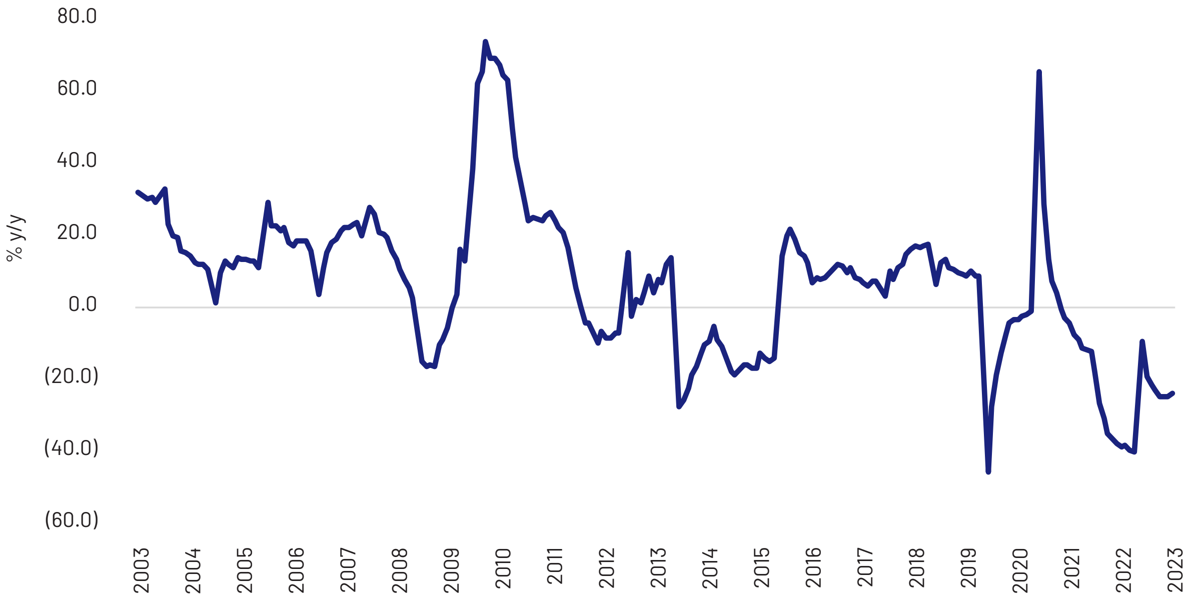
[1] CaixaBank estimate

[2] Tier 2 includes cities with GDP of USD68-299bn; tier 3 cities report GDP of USD18-67bn

China's property sales and investment posted double-digit declines as the government's efforts to support big cities failed to bolster confidence in the sector. However, property easing measures have stabilised sales volumes and values to a certain extent.

- The decline in property sales by floor area narrowed to -19.8% y/y in September vs -24.0% y/y in August. However, property sales contracted at a higher rate of 7.5% y/y over 9M23 vs a 7.1% y/y decline over 8M23
- New construction starts measured by floor area dropped by 23.4% y/y in 9M23 vs -24.4% y/y in 8M23, suggesting that developers remain cautious amid muted demand

China's new construction starts by floor area, accumulated growth

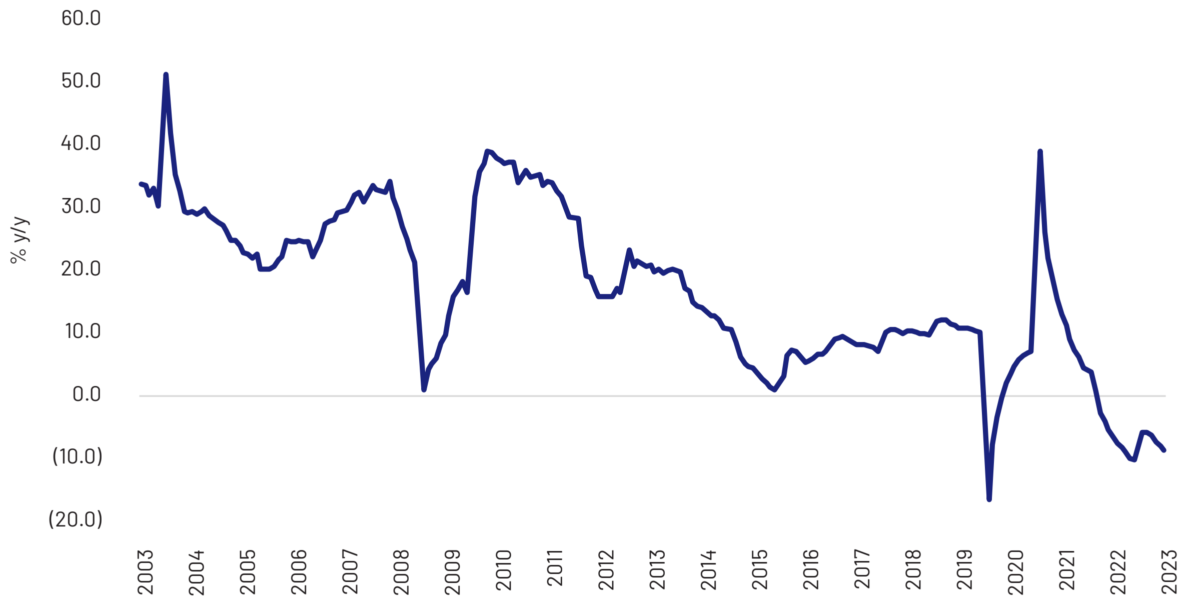


Source: National Bureau of Statistics

Funds raised by China's property developers were down by 13.5% y/y vs a 12.9% slide in 8M23.

Shattered consumer confidence resulted in a contraction in property investments by 18.7% y/y in September for a 19th consecutive month vs -19.1% y/y in August and -17.8% y/y in July. For 9M23, property investment declined by 9.1% y/y vs an 8.8% y/y drop in 8M23.

China's property investment, accumulated growth



Source: National Bureau of Statistics

This downturn is likely to continue due to lower construction starts, low consumer confidence and oversupply of homes in lower-tier cities.

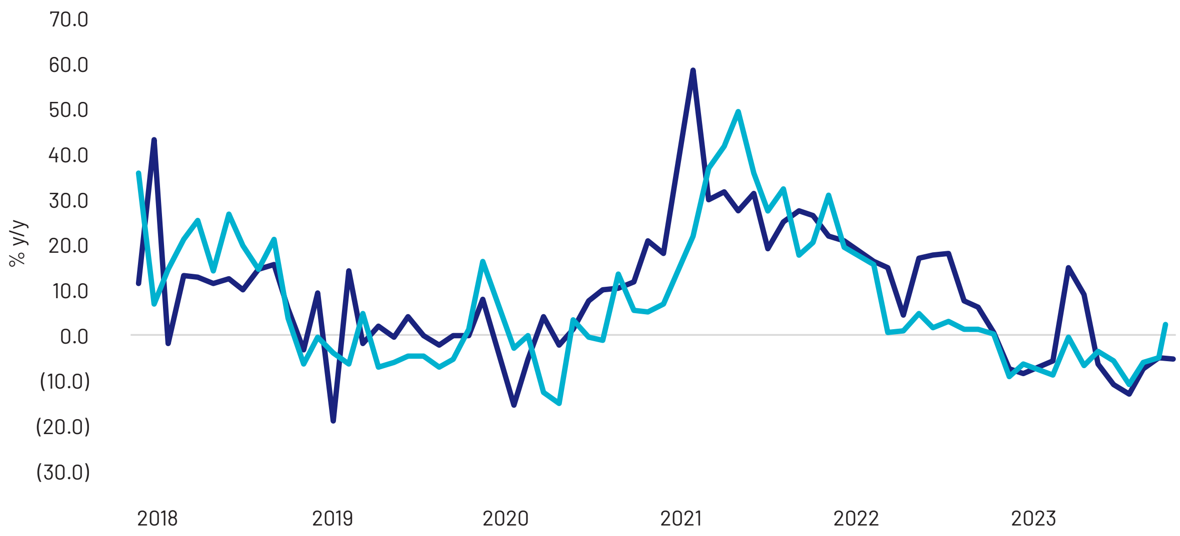
Trade slump appears to be easing but still contracting, with a long recovery pending

Trade has been muted in China. Imports have been affected by weak domestic consumption, and exports have been impacted by weak appetite for Chinese goods, driven by slowing demand in developed economies and efforts to diversify supply away from China. The situation was worsened by the production ramp-up by Chinese companies to accommodate the surge in orders anticipated with China's reopening that led to inventory stockpiling. Manufacturers have recently faced weakened orders from both domestic and overseas customers due to the war between Israel and Hamas, resulting in the manufacturing PMI falling to 49.5 in October.

Recent indicators signal an easing of the trade slump, but imports and exports are still contracting and have a long recovery ahead.

- China's exports fell by 6.2% y/y in September vs -8.8% y/y in August and -14.5% y/y in July
- Imports in September slipped by 6.2% y/y vs -7.3% y/y in August and -12.4% y/y in July
- The trade balance rose to USD77.7bn in September vs USD68.4bn in August

Monthly exports vs imports growth in China



Source: FactSet

Exports declined by 5.7% y/y in 9M23 vs 12.5% y/y growth over 9M22, primarily due to a decrease in exports to the US (-16.4% y/y) and the European Union (-10.6% y/y). Shipments to Southeast Asian countries dropped by 4.8% y/y. Imports from these regions were down by 7.5% y/y (US: -6.0% y/y) over 9M23 vs 4.1% growth during 9M22.

China recorded an uptick in trade with Russia, with exports growth of 56.9% y/y and imports growth of 12.7% y/y.

Although we expect imports to recover gradually with the modest increase in infrastructure spending, exports growth is likely to weaken given diminishing foreign demand.

How could China overcome deflationary risk?

The Chinese government has shifted from its traditional form of stimulus of investing in large infrastructure projects to targeting consumers to drive household consumption and address the underlying issues of the property sector.

The latest CPI suggests that the economy is still fragile, with deflationary pressure continuing, and we believe that ongoing policy support is needed maintain the recovery momentum.

The impact of the recently-rolled-out macro and housing-related stimulus measures, including allowing the country's biggest cities to ease home-purchasing restrictions, encouraging banks to lower interest rates on existing mortgages and reducing the down-payment ratio for first and second homes, is likely to be modest and could take several months to feed through to the wider economy.

Policymakers have rolled out targeted measures designed to boost demand; however, the stimulus has not been impactful enough to boost household income and reduce precautionary saving to drive a complete economic revival.

China plans to implement fiscal stimulus measures to support its economic recovery, relying on debt and state spending. The stimulus plan rolled out towards end-October aims to boost growth in competitive sectors such as advanced manufacturing and renewable energy as the government plans to replace previous economic drivers such as the property sector, while cautiously monitoring the debt level. China has announced plans to issue sovereign debt of CNY1tn in 4Q23 to support disaster recovery and construction.

The central government has also formalised a process enabling local governments to borrow funds for the coming year, starting in 4Q23, to support fiscal policy stability.

The PBoC lowered the rate of the one-year medium-term lending facility (MLF) by 15bps to 2.5% on 15 August, the largest cut since April 2020. It also reduced the seven-day reverse repo rate by 10bps to 1.8%. Subsequently, the one-year loan prime rate (LPR), the peg for most household and corporate loans in the country, was slashed by 10bps to 3.45%. However, the five-year LPR, the reference rate for most mortgages, remained unchanged at 4.2%. At its latest meeting, on 20 October, the PBoC kept its benchmark lending rates unchanged given the ongoing economic stabilisation. Further monetary easing is also constrained by a weaker CNY. This was anticipated by the market, as the authorities can afford to wait before implementing further monetary easing amid signs of economic stabilisation. However, we cannot rule out further rate cuts given the persistent deflation risk.

The PBoC injected CNY289bn into the financial system via a one-year policy loan in mid-October, the largest amount of cash support since late 2020.

China's financial-sector authorities recently proposed setting up a stock-market stabilisation fund to boost flagging confidence among domestic investors. China halved the 0.1% stamp duty on stock trading, effective from 28 August, to boost the capital-market recovery and investor confidence.

How could deflationary pressure impact the economy?

» **Slowdown in economic growth:** Economists believe low and steady price inflation is necessary for a healthy economy. Most advanced Western economies typically target inflation of c.2% per year. However, deflationary pressure could lead to a major setback in China's economy, as widespread price declines for goods and services could lead to a downward spiral of economic contraction, job losses and financial instability. The size of China's economy is expected to reduce to c.67% of the US's in 2023[3] vs c.76% in 2021; deflationary pressure could delay China's emergence as the world's largest economy.

» **Inflated real burden of debt:** Deflationary pressure is particularly risky for countries such as China with high debt burdens (debt to GDP at c.280%) since it adds to debt-servicing costs for borrowers and is likely to prompt them to reduce resource allocation for spending and investment. Deflation elevates the actual burden of debt, as the rising value of money makes fixed loan payments more expensive than other goods and services.

» **Negative demand cycle:** Deflationary pressure could initiate a damaging cycle, with the anticipated price decrease prompting consumers to postpone purchases, leading to reduced demand, lower production and lower corporate profitability. Reduced profitability could lead to measures such as wage cuts, hiring freezes and layoffs, reducing consumer spending in an infinite loop. Reduced income results in deferred borrowing and investments, adding to deflationary pressure.

What is the likely impact on the rest of the world?

China is the world's second-largest economy; it generated USD17.9tn in GDP in 2022. Hence, its economic health can influence global trade, investment flows and commodity prices.

» **Easing price pressure in other economies:** China represented a significant 14.4% share of the global trade of goods in 2022. A deflationary pull in China could ease price pressures in other parts of the world as cheaper exports from China are likely to cool inflation in the importing countries. In addition, as China is the largest commodity consumer, its reduced demand for commodities could drive down global commodity prices, reducing inflationary pressure.

» **Putting the global demand-supply balance at risk:** China is the world's largest importer of iron ore, copper and crude oil and one of the largest consumers of machinery, hi-tech goods and luxury goods. It imports c.70% of the global share of traded iron ore, c.72% of aluminium and c.60% of copper and soybeans. It also imports over 25% of the global share of traded crude oil and consumes over 50% of the global production of coal. China was the US's third-largest trading partner as of August, representing 10.9% of total US trade. Hence, shrinking imports could translate into a slowdown in economic growth of its trading partners and severely impact the global demand-supply balance.

» **Increasing competitive pressure in overseas markets:** A flood of low-priced Chinese goods could hurt foreign competitors, forcing them to lower their prices or risk losing market share; this will likely be followed by the implementation of measures such as wage cuts or layoffs, leading to an economic slowdown.

[3] Goldman Sachs estimates

Previous periods of deflationary pressure in China

China witnessed a short period of deflation at the end of 2020 and early 2021, driven largely by the collapse in the price of pork.

Prior to this, China avoided broad deflation (1) amid the 2009 global financial crisis despite the pillars of growth stalling and a record-high youth unemployment rate of over 20% and (2) amid weak foreign and domestic demand for Chinese goods in 2012.

In addition, during 1998-2002, China witnessed a persistent decline in prices owing to the monetary and fiscal tightening initiated in 1993, compounded by the lack of exit mechanisms for failed enterprises. This was a result of the real estate investment boom in the early 1990s, which led to a clampdown on lending by state-controlled banks in the latter part of the decade.

Is the situation comparable to deflation in Japan?

Japan was trapped in a deflationary spiral and economic stagnation from the 1990s for over 20 years. China has similarities, with its housing bubble, bad debts, ageing demographics and lack of household and business confidence. China's population aged 65 or older accounted for 13.7% of its total population in 2022 vs 12.9% in Japan in 1991.

However, we do not see a risk of China reaching the level of Japan's crisis due to the following:

- Steady core inflation
- A gradual recovery in consumption and trade
- China's lower urbanisation rate of 63.6% in 2022 vs Japan's 77.5% in 1991 indicates higher upside potential for a productivity boom and more room for housing demand
- China's balance-sheet stress and debt overhang are restricted to the real estate sector

Conclusion

While China's economy is showing signs of stabilising, there are concerns over the sustainability of the recovery. The latest CPI being flat raises concern over the continued deflationary pressure.

Underlying issues such as the real estate crisis, weak consumer spending, the trade slump, elevated debt levels and an ageing population continue to weigh on the economy. Measures rolled out by the government have not been impactful enough and would take time to feed through to the wider economy. We believe that ongoing policy support is needed to maintain the recovery momentum given the fragile economic condition. The PBoC kept its benchmark lending rates unchanged at the latest fixing, given signs of economic stabilisation. Further monetary easing is also constrained by a weaker CNY, although we cannot rule out additional rate cuts. We emphasise the importance of further fiscal stimulus and structural reforms focused on shifting the economy to consumer-led growth while driving urbanisation and addressing the real estate crisis. China does plan to implement fiscal stimulus measures to support its economic recovery, relying on debt and state spending, despite the already elevated debt levels. The stimulus plan rolled out towards end-October aims to boost growth in competitive sectors such as advanced manufacturing and renewable energy as the government plans to replace previous economic drivers such as the property sector, while cautiously monitoring the debt level. China has also announced plans to issue sovereign debt of CNY1tn in 4Q23 to support disaster recovery and construction. We believe that the recent measures are steps in the right direction for maintaining its economic recovery.

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Sandunika has over eight years of experience in investment research, corporate finance, and business system analysis. She is experienced in financial modeling, valuations, investment note writing, ESG analysis, and company, industry, and macroeconomic research. At Acuity Knowledge Partners, she is a senior analyst in the Equity Projects team based in Colombo. She is a CFA Level III candidate and an Associate member of CIMA (UK).

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Acuity was established as a separate business from Moody's Corporation in 2019, following its acquisition by Equistone Partners Europe (Equistone). In January 2023, funds advised by global private equity firm Permira acquired a majority stake in the business from Equistone, which remains invested as a minority shareholder.

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