Economics

DBS Flash

China: Disinflation is back

Group Research

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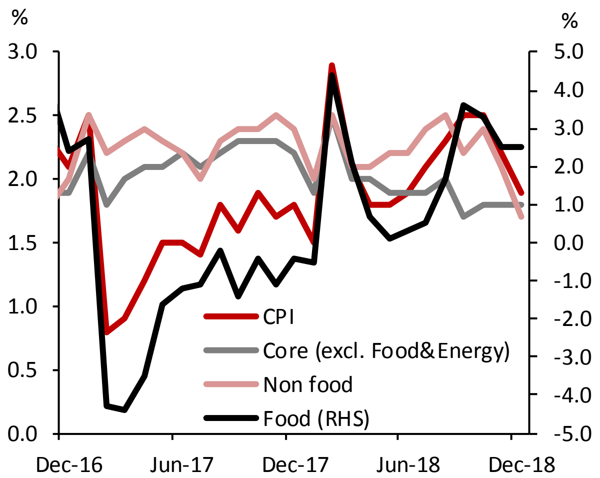
Nathan Chow
Strategist/Economist

Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@dbs.com

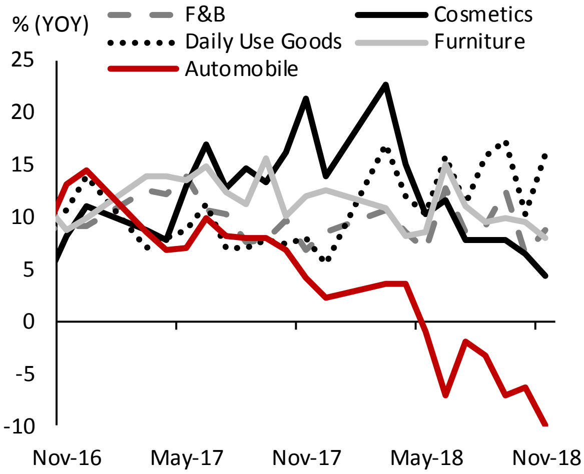
Chart 1: CPI by category



Consumer price inflation fell to 1.9% YoY in December from 2.2% in November (Chart 1). Non-food inflation slowed for a second straight month to 1.7% from 2.1%, driven by significant decline in transportation inflation due to lower oil prices. Food prices held steady at 2.5%. Pork prices went down 1.5%, suggesting the fallout from African swine flu are contained. Core inflation was flat at 1.8% but has been trending down over the past year. Meanwhile, producer price inflation decelerated to 0.9% from 2.7% in November, marking the lowest reading since September 2016.

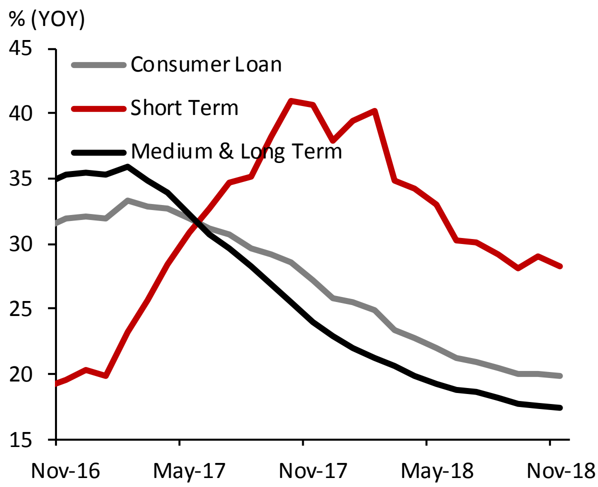
Looking forward, inflation may get a lift during the Lunar New Year holiday in January-February. **The risk of disinflation, however, has risen for the medium term on the following reasons**:

Chart 2: Retail sales by category



- **Weakening growth momentum:** Both the official and Caixin manufacturing PMIs contracted in December. Faltering demand has weighed on factory prices. The prices of raw materials and manufactured industrial inputs slid over the course of 2018. Also, consumer confidence has been sapped by job insecurity and slower wage growth. That was evident by the across-the-board drop in discretionary goods spending from cosmetics to automobiles (Chart2). Fading credit impulse on the back of regulation tightening points to persistent weaker consumption (Chart3) that will dampen non-food inflation.

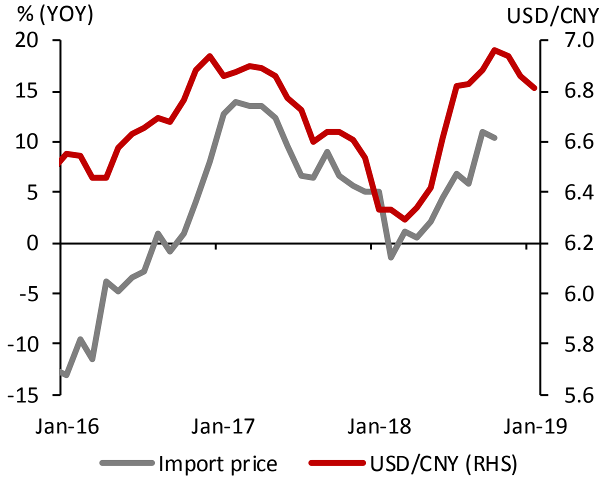
Chart 3: Comsumer loans



- **Slumping energy prices:** The fall in oil prices during Q4 reflected weaker demand in the global economy. Even output cuts by OPEC could not reverse the trend. Apart from China, growth has also slowed across major advanced and emerging economies. Real GDP in Germany and Japan contracted quarter/quarter in Q3. Yields on 5Y US Treasury notes fell below 2Y and 3Y notes last month, a development that heralded past economic recessions. Fuel demand as a result is likely to remain tepid amid gloomy outlook. Oil-related inflation in China (such as motor-fuel surcharges) will continue to trend downward. By our estimation, a 10% decrease in oil prices could drag China's headline CPI inflation by 0.2 percentage points.

- **Import price inflation pressures has eased:** Import price inflation surged to 10.4% YoY in October from 2% in May on a sharp CNY depreciation (Chart 4). PBoC's tougher currency management in November has since helped to stabilize USD/CNY around 6.85-6.95, as evidenced by the fall in the CNH 1M risk reversal to the lowest since May 2017. Demand for bearish options wagers remained weak despite last Friday's announcement to lower the banks' reserve requirement ratio (RRR) this month. A more stable CNY, coupled with Beijing's plan to "reduce and remove" tariffs on American products, would help to cool import prices.

Chart 4: Import price and CNY



Deflationary expectation, when entrenched, is not positive for consumption. Sliding factory prices will further erode corporate profits and weaken the debt repayment ability of indebted companies. **Authorities will, in our view, become increasingly aggressive in rolling out stimulus measures.** The RRR cuts in the coming weeks are just the first steps to cushion the economy. We expect two more reductions in the RRR alongside reverse repo rate cuts later this year.

Group Research

Economics & Strategy

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Masyita Crystallin, Ph.D.
Economist – Indonesia & Philippines
+62 21-2988-4003 masyita@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Neel Gopalakrishnan
Credit Strategist
+65 6878-2072 neelg@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao
Economist - Eurozone & India
+65 6878-5282 radhikarao@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Duncan Tan
FX & Rates Strategist - ASEAN
+65 6878-2140 duncantan@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).