China

15 July 2024

China: the danger of entrenched disinflation

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- China's growth disappointed in 2Q due to weak domestic demand, poor transmission from resilient external demand to domestic demand and the drag from the property market.
- China is still able to achieve its growth target this year on the back of strong manufacturing sector and resilient external demand.
- What worries more is the danger of entrenched disinflation. China's nominal GDP growth has been below real GDP growth for five consecutive quarters.
- The delay in the CPI rebound underscores the increasing urgency for more decisive policy support from China to avoid entrenched disinflation expectations.

The Chinese economy decelerated more than expected to 4.7% year-on-year (YoY) in the second quarter from 5.3% YoY in the first quarter. On a sequential basis, the economy grew by only 0.7% quarter-on-quarter (QoQ) after seasonal adjustment, slowing notably from 1.5% QoQ SA in the first quarter. For the first half of this year, the economy grew by 5% YoY, aligning with the government's target of "around 5%" growth. External demand played an important role in driving China's growth in the first half, with net exports contributing 13.9% of China's growth after dragging the economy down by 11.4% in 2023.

Chart 1: China's GDP contribution

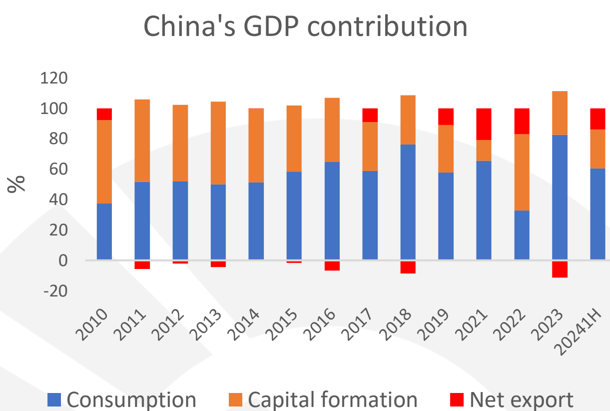
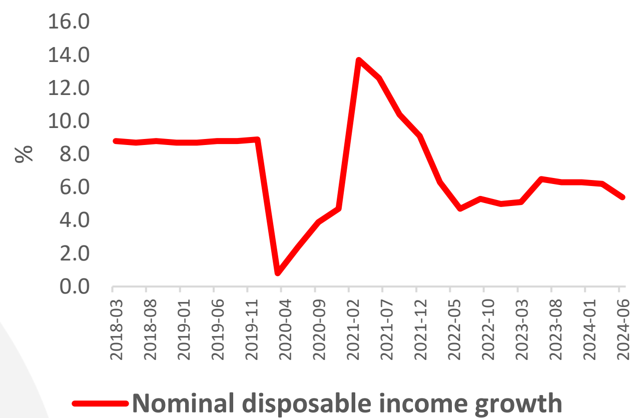


Chart 2: Nominal disposable income growth



Source: Wind, CEIC, OCBC Bank

Despite resilient external demand, the deceleration of growth in the second quarter was mainly attributed to three reasons. Firstly, domestic demand remains weak. China's retail sales in June moderated to 2% YoY, although catering sales remained resilient, accelerating to 5.4% YoY. Consumption is influenced by three factors: income growth, income expectations, and the wealth effect. Although

China's nominal disposable income grew by 5.4% YoY in the first half, outpacing the 4.1% nominal GDP growth, income expectations have weakened notably due to news about pay cuts. This, coupled with the negative wealth effect from both the property and equity markets, weighed down domestic demand.

Secondly, the transmission from resilient external demand to domestic demand has been disrupted by a weak outlook on the currency, leading to a decreased willingness among exporters to sell foreign currency. The increase in foreign currency deposits did not boost domestic consumption.

Chart 3: Willingness to sell foreign currency fell

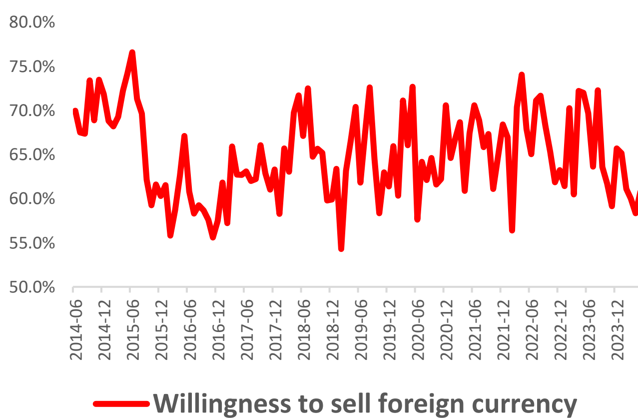
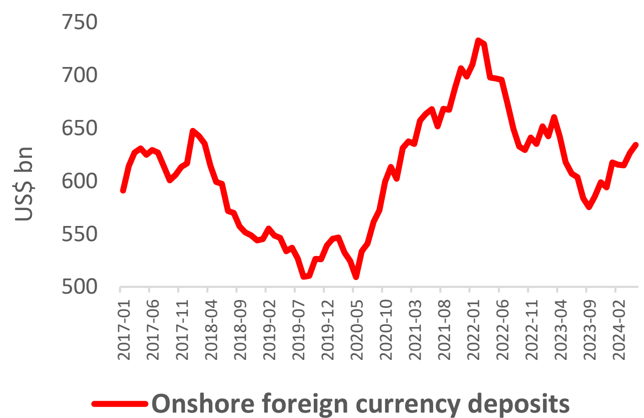


Chart 4: onshore dollar deposits increased



Source: Wind, CEIC, OCBC Bank

Thirdly, the drag from the property market remains significant. Real estate investment fell by 10.1% YoY in the first half of 2024, the same rate of decline as from January to May, and slightly greater than the full-year decline of 9.6% last year. Although transaction volumes have improved since late June after China announced a package of measures in May, it has yet to significantly impact real estate investment.

Looking ahead, despite the disappointing 2Q GDP data, we believe it is still possible for China to achieve its growth target of "around 5%," though the range may have shifted from 5-5.2% to 4.8-5%. We see three supporting factors here.

Firstly, manufacturing will continue to support China's growth. Both manufacturing output and investment have outperformed the headline growth. This strength in manufacturing is due to increased policy support and China's push for equipment upgrades and trade-ins of consumer goods. As of the end of June, the balance of medium- and long-term loans for the manufacturing sector grew by 18.1% YoY, significantly higher than the overall credit balance growth rate of 8.8%. Additionally, investment in equipment and tools grew by 17.3% YoY in the first half of the year, contributing 2.1 percentage points to the overall growth in fixed asset investment, with a contribution rate of 54.8%. Overall, we expect the manufacturing sector to remain a key driver of production and fixed asset investment.

Secondly, China's goods trade surplus hit a record high of $99 billion in June. Strong demand from the US and EU during a relatively low season, as well as strong demand for electronic products, suggests that China's exports might be supported by front-loading activities due to concerns about increasing tariffs ahead of the US election. These front-loading activities may keep China's exports supported in the third quarter.

Thirdly, the drag from the property market may start to narrow. According to the National Bureau of Statistics, three major projects have been actively promoted this year: affordable housing construction, "dual-use" public infrastructure projects, and urban village renovation. These projects have contributed 0.9 percentage points to real estate development investment. Additionally, the recovery of home purchase transaction volumes may help set the floor for real estate investment.

Entrenched Disinflation

What worries me most from the latest growth data is not whether China can achieve its growth target, but rather the danger of entrenched disinflation. China's nominal growth also decelerated to 4% in Q2 from 4.2% in Q1. Nominal GDP growth has been below real GDP growth for five consecutive quarters. Persistent weak inflation may pose challenges for the Chinese economy, potentially leading it into a vicious cycle. The lack of urgency to spend due to the anticipation of price wars may create further shocks to domestic consumption, prolonging China's battle against disinflation.

Chart5: China's deflator has been negative for the past five straight quarters

Source: Wind, OCBC

The weak inflation print, combined with weak credit growth and money supply, argues for more aggressive monetary policy support. However, between interest rates and exchange rates, the central bank currently appears to prioritize exchange rate stability. Although the current low inflation rate supports further interest rate cuts in China, concerns about the impact of such cuts on exchange rate stability

constrain the central bank's interest rate policy. As the timing of the Federal Reserve's rate cuts is pushed back, if China continues to prioritize exchange rate stability, its domestic monetary policy could be excessively influenced by external factors for an extended period, leading to a loss of proactive macroeconomic control.

Disinflation and RMB exchange rate stability are becoming a dilemma for China's monetary policy. Prioritizing exchange rate stability could delay China's recovery from disinflation. Conversely, aggressive monetary easing could amplify depreciation pressure on the RMB, intensifying financial market volatility. We think China’s policymakers may have to deal with this dilemma.

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