FOR PROFESSIONAL INVESTORS – 24 April 2024

Chi Time

The global impact of China's disinflation

Do not impose on others what you yourself do not desire.

Confucius

As China restructures its growth model by shifting investment from property to new infrastructure[1] and high value-added manufacturing, it also raises investors' concerns about its disruption on investment returns. The shift is creating disinflationary pressures on both the Chinese and the global economy, squeezing profit margins and export market shares of manufacturers outside China.

There is no evidence yet that China is exporting deflation at this point. Disinflationary pressures in China could help lower tradeable goods prices, facilitating disinflation abroad and help offset some of the structural rise in global inflation due to deglobalisation and green transition.

Creative destruction & structural disinflation

China is going through a 'creative destruction' process (see 'Chi on China: China's Structural Growth (II) – Thinking Outside the Growth Box", 14 February 2023') in which new, sunrise, industries (notably high-tech, semiconductor and Internet of Things) replace old, sunset, industries (including the property sector). This process is inherently deflationary because the rate of destruction is faster than the rate of creation.

The investment rebalancing process is seen in the decline in China's investment in the property sector and the simultaneous increase in its capital expenditure on high value-added manufacturing and new infrastructure (Exhibit 1). However, private-sector demand has been sluggish, hence, excess capacity has built up, reducing capacity utilisation (Exhibit 2), and eroding pricing power and profit margins. This matters not only for China but,

[1] According to the Chinese government, the new infrastructure investments include telecommunications, 5G/6G networks, AI development, fintech, energy transition and inter-city transportation and rail system.

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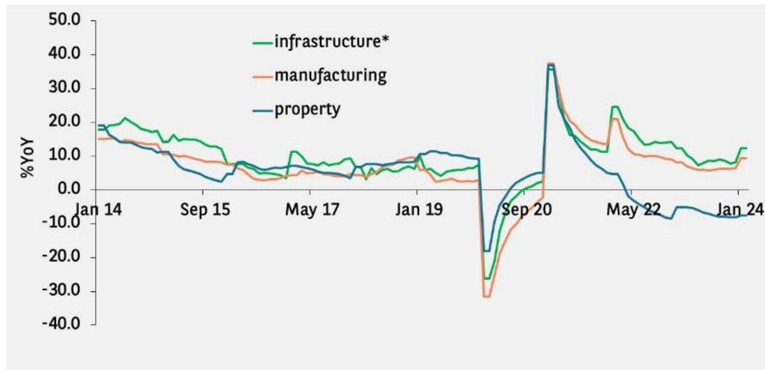
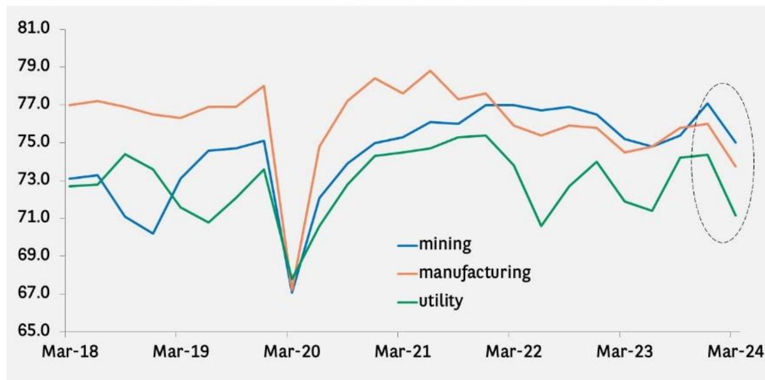
given its size, also for the world at large. Economies that compete with China will face intense margin pressures and potentially a loss in export market share.

Exhibit 1
China's investment shift - from property to manufacturing & infrastructure



* incl. new infrastructure such as IT & tech equipment
sources: CEIC, BNP Paribas Asset Management 12 Apr 2024

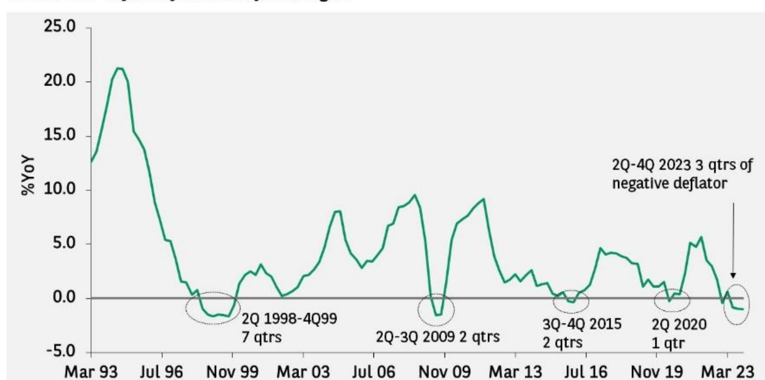
Exhibit 2
China's industrial capacity utilisation rates (%) have fallen, creating excess capacity



sources: CEIC, BNP Paribas Asset Management 19 Apr 2024

Domestically, the excess capacity has led to another round of deflation, with the GDP deflator falling since the second half of 2023 (Exhibit 3). Nevertheless, China is still unlikely to fall into a Japan-style deflation quagmire (see [‘Chi on China: Is China Falling into a Balance Sheet Recession?", 16 August 2023’]). This is because a large part of its economic problem is cyclical in nature, which should be simple to fix by aggressive policy easing.

Exhibit 3
China's GDP deflator fell into deflation again

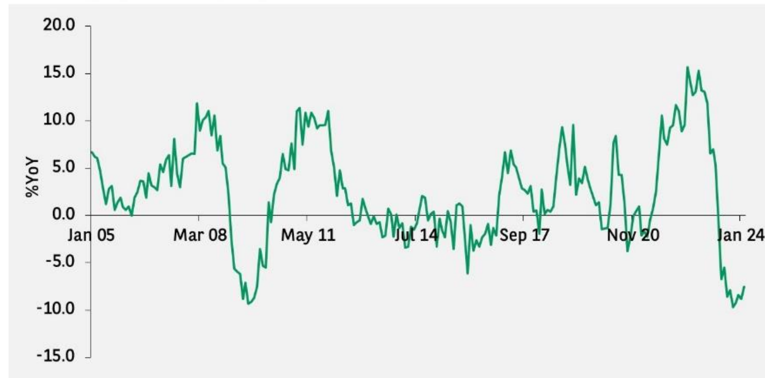


sources: CEIC, BNP Paribas Asset Management 19 Apr 2024

The global spillover

Internationally, China's export prices are falling faster than the pace during the 2009 Global Financial Crisis (Exhibit 4). This is good news for importers of Chinese goods but bad news for China's export competitors.

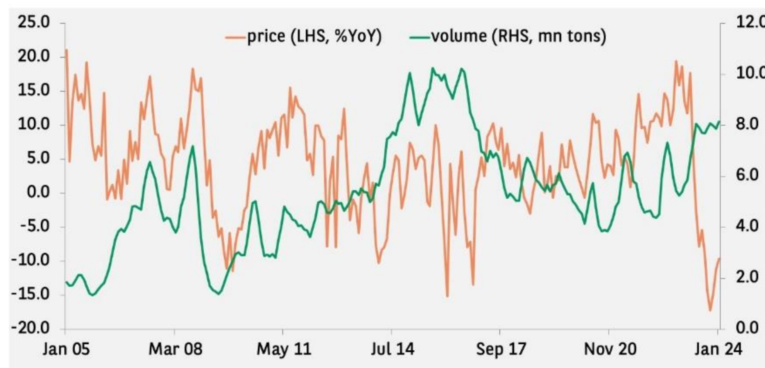
Exhibit 4
China's export prices have plunged



sources: CEIC, BNP Paribas Asset Management 19 Apr 2024

Even commodity prices are feeling the downward pressure, with steel being a notable example as China is the world's largest producer and consumer of steel. The sharp decline in its property sector has cut steel demand significantly, creating an over-supply condition that overwhelms the demand from the other industries, such as shipbuilding, cars and infrastructure. A large part of China's production is exported, pushing down steel export price (Exhibit 5).

Exhibit 5
China steel export volume and price*

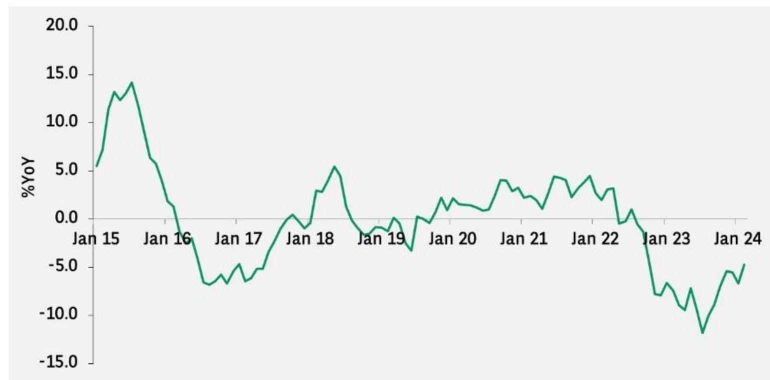


* 3 month moving averages
sources: CEIC, BNP Paribas Asset Management 19 Apr 2024

The renminbi exchange rate

The price declines have dragged down the renminbi's real effective exchange rate (REER), which reflects both changes in the nominal exchange rate and relative prices between China and other countries. China's REER has weakened sharply since 2022, due to both a weak nominal renminbi exchange rate against other currencies and falling domestic prices relative to other countries (Exhibit 6).

Exhibit 6
Renminbi real exchange rate has fallen sharply since 2022



sources: BIS, CEIC, BNP Paribas Asset Management 19 Apr 2024

In 2023, the renminbi's REER fell the most compared with its Asian peers (Exhibit 7), boosting China's export competitiveness. The resulting downward pressures on global prices mean that if manufacturers elsewhere do not cut prices to compete with China, their export volumes are likely to suffer.

Exhibit 7
The renminbi's REER depreciated the most in 2023 (%YoY)

sources: BIS, IMF, CEIC, BNP Paribas Asset Management 19 Apr 2024

Is China exporting deflation?

There is no conviction yet for China exporting deflation. Local deflation is likely to be a cyclical phenomenon because:

1) Aggressive policy easing can fix the cyclical excess capacity and ease the structural drag on growth stemming from creative destruction, ending the deflationary pressures.
2) Excess capacity is focused on the secondary sector of the economy, which only accounts 38% of GDP and 29% of employment, while the tertiary sector, which accounts for 55% of GDP and 47% of employment, has shown recovery momentum. In other words, excess capacity is not systemic so that the resultant deflationary pressures are not as intense as observers fear.
3) US import price data from the major developed markets and key Asian trading partners have shown even larger price declines than from China in 2023, arguing that prices were falling outside China too.

Challenges

Manufacturing economies that compete with China face the biggest challenge from China's disinflationary pressures. Europe, Japan, Thailand and South Korea appear to be the most exposed to rising trade competition from China, while Mexico, Brazil and the US appear less at risk.

Meanwhile, commodity exporters, including Australia, Indonesia, Colombia and South Africa also face challenges from China's sharply reduced demand for commodities as its property sector shrinks and investment shifts from commodity-hungry industries to tertiary and high-tech, green industries which are less commodity-intensive.

Finally, if China's disinflation prolongs, equity markets of the economies that have larger exposure to China's trade competition and commodity demand will face downside pressure than those that are more insulated from China's events.

Chi Lo BNP Paribas Asset Management

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