



FOR PROFESSIONAL INVESTORS – 10 August 2023

Chi Flash

IS CHINA FALLING INTO DEFLATION?

By a continuing process of inflation, government can confiscate, secretly and unobserved, an important part of the wealth of their citizens.

John Maynard Keynes

I do not intend to add to the noises, but just would like to put some economic sense back into the discussion on China's deflation.

China's July YoY negative CPI is unlikely to be a harbinger for prolonged deflation. Technically, the July data was a result of a high base. Weak pork and energy prices were mainly responsible for the decline in headline CPI in July. All this is a no brainer.

Let's look at the fundamentals. Deflation will emerge under several conditions:

- Monetary contraction – i.e. a decline in money supply due to monetary tightening. This is clearly not the case in China.
- Demand destruction, as reflected in rising unemployment, falling income and contraction in consumption, investment, and exports. Except exports, this is also not the case in China.



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- Demand is weak, income growth is slowing, but they not contracting.
 - Youth unemployment is high, but the overall labour market conditions are not dire.
 - There is recovery in demand, mostly concentrated on domestic services & tourism at this point (note touring prices jumped by over 10% YoY in July, for example).
 - Non-food prices remained unchanged from last year's level in July, rebounding from -0.6% YoY in June.
- Persistent loss of confidence. This is partially true in China, mainly because of the zero-Covid policy and the bad property market. But it is too early to conclude if the confidence loss is persistent. More assertive policy easing in coming months can stabilise the property market and improve public confidence, reviving private sector spending and investment. So, Beijing needs to act quickly and decisively to shore up activities and confidence before the current pessimism becomes entrenched and hurt growth further.

 - Increase in the real value of debt. This is a long-term factor and is also partially true in China, as the debt ratio rises when inflation falls. But Beijing is aware of the debt problem and has been addressing it over the years, as I have long argued. There is evidence showing Beijing sustaining deleveraging efforts through good and bad economic times.

Given the reform and debt-reduction resolve, I don't think China will fall into a debt-deflation spiral.

I hope this makes some economic sense.

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