

Where China leads, others will follow

A consistent theme of our published research in recent months has been a view that headline inflation rates in a number of major economies are likely to turn negative in the first half of this year, fuelling concerns about deflation. Although headline inflation rates in the G7 economies – the US, the UK, Germany, France, Italy, Japan and Canada – have fallen sharply since last summer, none has yet turned negative. But, with US and Japanese inflation at 0%, we think it’s only a matter of time. Furthermore, although inflation has not turned negative just yet in the old-world economies of the G7, statistics released this week show that it has in China.

Earlier this week, China became one of the first countries to release its February inflation statistics. They showed the inflation rate dropping from 1.0% in January to a worse than expected -1.6%. Food prices were the main reason for the decline. They fell 1.9% year on year (y/y) versus a 4.2% y/y rise the previous month.

China’s National Bureau of Statistics (NBS) took the unusual step of issuing a separate statement in which it explained that the decline in both the CPI and the PPI (the latter fell a larger -4.5% y/y) was mainly due to lower raw-materials prices and holiday-related distortions. The NBS also stated that it was too early to conclude that deflation had returned.

The NBS makes a fair point. As the chart shows, food is the largest driver of the CPI. Indeed, food prices have been responsible for two deflation scares and two inflation scares in the past decade alone. This argues against putting too much emphasis on the headline result, as the decline may reverse in the coming months if food prices firm. However, CPI excluding food also turned negative, falling to -1.2% y/y, versus -0.6% y/y the previous

month. That makes the official attempt at talking up inflation sound a little hollow.



We expect further deflation in China in the coming months.

Looking ahead, we see two main reasons to expect more weakness in Chinese inflation. First, as the chart shows, there is a tight leading indicator relationship between Chinese money supply growth and inflation – so tight, in fact, that it’s probably the envy of many a western central banker engaged in or contemplating quantitative easing. At present, the deceleration we have seen in Chinese MI growth suggests that the inflation rate will slip further into negative territory in the months ahead. Second, the Chinese economy is growing below its potential growth rate of 8-9%. If, as we expect, it continues to do so through the course of this year and into next, it will keep building up deflationary pressure.

Given our expectation that inflation will move further into negative territory, the Chinese central bank should find the room to ease monetary policy further in order to stimulate the economy.

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