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Economic Watch

China | China’s low inflation environment bears some changes

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For the past two years of the pandemic time, the sharp contrast of China’s deflation and the global reflation has always been eye-catching which has created uncynchronized business cycle and monetary policy cycle between China and the other main economies. However, the low inflation environment in China during the past two years when China “first-in, first-out” of the pandemic while the rest of the world was grappling against the coronavirus has started to bear some changes recently with the CPI outurns trending up.

Appearantly, it looks quite intricate, and even ironical, but if we dig out the underlying reasons of the recent inflationary trend upward change in China, it is not that difficult to understand how it goes. Several important macro factors both globally and domestically contribute to this change: First, the imported inflation of energy and agricultural commodities due to the western countries’ sanctions for Russia-Ukraine war has played a significant role on China’s energy and agriculture products inflation; under this circumstance, the pass-through effect from high PPI to CPI gets strenghthened. Second, the Omicron virus flare-ups have come back to China recently; Chinese authorities’ strict “zero tolerance” Covid-19 policy and the lockdown measures in Shanghai and other cities have led to supply-side stagnacy and supply-chain disruptions which pushed up domestic inflation. Third, China’s special African Swine Flu effect which was the prime reason to sustain China’s previous low inflation environment also has been dissipating over time. Finally, low base effect of the past year also plays some role on a currently trending-up inflation.

Under the circumstance of a changing inflation environment, together with the aggressive US FED interest rate hike and central bank balance sheet reduction, the policy room for the PBoC to conduct interest rate cut or other monetary easing measures might be shrinking, posing new challenges of policy maneuver to offset the adverse effect of lockdown and “zero tolerance” pandemic measures.

In particular, April’s CPI index edged up to 2.1% y/y from 1.5% y/y in the previous month (Consensus: 1.8%), supported by escalating prices of energy and agricultural products. By components, the largest increase is transportation fuel price which ticked up by 28.4% y/y; the second largest increase is vegetable price which jumped to 24% y/y. Both reflect the imported inflation from sanctions posted by the western countries on Russia for the Russia-Ukraine war. On the other hand, due to the fading effect of African Swine Flu cycle which used to contribute significantly to China’s low inflation environment, pork price also shrank its declining to -33.3% compared with the -40% ytd y/y for January to April. (Figure 1)

Meanwhile, PPI maintained at the relatively high level but continued its downward trend in April to 8% y/y from 8.3% y/y in the previous month (Consensus: 7.7%). The decline of PPI was largely due to the government’s arduous effort to ease imported surging commodity prices by increasing its reserved commodity supply recently as well as to take a balance between carbon neutrality target and fossil fuel production. However, due to the significant imported inflation, prices in mining and coal still increased to 53.4% y/y, oil and gas price also ticked up to 48.5% y/y, the highest two growth rate by components. Altogether, the downward trending producer prices have

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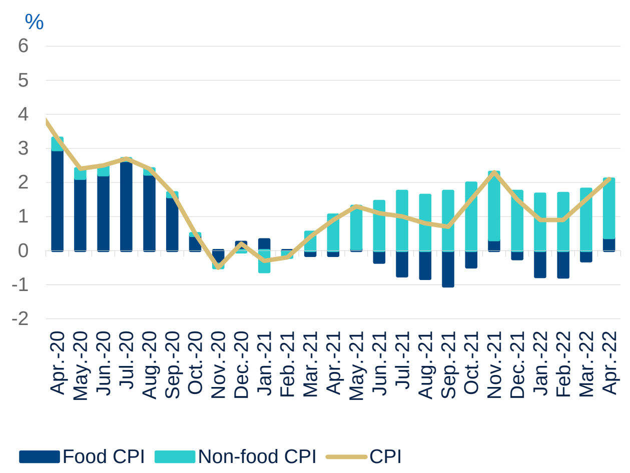
alleviated hardship over higher costs for the midstream-to-downstream sectors, which previously suffered pressure from global supply-chain bottleneck and surging raw material costs. (Figure 2)

In sum, China's low inflation environment seems to experience some changes recently. Under the big picture of continuously surging global inflation, China seems like not to be an exemption. Surging global energy and agricultural prices due to the sanctions for the Russia-Ukraine war, China's lockdown measures and supply-side disruption, as well as the fading effect of African Swine Flu cycle all contribute to this significant change. Under the circumstance of a higher inflation, together with the aggressive US FED interest rate hike and central bank balance sheet reduction, the policy room for the PBoC to conduct interest rate cut might be shrinking, although we anticipate targeted easing measures indeed will be conducted, posing new challenges of policy maneuver to offset the adverse effect of lockdown and "zero tolerance" pandemic measures.

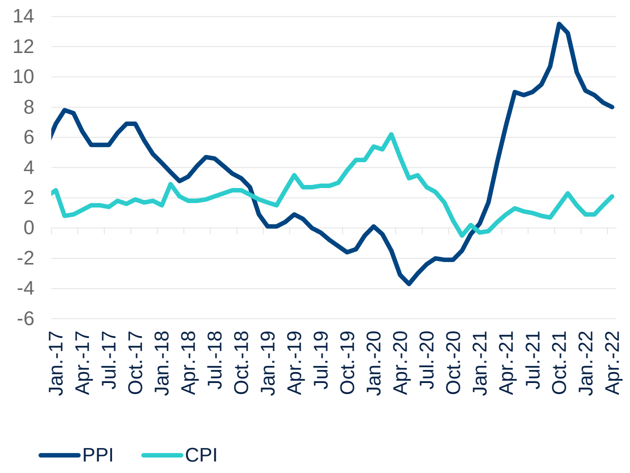
Looking ahead, we expect CPI may continue to pick up due to the low base effect of the past year and the reasons stated above while a convergence between CPI and PPI will continue in 2022. Thus, we maintain our prediction of 2022 and 2023 CPI both at 2.5%.

Figure 1. **CHINA'S LOW INFLATION ENVIRONMENT SEEMS TO GET SOME CHANGE RECENTLY (%)**



Source: CEIC and BBVA Research

Figure 2. **THE CONVERGENCE BETWEEN PPI AND CPI WILL CONTINUE (%)**



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