China Watch

Will China export deflation to the world?

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GEM Economics
Asia | China

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Price declines in China triggered spillover concerns

With China's CPI inflation dipping into the negative zone and PPI deflation persisting since 4Q22, some market observers argue that China is now exporting deflation to the rest of the world. Such concerns stem from the belief that Chinese manufacturers, particularly in sectors with overcapacity, seek to boost sales overseas by slashing prices, as domestic demand is still weak. Some worry that the overcapacity and deflation problem could only worsen over time, as Chinese policymakers are unlikely to introduce a major policy stimulus package to boost domestic demand.

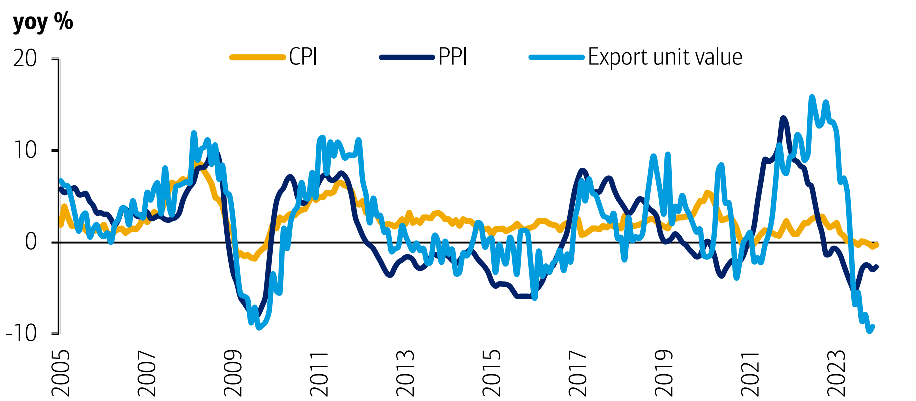
Falling export prices ≠ deflation

At first glance, such concerns are not unfounded – the prices of goods shipped out of China indeed declined in recent months (Exhibit 1). During Jun-Nov 2023, China's overall export prices fell by 8.0% YoY on average, with notable drops seen across both intermediate goods (e.g., ferrous metals -22.2%; chemicals -19.2%) and consumer goods (e.g., furniture -17.3%; clothing -8.0%).

Can we conclude this is a sign of exporting deflation? Not so fast. Let's not forget that deflation is defined as a general decline in prices of goods and services. However, we cannot label any decline in goods prices as "deflation" (for example, price declines caused by technology upgrades – especially in electronic products – or unwinding supply bottlenecks are not called deflation.)

In our view, the broad-based decline in China's export prices in 2023 was driven more by cooling global commodity prices and easing supply chain pressure (Exhibit 2) than by domestic deflationary factors (e.g., excess capacity). Throughout the year, China's import prices also fell notably and moved in tandem with the export prices (Exhibit 3).

Exhibit 1: China's CPI, PPI & export price index
China's export prices declined notably in recent months, at a time when CPI and PPI prints were both negative



Source: BofA Global Research, CEIC

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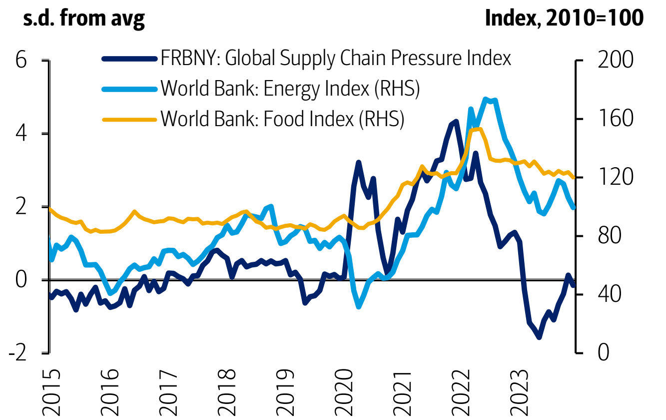
Exhibit 2: Global commodity and supply chain pressure index

Global supply chain pressure and energy prices eased notably in 2023



Source: Haver Analytics

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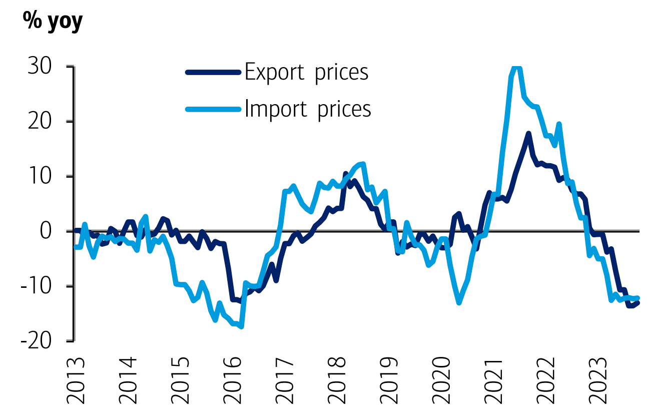
Exhibit 3: China's export vs. import prices (USD terms)

China's import prices dropped in tandem with export prices



Source: BofA Global Research, CEIC

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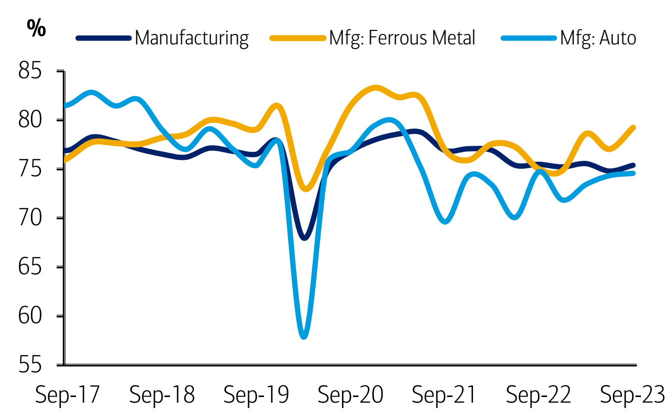
Would anyone conclude that China is exporting and importing deflation based on the observation of declining prices in both exports and imports? Probably not. But if prices of tradeable goods prices are not reliable indicators, how about price drops in sectors with overcapacity? For the most often cited example lately — the auto sector – which has experienced a price cut for months due to overinvestment and spare capacity (Exhibit 4), the export price decline so far has not been as significant as what the headline export prices would suggest (Exhibit 5).

Exhibit 4: Industrial capacity utilization ratio

Capacity utilization ratio in auto sector stands much lower than the pre-Covid level



Source: CEIC

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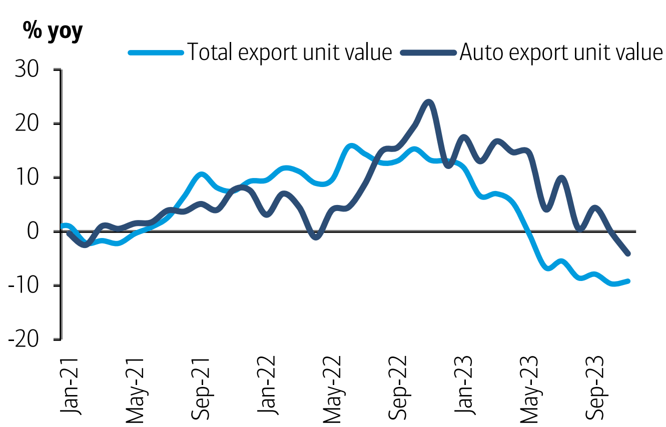
Exhibit 5: Total export price vs. auto price

The decline in auto export price has been modest compared with the headline export price



Source: CEIC

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Not a game changer for DM inflation dynamics…

Regardless of the drivers, China's lower export prices have contributed to softer import prices of manufactured goods in the US and Europe, the two key trade partners of China (Exhibit 6 and Exhibit 7). Yet, in both cases, the decline in import prices from China was much less than that in the overall import prices, suggesting that China might not be the most important driving force here. While it is hard to disentangle the effects of improving supply chains and falling import prices from China, we believe the former has likely dominated the disinflation seen in the US CPI in 2023. In Europe, the main driver for falling import prices last year was energy prices.

While China might have contributed to the core goods disinflation to some extent, we believe it plays a limited role in the overall inflation dynamics in the US and Europe, for a number of reasons:

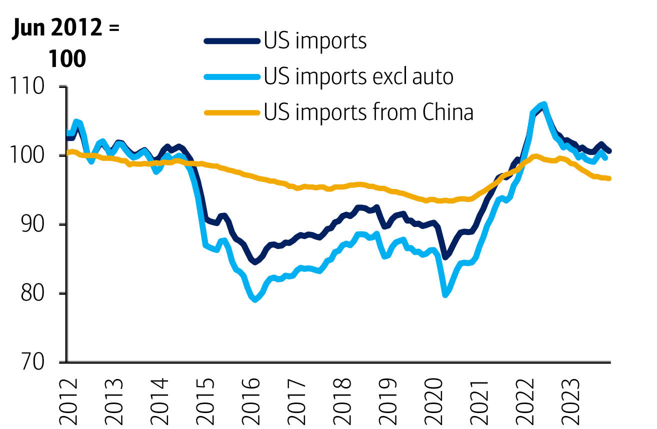
1. Goods imported from China account for a notable share of the total imports in the US/Europe (16.5%/20.8%, respectively), but their actual weights in the CPI baskets are likely very small. Part of the reason is that a sizable share of imports from China are intermediate and capital goods, which would take time to feed through to consumer prices (Exhibit 8). For the US, we estimate the share of Chinese imports in the total US goods consumption is less than 5% (and goods account for approximately 40% of the US CPI basket)[1].

2. The declines in import prices from China may not be fully passed through to consumer prices, as the cost savings could be absorbed as profit margins along the distribution channels.

3. Prices of Chinese goods likely have little impact on services prices, which remains sticky and will be the key determinant for the last mile of disinflation, especially in the US (Exhibit 9 and Exhibit 10).

Exhibit 6: US import prices

US import prices from China dropped by 2.0% YoY in Jan-Nov 2023, while US headline import prices declined more by 3.1% during the same period



Source: BofA Global Research, U.S. Bureau of Labor Statistics, CEIC

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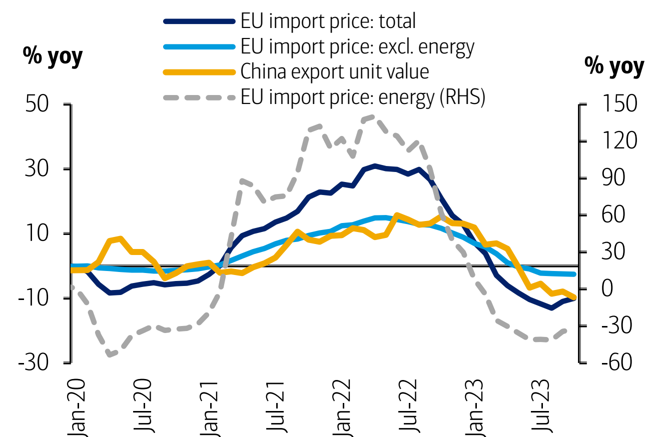
Exhibit 7: EU import price

EU import price decline was driven more by energy than imports from China



Note: We use China export unit value in this chart as an index for EU import price from China is not available

Source: BofA Global Research, U.S. Bureau of Labor Statistics, CEIC

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...but probably a silver lining

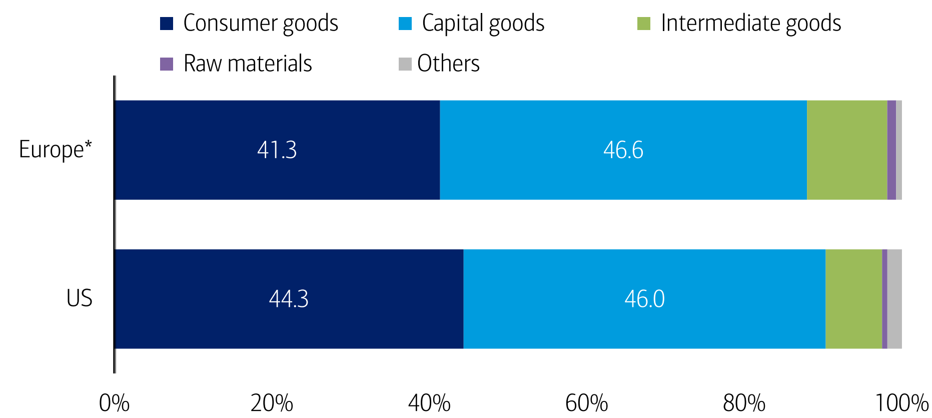
Of course, one could argue that in a general equilibrium world, tepid Chinese demand would suppress global commodity prices and, therefore, result in lower inflation in other parts of the world. After all, China is a price maker, not a price taker, in major commodity markets. In the meantime, lower Chinese prices send an important signal to expectations around the entire supply chains, given China's role as a key supplier of intermediate and capital goods to the rest of the world. For some countries in Europe, weak Chinese demand might also dampen their export demand and, hence, lower the European domestic capacity utilization, leading to less price pressure.

That was the worry in 2015, when DMs struggled with inflation undershooting against a similar backdrop of weak growth, property market downturn and persisting PPI deflation in China. But the story today is almost exactly the opposite. At a time when DM central banks are still striving to bring inflation down to targets and the Red Sea disruptions add

[1] We measure the share of US consumption goods imported from China, using detailed trade data at HS6 level and aggregate based on the Broad Economic Classification from the UN. This estimate suggests that Chinese goods account for a much smaller share of total goods consumption in the US, than what would be shown by the share of US goods imports from China.

uncertainty to the inflation outlook (see report link), weaker Chinese demand is probably a silver lining on manufactured goods price stability rather than an adverse shock.

Exhibit 8: Goods imports from China: breakdown
A sizable share of US/Europe imports from China are intermediate and capital goods



Note: We use Germany, France, Italy, UK, Spain and the Netherlands for Europe
Source: BofA Global Research, WITS

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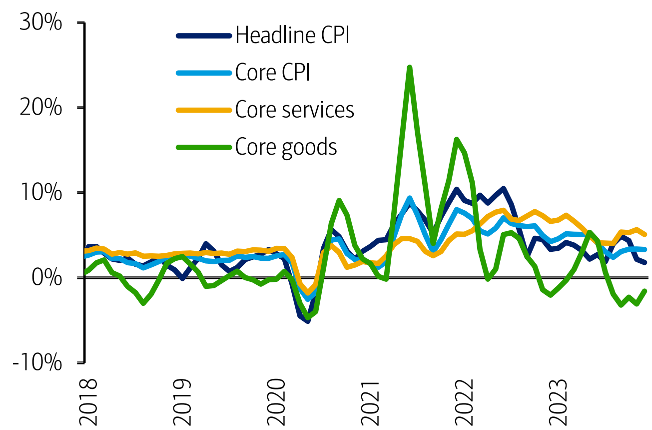
Exhibit 9: Measures of US CPI (3-month % change annualized)
US core services CPI inflation significantly outpaces headline CPI



Source: Haver Analytics

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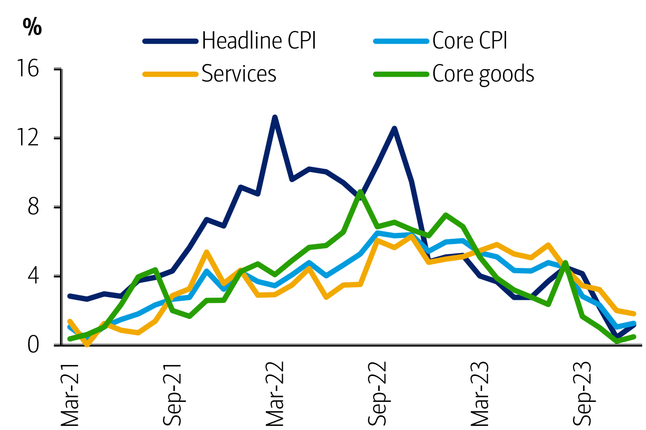
Exhibit 10: Euro area instantaneous inflation
Euro area core goods inflation already dropped to a low level



Note: Original methodology from Eeckhout (2023).
Source: BofA Global Research, Eurostat.

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Modern economies unlikely to "export deflation"

Despite China's subdued inflation figures in recent months, we do not believe China will be stuck in a deflationary spiral. With the effect of infrastructure stimulus kicking in, we expect PPI inflation to turn positive to 0.3% YoY in 2024 (vs. -3.0% in 2023). This should translate into a pick-up in export prices in 2024.

But what if China's demand and inflation fail to make a comeback? Should we worry about China eventually dragging the world into deflation?

We do not think so. As argued by our Head of Global Economics, Claudio Irigoyen, in his recent report (see link: Around the world in 5 questions), China can, at most, export goods deflation but not overall deflation to other countries. As long as central banks have independent monetary policies, they can set medium-term inflation targets at any level. In other words, to a modern economy with an autonomous control of its money supply and interest rates, another country would not be exporting inflation/deflation to it through trade.

This implies the goods deflation exported by China will translate into overall deflation or lower inflation for other countries only if those recipient central banks accommodate that shock. If central banks choose to fight back by setting monetary policy to generate an offsetting increase in the price of non-tradables, deflationary pressure will unlikely prevail. At the maximum, this "exports of goods deflation" can affect the relative price of goods vs. services. In other words, saying that China is exporting goods deflation is as true as saying that China is exporting services inflation.

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