CHINA ECONOMIC UPDATE AUGUST 2017

Unwinding road ahead – weaker Chinese producer prices providing headwinds for advanced economy inflation

NAB Group Economics

Headline consumer prices in advanced economies have been weak in recent years – particularly across 2015 and the first half of 2016 – despite highly expansionary (and in many cases, unconventional) monetary policy. A range of factors have contributed to this trend, including deflation in many Chinese goods exports – a trend evident for a number of years. China's growing market share in key consumer goods segments has increased global deflationary pressures, posing a challenge for inflation targeting central banks.

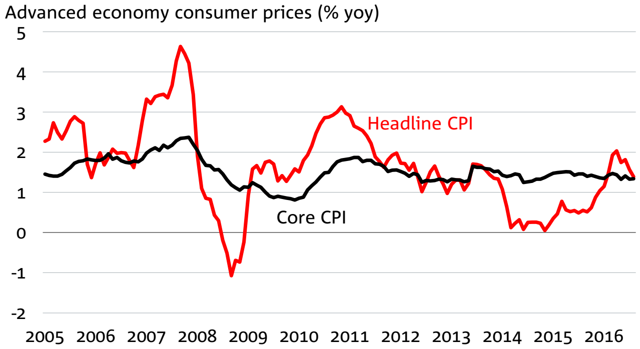
ADVANCED ECONOMY INFLATION STILL RELATIVELY SUBDUED

The post GFC period has been one of typically low levels of inflation in advanced economies – particularly over 2015 and the first half of 2016, when weighted average headline inflation drifted near zero.

Headline inflation recovered considerably from the second half of 2016 – with consumer prices reaching 2.0% yoy in February 2017 – before retreating back to around 1.3% yoy in June. That said, this uptick largely reflects trends in highly volatile components – such as food and fuel prices – with measures of core inflation remaining somewhat more subdued. In recent times, core inflation peaked at 1.6% in April 2014 and has generally trended lower in subsequent months – below most central bank targets.

HEADLINE AND CORE CPI

Modest inflation post GFC

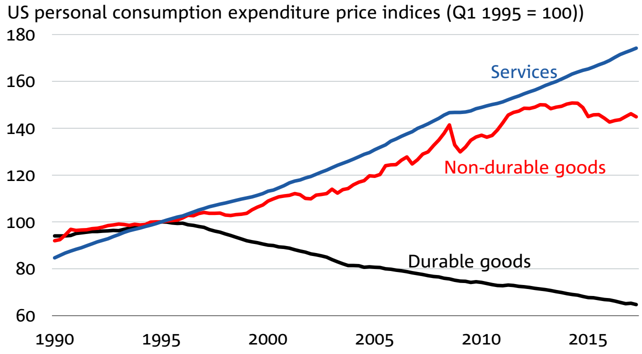


Sources: Datastream, NAB Economics

A longer term contributor to the softening inflation trend has been the increasing penetration of Chinese producers into global durable goods markets. Durable consumer goods – household items that last more than three years – have seen falling prices in many markets for a number of years – in the case of the United States, durable goods prices peaked in early 1995 and have fallen since.

US PERSONAL CONSUMPTION

Durable goods deflation since 1995



Sources: Datastream, NAB Economics

China is also a major exporter of capital goods and components – which has generally lowered the cost of production of consumer goods manufactured in other regions.

Beyond China driven deflation, other factors that have influenced the low levels of core inflation include the high levels of unemployment and idle production capacity in many advanced economies – which has constrained wages growth in many countries. Even in the United States – where unemployment has fallen below 5%, real median household income is below its pre-GFC levels.

Date **August 2017** | Author **Gerard Burg** – Senior Economist – Asia

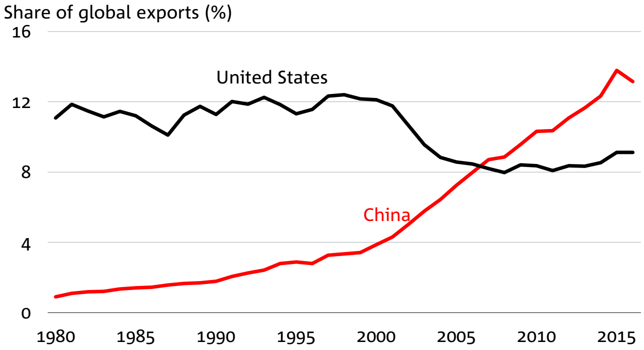
Prior to the global financial crisis, it was generally argued that deflationary pressure from Chinese goods could be offset by monetary policy tools. However recent years have seen major advanced economy central banks cut interest rates to or near zero as well as adopting unconventional monetary policy – most notably quantitative easing – without a sustained recovery in core inflation levels (back towards target). This suggests that there are a number of headwinds in the current climate that are making inflation targeting more challenging.

CHINA'S GROWING INFLUENCE ON GLOBAL MARKETS

Exports have been a critical element to China's economic development since the reform and opening up of 1978. China's share of global trade has expanded considerably across the past few decades – with World Trade Organization data showing that China overtook the United States as the world's largest exporter in 2007 and its share of global trade rose to over 13% in 2016.

CHINA DOMINATES GLOBAL TRADE

Number one exporter since 2007

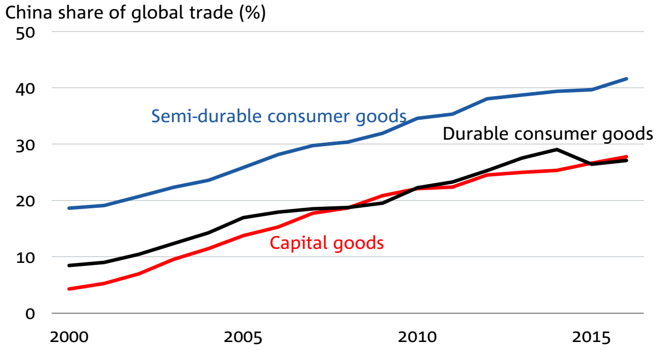


Sources: World Trade Organization, NAB Economics

That said, disaggregation of global trade shows some quite divergent trends in different markets. China remains an importer of industrial inputs and fuels & lubricants, while the country is a major exporter of capital goods and consumer goods. China's share of global trade of in both capital and durable goods rose to around 27% in 2016 (from under 10% in 2000), while China's share of semi-durable goods exceeded 40% (UN Comtrade).

CHINA'S EXPORT SHARE GROWING

Dominant in a range of key categories



Sources: UN Comtrade, NAB Economics

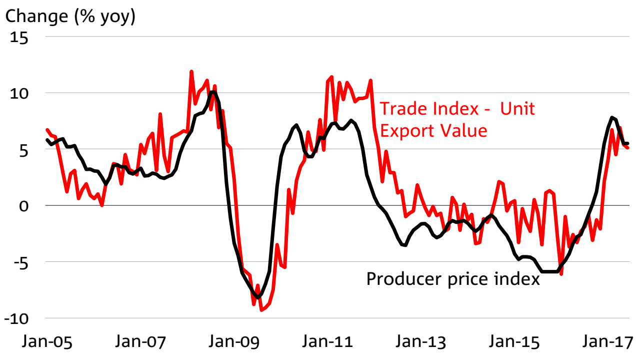
That said, Chinese exporters are not solely responsible for trade-related deflationary pressure – other exporters in Asia have intensified competition in global markets. This is evident in the decline in US dollar denominated import prices in the United States from China, Japan and other industrialised economies of Asia since 2012 – although part of this trend reflects strengthening in the US dollar over this period.

CHINA'S PRODUCER PRICES SUGGEST INFLATION UPTICK MAY BE OVER

In recent years, there has been a close relationship between China's export prices – as represented by unit export values – and producer prices – the factory gate prices for Chinese manufacturers. Producer prices fell for over four years between March 2012 and August 2016, with export prices dragged lower for much of this period.

EXPORT AND PRODUCER PRICES

Close link from factory gate to the world

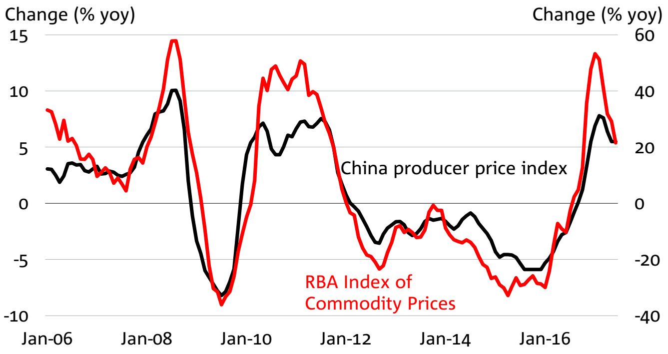


Sources: CEIC, NAB Economics

The biggest volatility in producer prices has been in capital goods – which represent the largest share of China's exports. Unlike consumer goods – where the volatility in prices has been far more modest – the movements in capital goods prices have been closely correlated with the trends in global commodity markets. The acceleration in Chinese producer prices coincided with a recovery in commodities – as the RBA Index of Commodity Prices rose from a cyclical low in January 2016.

PRODUCER AND COMMODITY PRICES

Chinese producers tied to global trends



Sources: CEIC, Datastream, NAB Economics

Despite some volatility in individual markets in recent times, aggregate commodity prices have been trending lower since the early part of 2017. The RBA index in July was around 14% below the recent cyclical peak recorded in February, and NAB Economics expect further (albeit modest) declines across the next two years. This would suggest that the inflationary boost experienced in advanced economies related to global commodity price movements, including through its effects on higher Chinese export prices, is likely to unwind in coming months.

CONCLUSION

The relatively weak levels of inflation in advanced economies in recent years have been a multi-faceted problem – with the deflationary effects of Chinese goods exports being one part of the equation. Given the current challenges faced by advanced economy central banks to meet inflation targets, easing global commodity prices – flowing through to Chinese and other major exporter goods prices – could provide a stronger headwind to advanced economy headline inflation.

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