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Asia Economics | Asia Pacific

The Viewpoint: China – Deflationary Pressures Still Persistent

Deflationary pressures appear to be persisting in China, while the policy response remains reactive. Against this backdrop, there are risks that the corporate sector slows wage growth, broadening the deleveraging trend to households and increasing deflationary pressures.

Key Takeaways

- Aggregate demand is weak. Our China economics team estimates the GDP deflator at -1.3%Y in 4Q23, the third consecutive quarter with over a 1% decline in prices.
- Nominal GDP growth will likely be 3.5%Y in 4Q23, marking the second consecutive quarter of below 4% growth.
- Corporate revenue growth is slowing. This may prompt the corporate sector to slow investment and cut wage growth.
- If this materialises, it could risk the start of household deleveraging, weakening aggregate demand and adding to deflationary pressures.
- A decisive shift towards active fiscal easing and rebalancing towards consumption is needed to address the deflation challenge, in our view.

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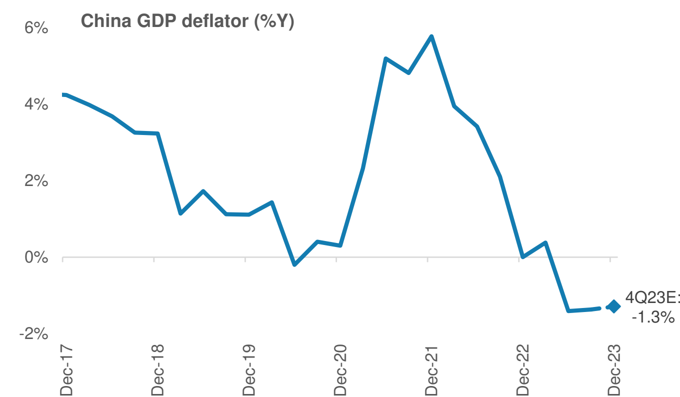
The deflation challenge remains alive

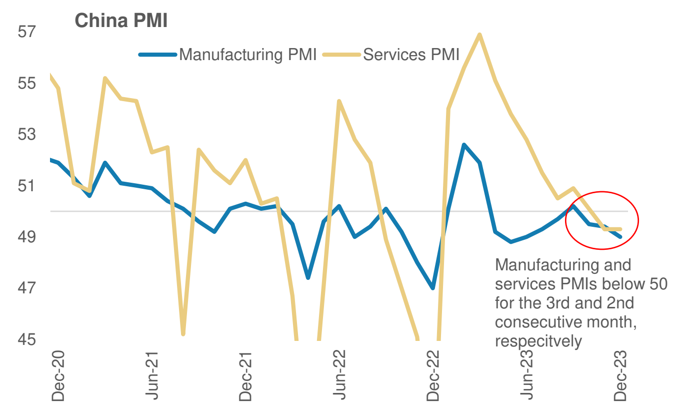
Weakening growth momentum, persistent deflationary pressure: Deflationary pressures are not abating. China's GDP deflator – the economy-wide measure of prices – dropped into negative territory in 2Q23 and remained there in 3Q23. With the incoming high frequency data, our China economics team is tracking the 4Q23 GDP deflator at minus 1.3%Y, meaning that there has been very little improvement in inflation dynamics. At its core, deflation is a reflection of weaker aggregate demand and, indeed, the momentum in economic activity also seems to have decelerated towards the end of last year. Our economics team is tracking 4Q23 real GDP growth at just 0.7%Q on a seasonally adjusted basis (see China Economics: 2023 Ends on a Soft Path, Jan 1), which represents a slowing from the 1.3%Q growth rate in 3Q23. Meanwhile, the official manufacturing PMI has remained below 50 for the third consecutive month and has in fact reached a six-month low. Services PMI has also dipped into contractionary territory for the first time since Dec-22 in November and remained flat in December.

Exhibit 1: GDP deflator is tracking at -1.3%Y in 4Q23



Source: CEIC, Morgan Stanley Research forecasts

Exhibit 2: Both manufacturing and services PMIs in contraction territory



Source: Haver, Morgan Stanley Research

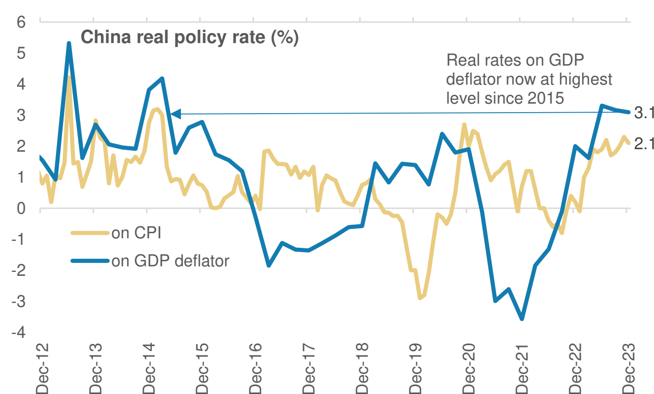
A still reactive policy response risks adding to deflationary pressures

As the balance sheets of property companies and local governments are deleveraging (with combined debt to GDP close to 100%), downside pressures on aggregate demand and the emergence of deflationary pressures were to be expected. Against this backdrop, policymakers have been taking measures to support growth. However, so far, the policy response has been reactive.

The policy response remains reactive

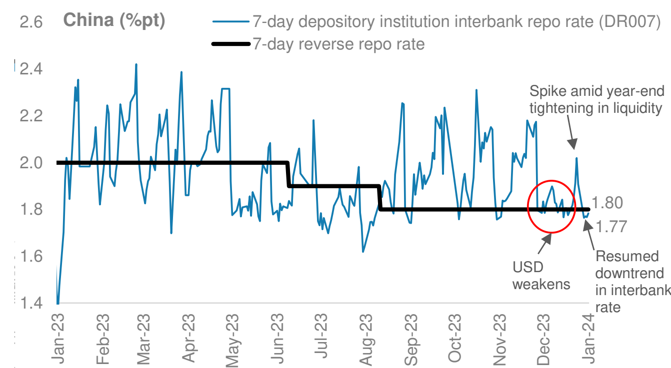
Real rates have risen: Policymakers have cut policy rates by 20bps and lowered the reserve requirement ratio twice, alongside liquidity injections. But, interbank rates have remained somewhat higher than the policy rate since September. To be sure, this dynamic has been observed across Asia in 2H23 as central banks sought to keep interbank rates higher to avoid currency depreciation pressures in a stronger US dollar environment. Interbank liquidity conditions have now eased at the margin, taking the interbank rate closer to the policy rate given the Rmb350bn liquidity injections via PSL in December and sizable MLF injections in 4Q23. But given the deflationary pressures, real policy rates adjusted for either the GDP deflator or CPI have risen to 3.1% and 2.1% respectively.

Exhibit 3: Real rates on GDP deflator basis now at an 8-year high



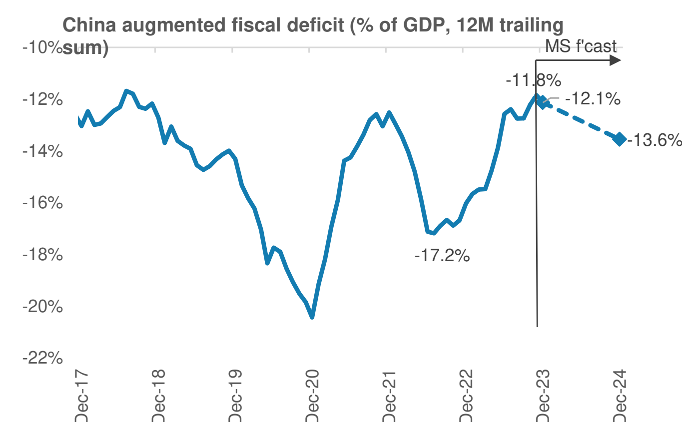
Source: CEIC, Morgan Stanley Research forecasts

Exhibit 4: Interbank rates had been kept higher than policy rates until recently



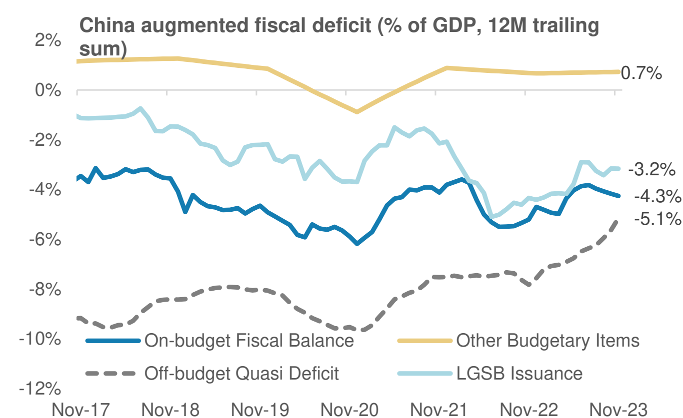
Source: CEIC, Morgan Stanley Research

Exhibit 5: Augmented fiscal deficit has narrowed substantially in 2023



Source: CEIC, WIND, Morgan Stanley Research forecasts

Exhibit 6: A narrowing of the off-budget deficit has not been offset by a widening of the on-budget deficit



Source: CEIC, Morgan Stanley Research estimates

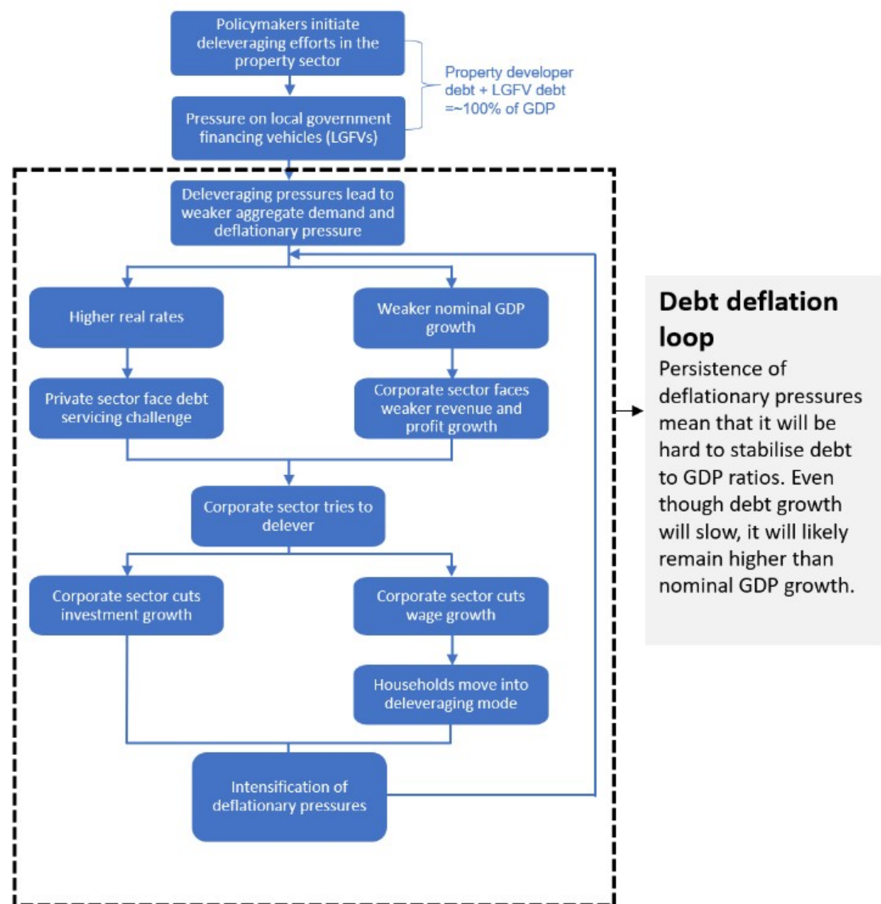
More active fiscal easing needed: To be sure, the room for monetary policy and local government fiscal easing is limited. So, policy support hinges on fiscal easing from the central government. On a trailing 12-month basis, the on-budget fiscal deficit narrowed from 4.7% of GDP in Dec-22 to 3.8% in Jul-23. While it did widen to 4.3% in Nov-23, it is still at a level that is narrower than a year ago. The reactive fiscal easing at the margin reflects why we think the reflation path will be bumpy. Looking ahead, our chief China economist Robin Xing expects below-target growth outcomes to prompt further fiscal easing (see China Musings: Reflation Progress and Next Signposts (14 Dec 2023) and China Trendspotting: Year End: Weak Growth vs. Potential Fund Inflows (28 Dec 2023).

What's holding back a more aggressive policy response? Gleaning from historical experiences in other economies, policymakers' concerns about reigniting misallocation leads them to gravitate towards being hawkish. In the case of China, our read is that policymakers are focused on making structural adjustments to levered balance sheets, though we believe that it is coming at the cost of weaker aggregate demand and persistent deflationary pressure.

The next phase of the debt-deflation-deleveraging challenge

The initial phase of the debt deflation challenge well underway: With concerns about an unproductive buildup of debt, policymakers initiated deleveraging in property sector balance sheets, resulting in knock-on deleveraging pressures on local governments' financing (the debt on these balance sheets is around 100% of GDP). The resulting weakness in aggregate demand has led to the onset of deflationary pressures – with the GDP deflator in deflation territory of -1.3% to -1.4%Y. This has meant that nominal GDP growth has been below 5%Y in the last three quarters and is tracking flat at a weak 3.5%Y in 4Q23. We are focused on tracking the GDP deflator as it is a broader measure of prices and it is more important to understand the evolution of nominal GDP growth and the evolution of debt to GDP.

Exhibit 7: China's debt-deflation-deleveraging challenge



Source: Morgan Stanley Research

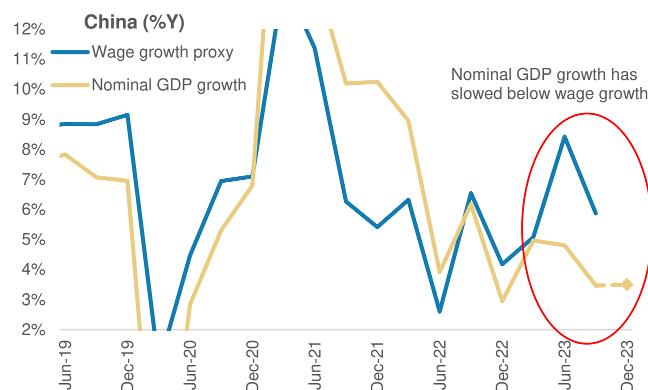
Corporate sector under pressure...: Weaker nominal GDP growth is weighing on corporate revenue growth and profitability, while higher real rates are also hampering the corporate sector's debt servicing ability. Against this backdrop, the corporate sector will also face deleveraging pressures and that will weigh on private capex momentum.

If nominal GDP growth continues to remain weak, the corporate sector may need to slow wage growth to manage the downside to its profit margins. Beyond the official aggregate data, we have seen reports of wages being cut in certain sectors, including for some local government workers, as well as media reports stating that there have been cuts in starting salaries for graduates, gleaned from data from recruitment platforms.

Exhibit 8: Nominal GDP growth has been weak, in turn weighing on corporate revenue growth

Source: CEIC, Morgan Stanley Research forecasts

Exhibit 9: If nominal GDP growth continues to stay weak, the corporate sector may have to slow wage growth

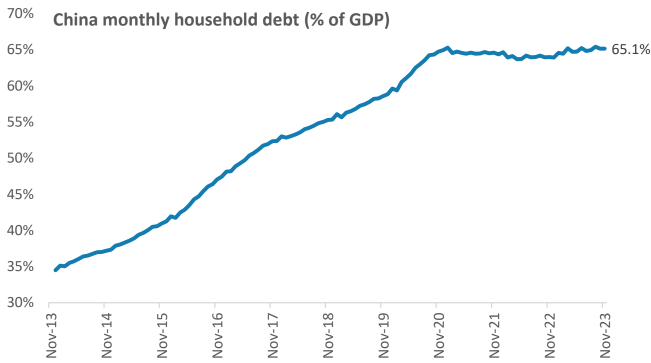


Source: CEIC, Morgan Stanley Research forecasts

...risking the spread of deleveraging pressure to households: The key risk now is that households could move into deleveraging mode too. Given that household debt to GDP accounts for 65% of GDP, household sector deleveraging would weigh on private consumption and act as an additional drag on the economy. Already, household debt growth has settled at a lower range of 6%Y (vs. the 2020-21 range of 12-13%Y). Households are facing negative wealth effects from weak asset markets. For example, secondary property prices in tier 1 cities have fallen by 16-28% from peak levels. Moreover, the price declines are broad-based and beyond just tier 1 cities, and our China property analyst Stephen Cheung notes that average house prices in China have dropped by about 25% from the 2Q21 peak.

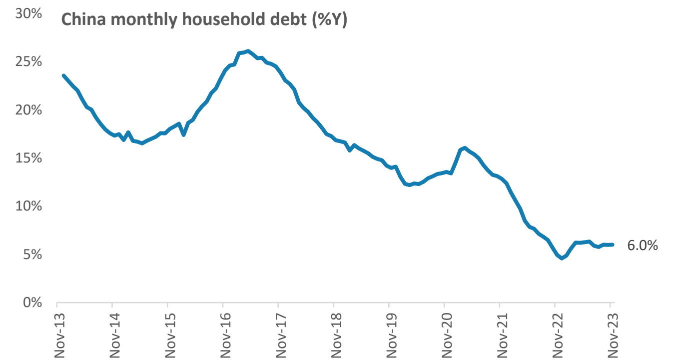
Against this backdrop, one of the key channels of transmission would be through expectations. As expectations for corporate returns decline, this would lead to a decline in wage expectations and downside in inflation expectations. If the policy response remains inadequate, we see a risk that deleveraging pressures could envelop more sectors, leading to further weakness in aggregate demand and keeping the debt-deflation loop alive.

Exhibit 10: If households start deleveraging, it would pose an additional drag on the economy



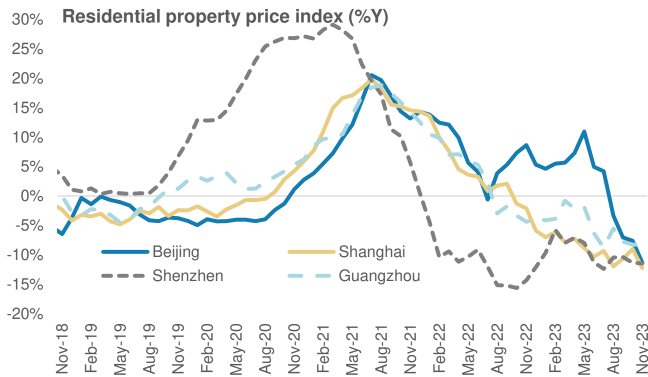
Source: CEIC, Morgan Stanley Research estimates

Exhibit 11: Monthly household debt growth has already settled at a slower pace



Source: CEIC, Morgan Stanley Research estimates

Exhibit 12: Property prices have continued to decline, particularly in tier 1 cities



Source: Centaline, Morgan Stanley China Property Research

How to get out of deflation

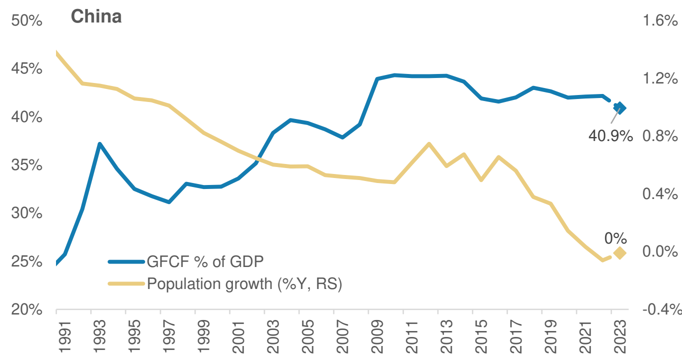
An exit from deflation, helped by global trade, looks challenging: Some investors have asked if China's strength in manufacturing means an exit from deflation could be engineered if external demand recovers. However, with DM growth expected to slow over the coming quarters, any export recovery is likely to remain constrained, in our view. In that sense, absent more coordinated policy support, policymakers would not be able to decisively address the problem of weak aggregate demand, deflation, and therefore aggregate corporate profitability.

Past experiences indicate deflationary episodes could be prolonged: As we have previously highlighted (see China's 3D Journey: How China could avoid a 1990s Japan situation (8 Aug 2023), past global deleveraging episodes have often been very prolonged. The prime example would be the US after the Global Financial Crisis, where even as policymakers took up the right anti-deflationary policy approach in the form of timely and aggressive monetary and fiscal easing, it would take the economy until 2016 for deleveraging headwinds to ease. Against this backdrop, the next two years, at least, will be challenging for China as policymakers will have to maintain support for growth for longer given the deleveraging headwinds.

Sustainable exit from deflation requires decisive fiscal easing and rebalancing: While we do see a gradual improvement, we don't think that the GDP deflator would reach the 2-3% growth rate which we think is necessary for ensuring more moderate levels of real interest rates and for improving corporate profitability and reviving private investment and wage growth. For a sustainable transition out of the deflation challenge, we believe China needs to manage aggregate demand with a rise in private consumption (see The Viewpoint: China – Will Rebalancing Follow Reflation? (29 Oct 2023).

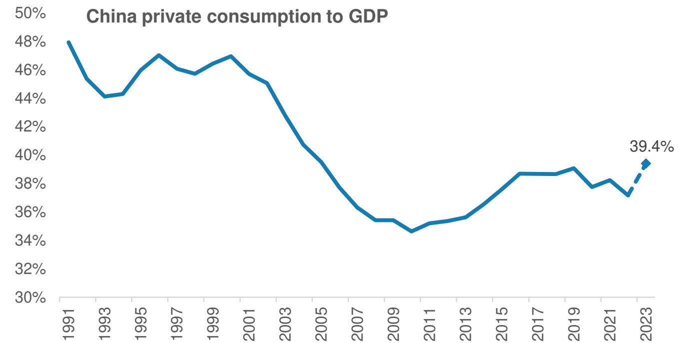
The decline in China's population means that maintaining a high rate of investment to GDP of around 41% in 2023 is resulting in diminishing returns. In that sense, reflating by stimulating investment would only be a temporary means of lifting aggregate demand and would complicate inflation management over the medium term. Specifically, policymakers could increase social welfare spending on education, health care and public housing, which could help unleash precautionary household savings. For now, there are few signs that this transition is materialising with government expenditure to GDP on social welfare having remained flat in recent years. Moreover, as our China economics team notes, the progress on rebalancing may remain limited. We remain on watch for policy signals on this front.

Exhibit 13: Investment to GDP has been higher than warranted



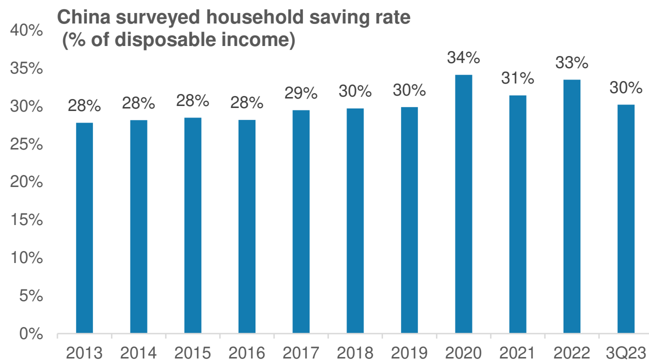
Source: CEIC, Morgan Stanley Research forecasts

Exhibit 14: Achieving moderate levels of inflation requires rebalancing the economy towards consumption



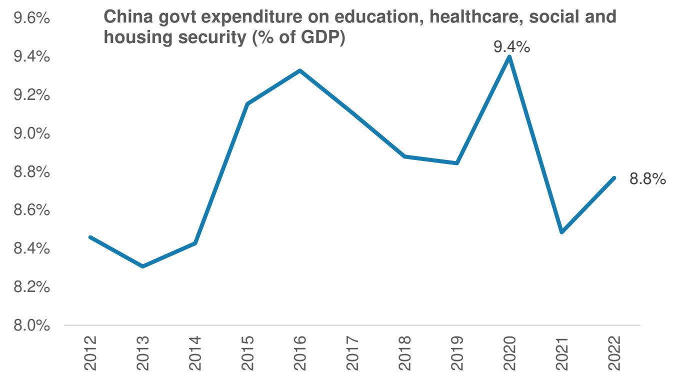
Source: CEIC, Morgan Stanley Research forecasts

Exhibit 15: Rebalancing can help unleash high levels of precautionary household savings



Source: CEIC, Morgan Stanley Research

Exhibit 16: Policymakers could focus on boosting social spending as % of GDP



Source: CEIC, Morgan Stanley Research

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