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Asia Economics | Asia Pacific

# The Viewpoint: How Big of a Deflationary Force Will China Be?

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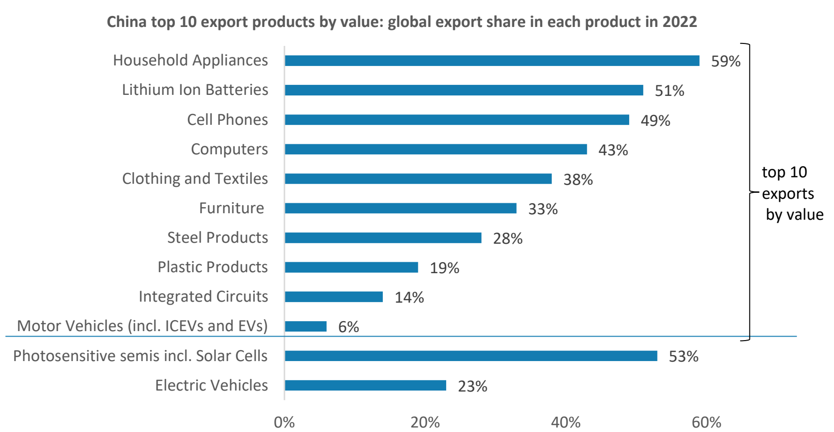
An elevated investment to GDP ratio increases excess capacity and deflationary pressures. Given China's outsized role in global goods manufacturing, we believe competitive pressures will rise and deflationary pressures will persist, which could heighten trade tensions.

## Key Takeaways

- China's investment ratio remains elevated at 41% of GDP. This is resulting in excess capacity and weighing on prices across sectors.
- China accounts for 29% of global manufacturing and its deflationary impulse will be felt elsewhere.
- This deflationary impulse is helping to ease inflationary pressure for now, but they risk posing a challenge for policymakers later on.
- Rising competition will pressure margins, especially in sectors where China has an outsized market share.
- The persistence of these issues could lead to a rise in trade tensions.

**Exhibit 1:** China has sizable market share in multiple key products




Source: CEIC, Morgan Stanley Research; Note: Motor vehicles includes both traditional vehicles and EVs.

# Introduction

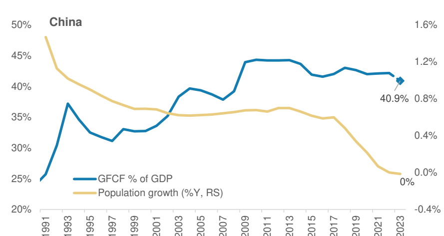
**China – How big of a deflationary force will it be?** China's deflationary pressures have been persistent. Considering the size of the economy and its linkages to global trade and markets, investors are asking about the implications of China's deflationary pressures for the rest of the world. In this note, we explore the scenario where China's deflationary pressures persist for longer and how they may be transmitted.

## Why China's deflationary pressures are likely to persist

**Deflation because of over-investment:** China has been in deflation now for three consecutive quarters. Its GDP deflator has averaged -90bps from 2Q23-4Q23. To be sure, this is not the first time that deflationary pressures have emerged in China. At the heart of the deflation challenge is China's continued reliance on an investment-driven growth model. For years, China has pursued an approach of stimulating domestic demand with a counter-cyclical push to investment whenever a global downturn weighs on its exports. Reflecting this, over the past 15 years, China's investment has been maintained at a high rate of an average of 44% of GDP.

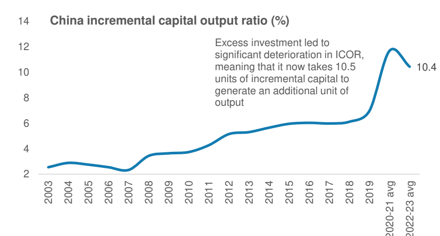
**The roots of the current deflationary cycle were planted in 2018:** Since trade tensions emerged from 2H18, the step down in global exports growth meant that China had to step up its support for domestic demand. Coincidentally, China's total population growth started decelerating sharply from 2018. This over-investment has been reflected in a sharp deterioration in the incremental capital output ratio and a sharp rise in debt to GDP. Since 2H21, as policymakers have sought to slow investment growth and deleverage the property sector and local government financing vehicles' balance sheets, China has faced the challenge of weaker aggregate demand and deflation.

**Exhibit 2:** Continued reliance on an investment-driven growth model has been at the heart of the deflation challenge



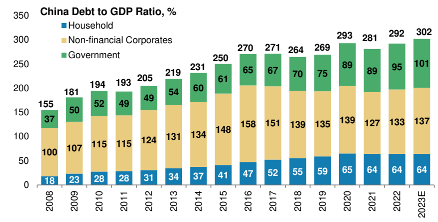

Source: CEIC, Morgan Stanley Research estimates

**Exhibit 3:** Over-investment has led to a decline in capital productivity, which has been more pronounced in recent years



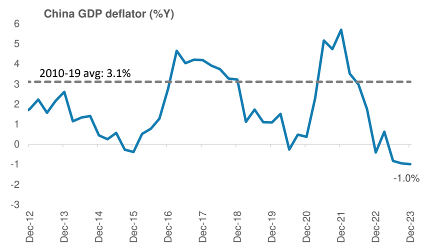

Source: CEIC, Morgan Stanley Research

**Exhibit 4:** The rise in debt ratios has led to a focus on deleveraging




Source: CEIC, Morgan Stanley Research estimates

**Exhibit 5:** GDP deflator has now been in deflation for three consecutive quarters




Source: CEIC, Morgan Stanley Research

**With easing still reactive, it will be some time before moderate inflation returns:** As we have been highlighting, policy easing remains reactive, slow and insufficient. While the recent monetary easing in the form of a 50bps RRR cut and 25bps targeted cuts on relending & rediscount rates and the reported stock market stabilization fund are positive signals, they nonetheless still indicate to us that easing is reactive. Indeed, we have been highlighting that in China's case, fiscal easing should play a more important role than monetary easing. Our chief China economist Robin Xing estimates that a US$1trn fiscal stimulus package over 2024/25 may be required to offset LGFV and housing deleveraging to lead the economy decisively out of deflation.

# China emerging as a deflationary force

**Over-investment and over-capacity:** Despite declining returns, China's investment to GDP remains high at 41% of GDP. Even though property investment is declining, nominal growth in infrastructure and manufacturing sector investment is relatively stable and averaged 7.5%Y in 2023 (compared with a nominal GDP growth rate of 5%). In an integrated global economy, the effects of this over-investment and the resultant excess capacity will extend well beyond China's weight in the overall aggregate. China has an influence over pricing power in other parts of the world given its role as a large market but, more importantly, it is the marginal competitor and that too of some size. We estimate that China accounted for 27% of global investment in 2023 compared with 22% in 2013. Hence, as China continues to invest with low return expectations, we believe this will continue to weigh on the price dynamics of a number of sectors, particularly those where China has a large market share.

## China's linkages with the rest of the world

On the supply front, China has consistently accounted for about 14-15% of global goods exports in recent years. In some key sectors, China has built up dominant global export shares, which can range from 23% to as high as 59% (see Exhibit 15). Exhibit 1

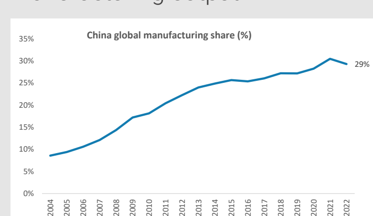
Even though China's share in global manufacturing output is already very high at 29%, policymakers are focusing on developing manufacturing capabilities in higher value-added goods as one of the new sources of growth. This has been reflected in China's high global export shares in green transition exports such as new energy vehicles, solar panels, and lithium ion batteries. Indeed, the exports of these segments grew sharply in 2023.

On the demand side, China's share of purchasing power parity-weighted global GDP has steadily risen to close to 1/5th. China accounts for 27% of global fixed capex but just 12% of global private consumption. Indeed, while its global goods import share has trended around 10%, its share of non-processing-related imports has risen from 55% in 2015 to 65% currently.

**Exhibit 6:** On the supply side, China accounts for 14% of global goods exports...

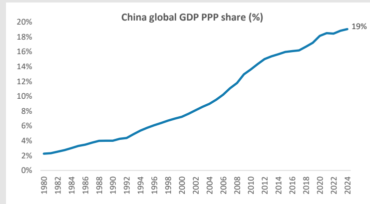

Source: CEIC, Morgan Stanley Research; Note: 2023 data as of Oct-23 on 12M trailing sum.

**Exhibit 7:** ...and 29% of global manufacturing output



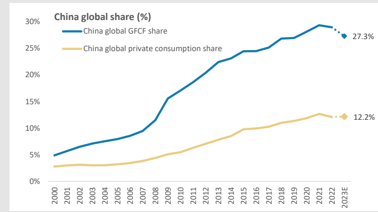

Source: CEIC, Morgan Stanley Research

**Exhibit 8:** China's PPP share of global GDP has risen to close to 1/5th



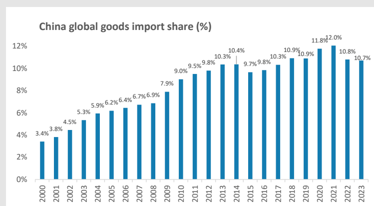

Source: IMF, Morgan Stanley Research

**Exhibit 9:** China accounts for 27% of global fixed investment



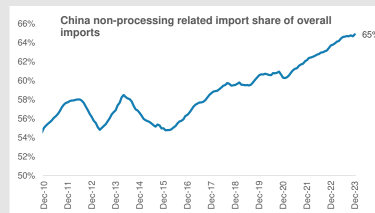

Source: World Bank, Morgan Stanley Research estimates

**Exhibit 10:** While China's global goods import share has been stable at around 11% in recent years...




Source: IMF, Haver, Morgan Stanley Research; Note: 2023 data as of Oct-23 on 12M trailing sum.

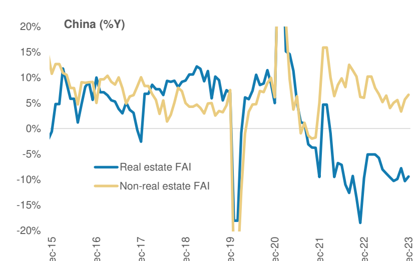
**Exhibit 11:** ...the mix is shifting towards non-processing related imports instead




Source: CEIC, Morgan Stanley Research

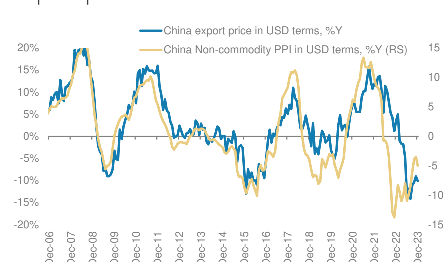
**The rise and rise of excess capacity in China:** To be sure, China's transmission of deflationary pressure has intensified only from 2H22, when global goods demand cooled off after the pandemic boom. Moreover, there were still lingering supply-demand imbalances that had to be worked through. But all through this period, China had continued to invest and the excess capacity issue only emerged in recent quarters. Indeed, over the last two quarters, China has been cutting prices of key manufactured goods such as cars, solar cells, lithium batteries, and older generation semiconductors. This is as China has capacity utilization rates of just 55% in cars, 65% in solar cell equipment and 76% in lithium battery equipment.

**Exhibit 12:** Non-real estate investment growth has held up, implying overinvestment in some sectors has persisted



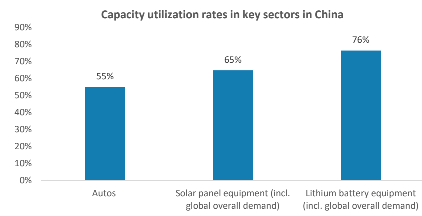

Source: CEIC, Morgan Stanley Research

**Exhibit 13:** China's weakness in non-commodity PPI prices tends to weigh on export prices



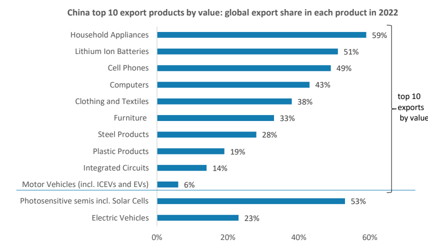

Source: CEIC, Morgan Stanley Research

**Exhibit 14:** Capacity utilization rates in key sectors are not that high even factoring in global demand




Source: Morgan Stanley China Autos and Industrials Research

**Exhibit 15:** China accounts for a sizeable global export share for multiple key products




Source: CEIC, Morgan Stanley Research; Note: Motor vehicles includes both traditional vehicles and EVs.

**A continued focus on manufacturing investment suggests this trend is here to stay:** There are a few signals that suggest to us that this trend of excess investment and over-capacity will persist.

**First**, from a cyclical perspective, the policy approach of stimulating growth remains principally investment. While we do believe that stimulating the economy through consumption would help with a rebalancing, the measures taken so far (such as a focus on monetary easing and directing lending to select sectors) are a clear sign that overall investment to GDP ratios will stay quite high for some time.

**Second**, policymakers are continuing to emphasize the country's industrial base and the scale and competitiveness of its manufacturing sector. They continue to take concerted actions to protect and upgrade its industrial base, seeking to maintain global competitiveness.

**Third**, global champions in select sectors have already emerged, particularly in those related to the energy transition.

# How China's deflationary pressures will spill over to the rest of the world

**We see two main areas where deflationary pressures will have an effect:**

1. **Disinflationary pressures – which will most affect economies with debt/ demographic challenges:** In thinking about the spillover effects of China on the rest of the world, we would usually highlight the growth implications (see our previous work on this topic here). But the persistence of the deflationary pressures will be the bigger challenge in this cycle. At the current juncture, most economies around the world are still dealing with a trailing issue of high inflation and so the deflationary impulses from China will help the disinflation process. For Asia, given that inflation has just moved into the comfort zone of central banks around the region, the downward pressure on core goods inflation will help keep inflation within central banks' comfort zones. But as this trend persists, we do think that in 6-12 months' time, there will be negative spillover implications on the nominal GDP growth trend in the region. In this context, economies that have high pre-existing levels of debt and weaker demographics – e.g. Hong Kong, Korea, Japan, Singapore, Taiwan, and Thailand – will face a greater challenge.
2. **Competitive pressures – which will risk a broadening of trade tensions:** There will be negative implications for the corporate sector of the economies which are competing directly with China. These pressures will be more acute for those sectors where China has excess capacity. In recent years, trade tensions have been more concentrated in a select few sectors and largely between the US and China. We think trade tensions took a back seat when supply chain disruptions were causing global inflationary pressure. However, as these inflationary pressures ebb and China's producers push their excess capacity to the rest of the world, there is a risk that we could see a renewed rise in trade tensions. In particular, the countries which are more likely to respond will be those who have domestic players in direct competition with China.

As an example, the European Commission opened investigations into China's EV sector in October 2023. In its statement, the President of the European Commission noted that "The electric vehicle sector holds huge potential for Europe's future competitiveness and green industrial leadership. EU car manufacturers and related sectors are already investing and innovating to fully develop this potential. Wherever we find evidence that their efforts are being impeded by market distortions and unfair competition, we will act decisively." For more details, please see the full statement from the European Commission.

The US presidential elections will be an important risk event to monitor in this context. For instance, media reports (Washington Post) suggest that former President Trump is considering options on the trade policy front, if re-elected, such as imposing a 10% across-the-board tariff on imports from all countries, including China, and he has spoken publicly about a potential move to downgrade China's trade status with the US.

## The transmission channels

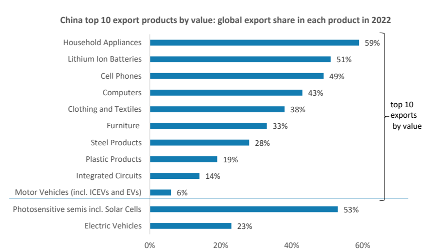
At a macro level, China will transmit its deflationary pressures to the rest of the world via trade, commodities, and its currency. From a micro perspective, the investments of Chinese companies in overseas markets will also be a key transmission channel.

### 1) Trade

Trade is the most obvious transmission channel given China's extensive trade linkages and its deep integration into global supply chains. China accounts for 14% of global exports. This challenge will be much more acute for select sectors where China has an even higher market share. For instance, as per the World Integrated Trade Solution Database, we calculate that China had a near 60% share in household appliances, 53% in solar cells, 51% in lithium ion batteries, and 23% in electric vehicles as of 2022. Moreover, the rapid growth of segments related to the energy transition – i.e. solar cells, batteries and electric vehicles – likely increased China's market share sharply in 2023.

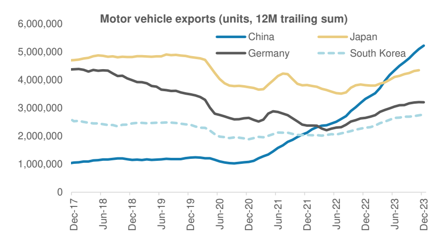
Within Asia, China is the leading trade partner for the Asian economies under our coverage, apart from India and the Philippines. For this channel of transmission, we are closely monitoring non-commodity PPI trends and China's export price index as well as the PPI trends in Asia ex China economies. For this cycle, China's PPI ex-commodities and export price index have already decelerated to -5%Y and -10%Y respectively ( Exhibit 13 ).

**Exhibit 16:** The transmission of deflationary pressure is more acute in select sectors



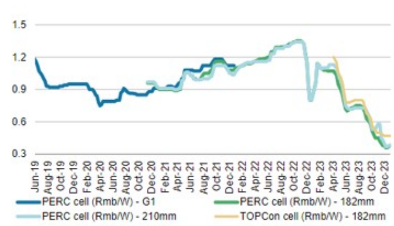

Source: CEIC, Morgan Stanley Research; Note: Motor vehicles includes both traditional vehicles and EVs.

**Exhibit 17:** For example, China is now the largest global autos exporter



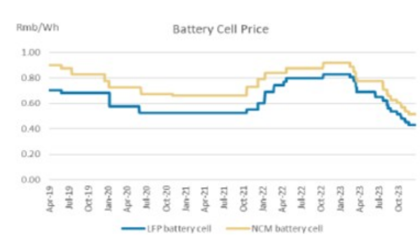

Source: CEIC, Haver, Morgan Stanley China Autos Research

**Exhibit 18:** Solar cell pricing has declined sharply in 2023



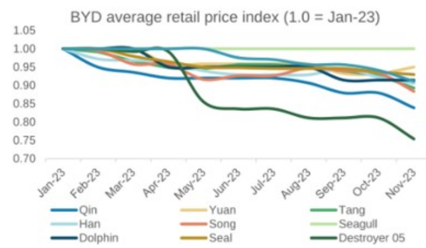

Source: PVInfoLink, WIND, SCI99, SMM, Morgan Stanley Utilities Research

**Exhibit 19:** Lithium battery cell prices have also halved in 2H23



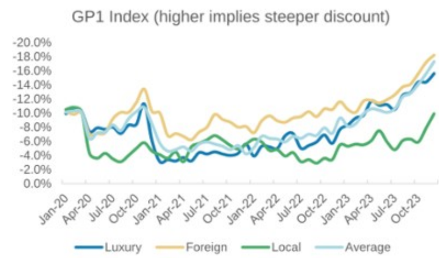

Source: WIND, ICC, Morgan Stanley China Energy and Chemicals Research

**Exhibit 20:** In the autos sector, we are observing deepening price cuts...



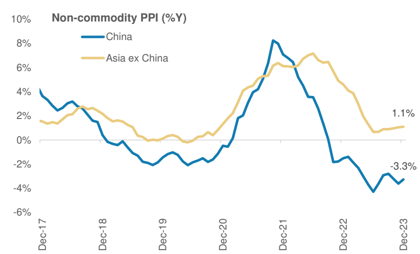

Source: Company data, CADA, Autohome, Morgan Stanley China Autos Research

**Exhibit 21:** ...and retail discounts



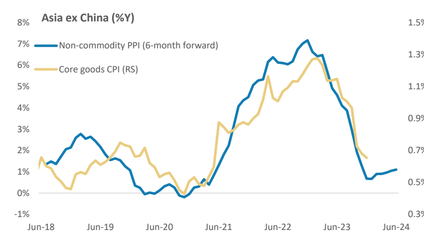

Source: Company data, CADA, Autohome, Morgan Stanley China Autos Research; Note: GP1 index shows dealers' new car gross margins excluding OEM rebates and auto insurance/finance commissions. The wider loss the GP1 index shows, the larger the sales discount.

**Exhibit 22:** China non-commodity PPI tends to weigh on Asia ex-China non-commodity PPI




Source: CEIC, Morgan Stanley Research

**Exhibit 2023:** For Asia ex China, PPI disinflation is passing through to core goods CPI disinflation




Source: CEIC, Morgan Stanley Research

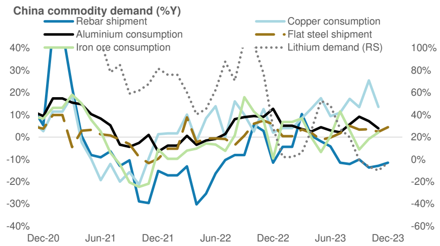
## 2) Commodities

We divide commodities into two buckets – consumption-linked items like oil and food and investment-linked items like ferrous and non-ferrous metals. Moreover, with the investment-linked items, there are different implications on commodities that are tied to property investment and those that are related to the energy transition. Our sector analysts highlight that the supply concentration also plays a role in the price trend.

Indeed, so far in this cycle, the trends in commodity demand have diverged. In particular, demand for materials used in construction, like long steel and cement, has been weak and this has been reflected in prices. On the flipside, materials for which demand is related to the energy transition have held up better – as policymakers continue to support spending on infrastructure in these areas.

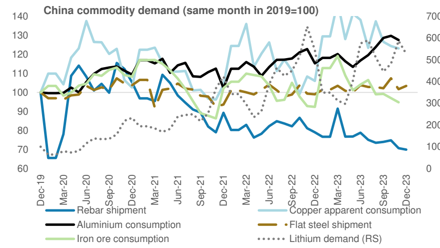
Even as medium-term growth slows in China, demand for energy-related items like oil and coal, food (edible oils, soya, corn) and energy transition-related materials (copper, lithium, nickel) will continue to hold up better. In contrast, construction-related materials such as long steel products (rebar), iron ore and cement will likely remain weak.

**Exhibit 24:** Demand for commodities related to property has been weaker…



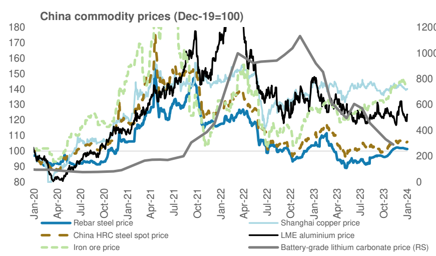

Source: MySteel, WIND, Morgan Stanley China Materials Research

**Exhibit 25:** …while demand for commodities related to the energy transition has been more robust




Source: MySteel, WIND, Morgan Stanley China Materials Research

**Exhibit 26:** We see similar trends in commodities pricing



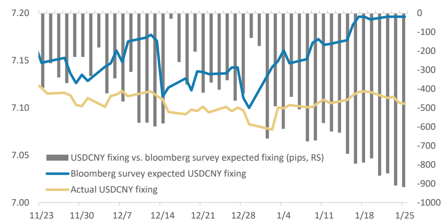

Source: Bloomberg, Morgan Stanley Research

## 3) Currency

To be clear at the outset, we are expecting moderate depreciation pressure in our base case. Our FX strategists believe that the CNY CFETS index could face 1-2% depreciation p.a. over 2024-25 against this backdrop (see China's 3D Journey: The CNY Outlook in a New Equilibrium, Dec-23). However, if the currency faces more intense depreciation pressure, it will likely weigh on deflationary pressure elsewhere in the world.

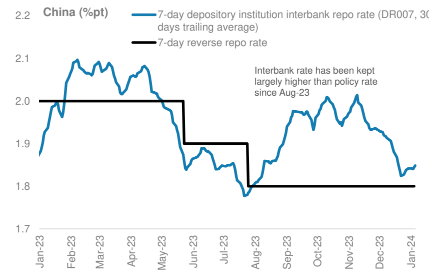
Currently, policymakers are leaning against the depreciation pressures. As we highlighted previously, we attribute this to the following. China faces the same challenges as other EMs in that if policymakers were to be seen to signal that they are accommodating a significant depreciation in the exchange rate, it could lead to persistent capital outflows and expectations of further weakness in the currency. This would then lead to a self-fulfilling loop where currency weakness translates into further depreciation pressure. Once such a scenario emerges, aggressive interest rate hikes would then be needed to stabilize expectations, which would be counterproductive for the deleveraging process.

**Exhibit 27:** Policymakers have leaned against currency depreciation pressure by keeping the fixing stronger




Source: Bloomberg, Morgan Stanley Research

**Exhibit 28:** Interbank rates were kept persistently above policy rates from August 2023




Source: Bloomberg, Morgan Stanley Research

## 4) Chinese companies' overseas expansion

Another area where deflationary pressures are being transmitted but might not be captured at a macro level is the overseas expansion of Chinese companies' operations. In some instances, domestic penetration rates have reached high levels, prompting companies to look for alternative sources of growth overseas. It is against this backdrop that companies may be prompted to expand overseas and, in so doing, increasing competitive pressures in other markets and putting downward pressures on prices there. This can already be observed in the consumer goods space and fast fashion as well as sectors related to the energy transition.

# What might help alleviate deflationary pressures

At the outset, our base case is that easing remains reactive and that the risks of a debt-deflation loop remain high. Against that backdrop, we think that the risks are skewed towards deflationary pressures persisting, with attendant spillovers to the rest of the world.

We do see a few factors that could potentially alleviate these deflationary pressures. First, we could get a strong benefit arising from a sustained boom in China's exports (our base case is that of a constrained recovery). If China's exports strengthen to like what we saw from 3Q16 onwards, this would help China manage its excess capacity issues and consequently alleviate some of the acute challenges over the debt-deflation loop.

Other sources of potential upside risk could emanate from aggressive policy easing. For instance, policymakers could take up easing measures that are tilted more towards boosting consumption than investment, which in our view for a sustainable return to moderate rates of inflation (i.e. 2-3%), we would need to see coordinated easing alongside a push to rebalance towards consumption.

Other easing measures could take the form of stimulating property or infrastructure spending – for instance, taking up a comprehensive resolution of property sector issues and going ahead with reported plans to take up urban village renovation in a meaningful way (see China Property: Potential Expansion on Urban Village Renovation, but Funding is the Key, 29 January 2024).

However, we do think this will be difficult considering the existing challenge of excess inventory even in tier 1-2 cities. On infrastructure, we already have evidence that returns from past investments have been weak, creating challenges for debt servicing by local governments. Boosting these areas of spending will push debt to GDP even higher and may only provide a temporary reprieve for the deflation challenge.

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