China's Stagflation Risk

Warning Signals

The prices of goods coming from global manufacturing hub is surging by the highest rate on record, contributing to fears about stagflation in the world's second largest economy at a time when it is already struggling with an extreme power crunch and deepening debt crisis.

A worrying sign is the pass-through of inflation from input prices to output prices. The input price inflation has been high for many months by now, driven by the rising commodity prices." But the jump of (the) output price index in October is alarming. These signals confirm that China's economy is likely already going through stagflation.

– *Zhang Zhiwei*, Chief Economist, Pinpoint Asset Management, Hong Kong

Stagflation occurs when inflation stays high, economic growth remains sluggish, and unemployment rises consistently. In recent weeks, China registered dramatically declining growth rates. Prices of coal, oil and other commodities are ratcheting up. The property sector has tanked in the wake of the Evergrande crisis. The government is cracking down on giant businesses. Coupled with pandemics and headwinds in external markets, not least a continuing trade or "cold war" with the United States, the market is awash with talks of impending stagflation. Analysts are of the view that stagflation in China is a "very real" risk in the next couple of quarters as factory gate prices rise at a quicker pace and an ongoing power crunch hurts economic growth.

Mindful of China's worsening demographics and lackluster productivity growth, some commentators are evoking comparisons with Japan's "lost decades".

According to a November 10, 2021 report of CGTN, Beijing's media network, China's official Producer Price Index (PPI), which reflects prices factories charge wholesalers for their products, rose by 13.5% in October from a year earlier, hitting the highest level since 1996. The Consumer Price Index (CPI), a major gauge of inflation, went up by 1.5% in October, up from 0.7% in September.

However, as a key CPI component, pork prices dropped 44% year on year in October, compared with a 46.9% plunge in September. Food prices dropped by 2.4% year on year, up from a drop of 5.2% in September, while non-food prices increased by 2.4%, up from a rise of 2% the previous month.

According to the report, core inflation excluding volatile food and energy prices registered a growth of 1.3% in

Key Chinese Manufacturing Index Shows Signs of Stagflation

A key indicator of the health of the Chinese economy, the Purchasing Manger's Index (PMI) contracted. Analysts say the indicators of stagflation in the Chinese economy are there.
China's factory activity contracted more than analysts anticipated in October for a second month as raw material prices remain high and domestic demand stays low due in part to uncertainty brought on by the pandemic, the National Bureau of Statistics (NBS) said recently.
Covid-19 returned officially in October, especially in northern China. The resulting decline in economic activity could further hamper the services sector because of tough restrictions to contain outbreaks.
The combined official measures point to increased economic instability in the last quarter of 2021 after a year of steady decline this year, in no small measure due to the pandemic.
This September, factory output was at its lowest since the pandemic began due to power rationing, the increased cost of raw materials, and environmental regulation.
According to Zhiwei Zhang, Chief Economist, Pinpoint Asset Management, "These signals confirm that China's economy is likely already going through stagflation."

Courtesy: dw.com

October, up from an increase of 1.2% in September while China has set a CPI growth target of around 3% this year, down from 3.5% last year.

Although there is no firm indication that elevated factory-gate prices are filtering through to consumers, some analysts warn that risk of stagflation is rising in China.

Stagflation in the offing?

"Stagflation is coming," Ren Zeping, chief economist at the Evergrande Group, warned earlier in March. "China's economic cycle is shifting from recovery to overheating and then stagflation, with rising inflation expectations and structural asset price bubbles," Ren warned. "We may be standing at a cyclical inflection point."

China remains the world's largest commodity importer, including copper and corn, whose prices are witnessing record highs in years.

The official manufacturing Purchasing Managers' Index (PMI)—an indication of sentiments among factory owners—is plummeting in China, together with the official non-manufacturing PMI measuring sentiments in the services and construction sectors.

According to a CNBC report of October 28, 2021, the risk of stagflation is "very real" in China over the next couple of quarters. The slowdown in the real estate sector has "very severely" hit China's economic growth, but confidence in the primary property market is not yet collapsing, according to the report. It further adds that a high PPI and power crunch have made it difficult for Beijing to stimulate the economy aggressively. The PPI jumped 10.7% in September compared with a year earlier, the fastest pace since October 1996 when data compilation started. Meanwhile, power cuts across the country prompted several big banks to slash GDP forecasts for China.

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However, as reported in the South China Morning Post, Ding Shuang, chief Greater China economist at Standard Chartered bank, downplayed the chance of stagflation in China this year, calling it "quite low". In 2020, China's consumer inflation rose 2.5% from the previous year against a government CPI growth target of about 3%.

Yu Yongding, a prominent Chinese economist and former central bank adviser, said the recent rise in raw material prices does not support the conclusion that China is at risk of stagflation. "None of the developed countries have reached their inflation targets yet, and we won't see an immediate change in the (Federal Reserve's) quantitative easing policy," Yu said.

As for hikes in fuel prices, Deng Haiqing, chief economist with financial firm AVIC Fund, said that higher shale oil production and new energy sources will likely add to the overall energy supply, putting a ceiling on crude oil prices.

As the world's largest trader and exporter, China's economy is closely integrated with the global economy. It is bound to be affected if there is any structural stagflation in the latter.

However, according to a Nikkei Asia report of October 15, International Monetary Fund (IMF) Chief Economist Gita Gopinath opines that global economic conditions are "nowhere close" to the 1970s-style stagflation. Supply chain disruptions and inflation fears notwithstanding, inflation rates are expected to return to normal in the near term.

As for China's property sector, Natixis, a French bank, thinks that any Evergrande contagion is limited to privately-owned and high-yield developers, especially smaller entities. Spillover effect into investment-grade names in China's dollar bond market hardly exists. As I explained in my November 2021 feature article in *The Global Analyst*, the Evergrande Crisis has been largely contained.

On China's "stagflation" fears, Gerald Lyons, UK Board Member of the Bank of China, gave an across-the-board assessment at an Asia Leaders Boardroom briefing on October 28, 2021. Despite headwinds, he remained positive about the Chinese economy.

Lyons pointed out that China was the first country recovering from the pandemics with positive growth, expected to average about 8% for the whole year, driven by strong exports, albeit not by domestic consumption. Against property sector borrowing excesses, China now adopts a vigorous prudential regime of "Three Red Lines". The three thresholds are:

1. A 70% ceiling on liabilities to assets, excluding advance proceeds from projects sold on contract,
2. A 100% cap on net debt to equity, and
3. A cash to short-term borrowing ratio of at least one.

Notwithstanding supply chain disruptions, part of the sudden coal shortage is due to China's imperative to meet Paris Agreement Climate Change targets. Similarly, Beijing's crackdown on the housing sector and big-tech monopolies is driven by a desire for "common prosperity". Apart from providing a more level-playing field for small businesses, this is intended to dismantle economic barriers for raising a family, helping to address the nation's worsening demographics.

These dynamics are elaborated upon in my feature article "China's Common Prosperity Goal" in the October 2021 edition of *The Global Analyst*.

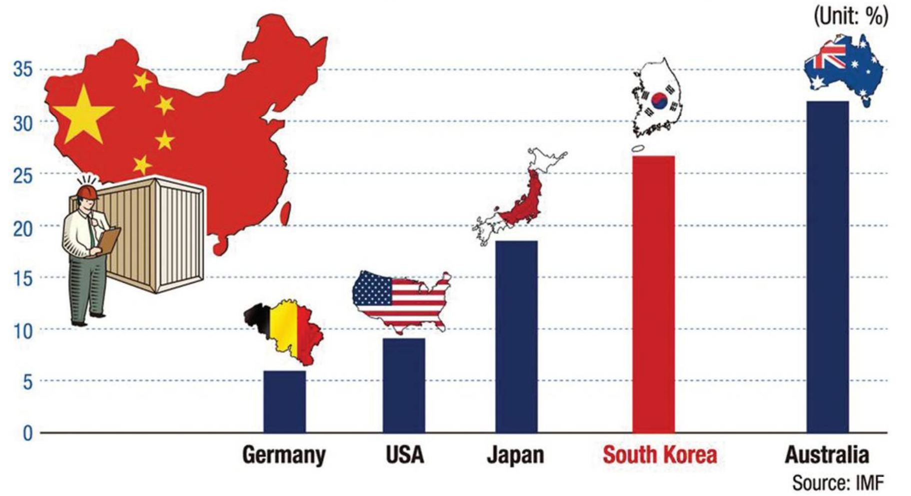
Additionally, China's "energy intensity", the quantity of energy input required to produce a unit of Gross Domestic Product (GDP), has been declining over the years. This is a drive to back away from an energy-intensive development model that had proven to be "unstable, unbalanced, uncoordinated and unsustainable" in words famously uttered by former Premier Wen Jiabao.

Over the 2021-2025 period, China aims to cut energy intensity by 13.5% and carbon intensity—a ratio measuring how much carbon is emitted in growing the economy—by 18%. These targets are geared to achieve "peak carbon emissions" by 2030 and "carbon neutrality" by 2060.

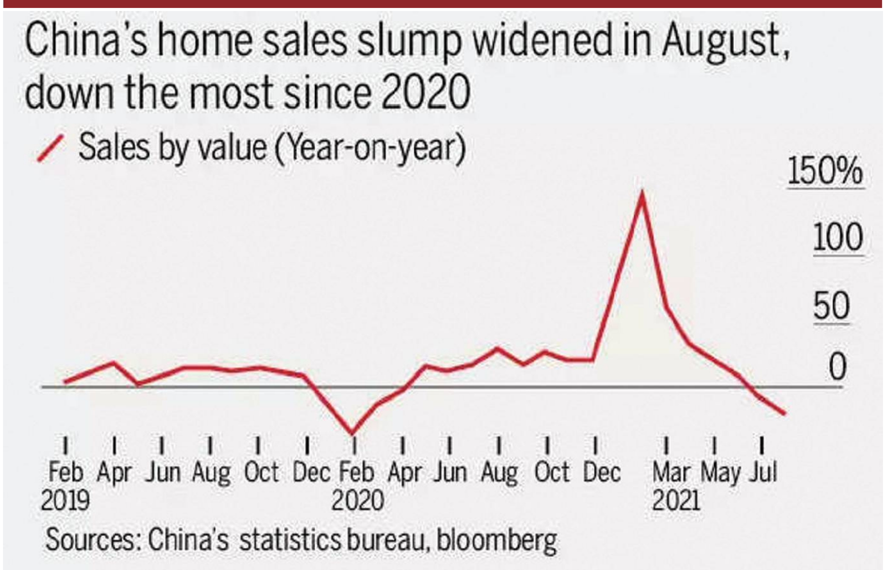
Beijing has repeatedly stressed that what the nation wants now is not rapid growth, but quality and sustainable growth. As a state-driven capitalist economy, China has an arsenal of tools to steer the economy on an even keel. For example, if push comes to shove, Beijing has sufficient financial resources to introduce a variety of economic stimulus measures.

For example, such measures could include subsidies to boost purchase of electric cars. They can also be geared towards jump-starting China's ambitious program to double its high-speed rail network, already accounting for two-thirds of the global total, to 70,000 km over the next 15 years. This would serve to hasten the urbanization rate, doubling China's consumer middle class to 800 million by 2035, as explained in my June 2021 feature article "China: No Longer the Global Growth Engine?" in *The Global Analyst*.

Shares of Exports Going to China by Country



Deepening Slowdown



Outlook

China's current price increases are not sustaining, and the nation's growth reversal is far from systemic 'stagflation'. While not entirely self-induced, it is in some way a painful adjustment towards a higher-quality, and more sustainable, if slower, growth model. This is in line with a development trajectory to realize the nation's second centenary goal of becoming a "strong, democratic, civilized, harmonious, and modern socialist country" by 2049, the centenary of the founding of the People's Republic of China. ■

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