THE **ASIA** ECONOMIC MONITOR

AUGUST 10, 2018
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China's CPI inflation ticked up in July and could edge higher in August, thanks to energy costs.

But tariffs are not yet likely to register, and slowing energy inflation will soon drive the headline lower.

China's PPI inflation is set to continue slowing, but RMB depreciation will provide some offset.

China's CPI Inflation is Likely to Slow Despite Tariff Hikes

China's CPI inflation rose to 2.1% in July, from 1.9% in June. The bulk of the uptick was driven by the non-core elements. We estimate that food inflation contributed 0.2 percentage points to the headline inflation rate in July, up from 0.1pp in June. We reckon the contribution from energy was greater, at 0.8pp in July, compared with 0.7pp in June.

Inflation excluding food and energy was unchanged at 1.9%. But services inflation also edged higher, to 2.5% in July, from 2.4% in June, after four months of declines. Recreational, cultural and educational articles and services inflation picked up sharply. This component is volatile, though, and should correct lower in coming months.

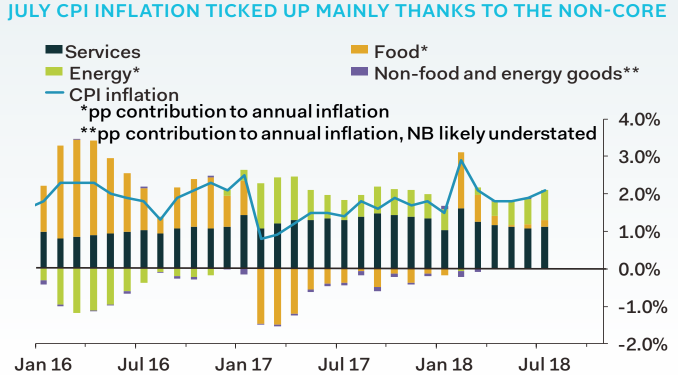
The underlying downtrend in services inflation appear to remain in place. Medical care service inflation slowed further in July, from elevated rates in previous months. The fast pace of healthcare inflation has now become a political issue, with Premier Li Keqiang setting himself the mission to bring it down. In any case, the base from last year is high, implying a further downtrend. The drag from communication costs intensified as well.

On the face of it, we see little evidence that either the tariffs hikes or cuts enacted in July have had any impact. The quality of the data is poor, however, and we can't extrapolate to reality in this case. In addition, it's to early to rule out any impact.

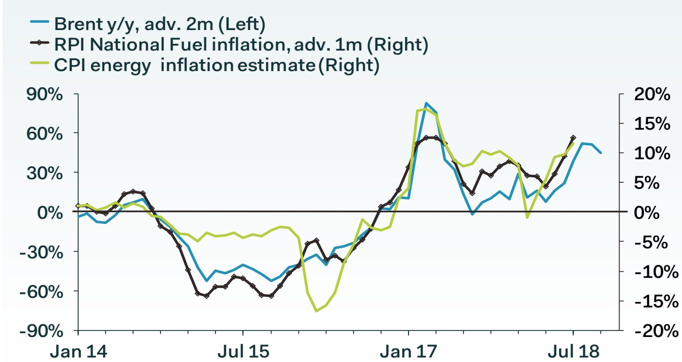
The one to watch on the tariff hike side will be pork prices, as imported soybeans are a prime source of feed. Chinese pork prices are notoriously volatile, and relatively important in the CPI basket. The trade data suggest that China stockpiled soybeans ahead of the imposition of tariffs in early July. *This will help to mute inflationary pressure, but the real test will come in August, when China typically becomes reliant on imports from the U.S.* We reckon China has been preparing, but it will be a squeeze.

Firms also appear to have been stockpiling oil and coal imports in preparation for hikes on imports from the U.S., currently slated for August 23. Again, this will dampen the inflationary hit, and it's likely that Chinese firms are finding it easier to find alternative suppliers than in the case of beans. *As a result, favourable base effects likely will dominate in coming months, bringing*

JULY CPI INFLATION TICKED UP MAINLY THANKS TO THE NON-CORE



CPI ENERGY INFLATION IS LIKELY TO PEAKS SOON



down CPI energy inflation. The breakdowns don't allow for concrete calculations on energy inflation in China, but the peak in year-over-year oil price increases was in June. Our best guess is that this will take around one month to hit retail prices, for which we have clearer data, and two months to reach CPI energy inflation. *In short, rising energy inflation could continue to put upward pressure on the headline in August, but this will reverse in September.*

Again, we can't see solid evidence of *slower* inflation thanks to the *cuts* to tariffs on a broad range of consumer goods in July. But firms have faced a sharp depreciation of the RMB in recent months, largely offsetting the tariff cuts. ***Overall, slowing energy inflation, combined with the ongoing downtrend in services inflation, are likely to be the dominant forces in the headline CPI inflation rate.***

The falling RMB will cushion slide in Chinese PPI

PPI inflation in China inched down to 4.6% in July, from 4.7% in June, ending three straight months of acceleration. The slowdown was to be expected, given the loss of momentum in monthly price rises signalled by the PMIs. In addition, the base last year rose after having fallen since March.

On our estimates, inflation of manufacturing goods—excluding processing—slowed to just 0.5% in July, after edging up to 0.7% in June, though we await further breakdowns. Strange revisions continue to play out in some of the subindices, but the downtrend in manufacturing goods inflation is clear.

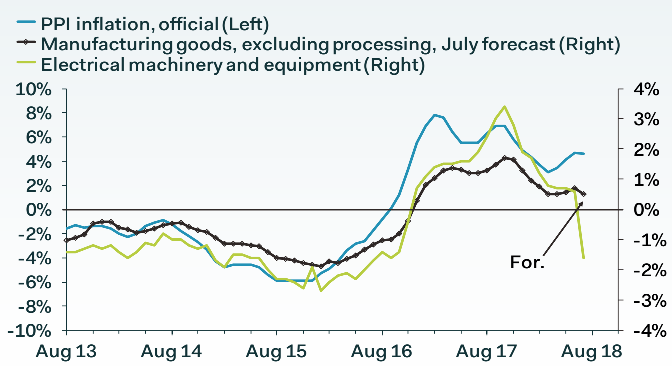
Looking ahead, the headline year-over-year rate likely will be driven yet lower, thanks to a steep climb in the base of the second half last year. This will weigh on industrial profits growth, which is already under pressure from falling sales volumes.

The weakening of the RMB, however, will prevent PPI inflation from falling faster in the second half. Commodity prices have largely been a source of disinflation since 2017, but that is now changing for China. The RMB's strong *start* to the year more than offset a rise in commodity prices. *The reverse is now happening.* The RMB's depreciation since May—exacerbated by the escalation of U.S.-China trade tensions—has more than wiped out the currency's gains for the year. Accordingly, the CRB All Commodities Index *in RMB terms* has risen about 6%, from its April low, despite having fallen sharply in dollar terms.

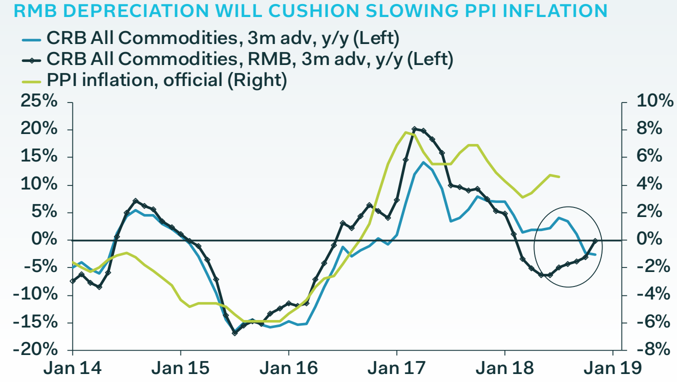
The rough three-month lag between commodity price movements in local currency terms and the PPI means that the past few months of price data have yet to reflect in full the RMB's declines. The PBoC is stepping up efforts to lean against the currency's depreciation, but the pressure on the RMB will continue. Even if the trade tensions reduce, the Fed is likely to begin signalling a more aggressive hiking path around the end of the year.

Slower PPI inflation will incentivise the authorities to increase support for GDP growth. But scope for a more substantial stimulus is limited, however, by the disappearance of the current account surplus.

MANUFACTURING PPI INFLATION CONTINUES TO SLOW



RMB DEPRECIATION WILL CUSHION SLOWING PPI INFLATION



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THIS WEEK IN BRIEF

Data and events covered in the Asian Data Wrap.

Monday, August 6

- **China: Current Account Balance (Q2)**

The current account flipped to a **$5.8B** *surplus* in Q2, from a $34.1B *deficit* in Q1. The goods trade surplus jumped, the services deficit stabilised, but the primary income deficit fell.

Tuesday, August 7

- **Japan: Labour Cash Earnings (6) 09:00 JST**

Wage growth shot *up* to **3.6%** y/y in June, from 2.1% in May, surprising the consensus for a *drop* to 1.7%. Growth could drop in July, but will rebound to the mid-1% range in August.

- **China: Foreign Reserves (7)**

FX reserves *rose* slightly to **$3,117B**, in July, from $3,112B in June, surprising the consensus for a *fall* to $3,107B. In reality, we think the authorities were *supporting* the RMB, with FX *sales.*

Wednesday, August 8

- **Japan: Current Account Balance (6) 08:50 JST**

The unadjusted current account surplus fell to **¥1,176B** in June, from May's ¥1,939B, below the consensus, ¥1,222B, thanks to seasonal weakness in primary income.

- **China: Trade Balance (7)**

The unadjusted surplus *narrowed* in July, to **$281B**, after *widening* to $41.5B in June, below the consensus, $38.9B. Imports were boosted by stockpiling and tariff *cuts.*

Thursday, August 9

- **Japan: Monetary Stock M2 (7) 08:50 JST**

M2 growth dipped to **3.0%** y/y in July, from 3.1% in June, below the consensus, 3.1%. Net revisions were *minus* 0.1pp.

- **China: CPI (7) 09:30 CST**

Inflation rose to **2.1%** in July, from 1.9% in June, above the consensus, 2.0%. The uptick was driven by faster non-core inflation, but energy inflation is soon likely to reverse.

- **China: PPI (7) 09:30 CST**

July PPI inflation edged down to **4.6%** y/y in July, from June's 4.7%, above the consensus, 4.5%. It should now continue to slow but RMB depreciation will moderate the downtrend.

Friday, August 10

- **Japan: PPI (7) 08:50 JST**

Inflation probably accelerated further, to **3.2%** y/y in July, from 2.8% in June. The output price sub-index of the July PMI survey rose to a fresh multi-year high. **Consensus: 2.9%.**

- **Japan: GDP (Q2) 08:50 JST**

Real GDP growth likely *surged* to **0.6%** q/q in Q2, after GDP *contracted* by 0.2% in Q1. Retail sales imply a strong rebound in consumption, while the Tankan survey and loan data imply a bumper quarter for capex. **Consensus: 0.3%.**

- **Japan: Tertiary Index (6) 08:50 JST**

We reckon that the tertiary index *fell* by **0.5%** m/m in June, after a 0.1% *increase* in May. **Consensus: -0.3%.**

August 10-to-15

- **China: M2 (7)**

M2 growth edged up to **8.1%** y/y in July, from 8.0% in June, as the authorities take an easier stance. **Consensus: 8.2%.**

CHINA ECONOMIC FORECASTS

GDP	q/q Official	q/q PM est.		y/y Official	y/y PM est.
Q1 2017	*1.5%*	*2.2%*	*2015*	*6.8%*	*4.7%*
Q2 2017	1.8%	1.2%	*2016*	*6.8%*	*5.7%*
Q3 2017	1.8%	1.6%	*2017*	6.8%	6.8%
Q4 2017	1.6%	1.4%	*2018*	6.4%	<5.0%
Q1 2018	1.4%	1.6%			
Q2 2018	1.8%	1.5%			

	CPI, y/y Headline	CPI, y/y Non-food	PPI, y/y Headline
Jun-18	1.6%	1.9%	4.7%
Sep-18	1.2%	1.8%	3.6%
Dec-18	0.7%	1.8%	2.3%
Mar-19	0.9%	1.8%	3.0%

JAPAN ECONOMIC FORECASTS

GDP	q/q	CPI	Headline	Core*
Q3 2017	0.5%	*Jun-17*	0.7%	0.0%
Q4 2017	0.3%	*Sep-18*	0.7%	0.2%
Q1 2018	-0.2%	*Dec-18*	0.2%	0.1%
Q2 2018	0.5%	*Mar-19*	0.4%	0.2%

*Excluding food and energy

KOREA ECONOMIC FORECASTS

GDP	q/q	CPI	Headline	Core
Q3 2017	1.5%	*Jun-17*	1.5%	1.3%
Q4 2017	-0.2%	*Sep-18*	1.8%	1.2%
Q1 2018	1.1%	*Dec-18*	1.5%	1.1%
Q2 2018	0.8%	*Mar-18*	1.5%	1.1%

ASIAN YIELDS

		Jun	Sep	Dec	Mar
10-year, %	China	3.50	3.55	3.60	3.65
	Japan	0.05	0.20	0.20	0.20
	Korea	2.50	2.55	2.60	2.65

ASIAN MONETARY POLICY FORECASTS

China	Interest rate corridor on hold for this year; 50bp RRR cut for all banks Sep/Oct and around Dec/Jan
Japan	Further dilution of the 2% inflation target; October hike to the 10-year yield target; reduction of the portion of current account balances facing a negative rate
Korea	7-day repo rate on hold until Q4 at the earliest.