

## We're worried about China, but things could be worse

China's latest activity data worsened across nearly every component. Markets have given up looking for fiscal stimulus, and have started making comparisons with 1990s Japan. We don't agree with the Japanification hypothesis, but clearly a substantial adjustment is underway, and we have trimmed our growth forecasts accordingly



China now looks set to endure a period of sub-trend growth. Pictured: a car factory in the eastern city of Tianjin

### Deflation is very different to this

A couple of weeks ago, [we wrote a piece](#) debunking an argument that was doing the rounds which argued that China had slipped into deflation and was turning into a modern-day equivalent of 1990s Japan.

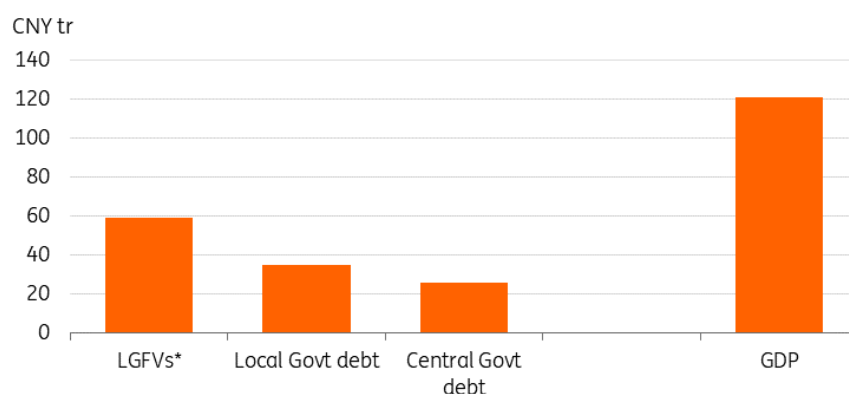
Being old enough to remember that period quite well (unlike I imagine most of the proponents of the idea), it was clear to us that there was no merit to this view.

Firstly, deflation is not negative consumer price inflation. Deflation is a much broader collapse in the general price level, which, in addition to consumer prices includes falls in real and financial asset prices, as well as money wages. And though we have seen some renewed falls in house prices, stocks are not looking very robust, and there is indeed some year-on-year decline in consumer prices, however, money wages are still positive.

Moreover, the single defining feature of 1990s Japan was that it was the result of a monetary-induced bubble and subsequent bust. There was a property element to Japan's problems, but much more besides. Japan's response was a massive fiscal expansion, which failed to do much more than saddle the economy with a mountain of debt, and the rest is largely history.

China's issues also concern the property market, but it is the existence of large-scale local government debt that is the main constraint on the recovery. There is little evidence of any financial or property bubble. As a result, the government responses, of which there have already been a great many, have almost entirely focused on supply-side measures, which are only having a very marginal effect on activity.

## Local government financing vehicles swell government debt



Source: LGFV debt estimates from the Rhodium Group, CEIC, ING

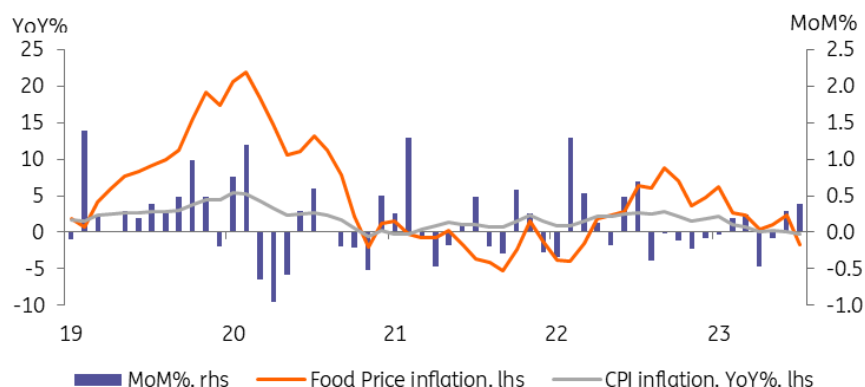
\*LGFV = Local government financing vehicle

## The outlook is for further weakness in economic activity

China now looks set to endure a period of sub-trend growth while it restructures this debt and alleviates some of the debt-service cost strains that are apparently weighing on some local government financing vehicles. Much of this off-balance sheet debt will need to be brought back on the balance sheet. Clarity over the scale of the existing problem will help determine the central government's response, as at this stage, we suspect that even they don't know. But lower interest rates for official debt and longer payment schedules seem very likely to dominate proceedings. Bucketloads of new debt, however, will not.

We think that China's longer-term potential growth rate is around the 5% mark. But in the near term, even this may present a challenge for policymakers to achieve. We have downgraded our GDP forecast for 2023 to 4.5% as the previous main engine of growth – consumer spending – is faltering. Estimating how long this balance sheet adjustment will weigh on the economy is pure guesswork at this stage, but a wet-finger estimate of two years seems a reasonable starting point. We are not looking for 5% growth to be achieved again until 2025.

## Chinese inflation is just unwinding earlier food price spikes



Source: CEIC, ING

China inflation monthly

### Inflation is low, but will recover

Such weakness is likely to keep inflation very subdued in the meantime. Much of the recent decline in overall inflation is due to falls in food price inflation, which spiked up to more than 10% in July last year on the back of swine fever-affected pork prices. This is yet another reason for dismissing deflation claims.

Indeed, if you create a conventional CPI index from China's year-on-year inflation series, then it looks like the price level rose by about 0.3% month-on-month in each of the last two months. So temporary base effects are doing most of the damage to inflation currently, and by November these will have passed. In the meantime, though, further negative year-on-year CPI inflation figures are likely to keep the 'deflation' argument alive for a while longer.

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