China flashes additional signs of reflation as Iran War impact emerges

China's consumer price index inflation moderated to 1.0% year-on-year amid typical post-Lunar New Year seasonality, but producer prices returned to positive levels for the first time since 2022. Energy-related subcomponents show pressures mounting as higher oil prices start to feed through to the economy

0.5% YoY

March PPI inflation

Back to positive levels for first time since September 2022

Post-Lunar New Year CPI dip could be short lived as energy surges

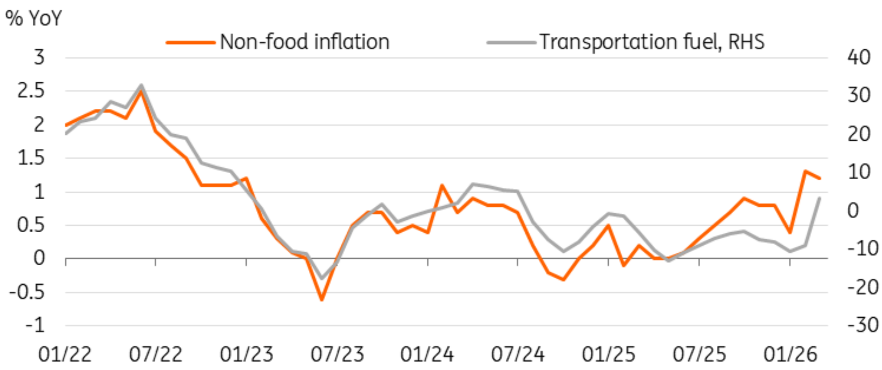
China's consumer price index inflation slowed to 1.0% year-on-year, down from 1.3%. Headline CPI came in slightly lower than expected but still leaves first-quarter inflation at 0.9% YoY, the highest since the first quarter of 2023.

Looking at the CPI breakdown, the slowdown was largely due to a normal price decline following China's Lunar New Year holiday. Food prices dropped -2.7% month-on-month in March, leading to a tepid 0.3% YoY growth overall. We are still seeing a drag from pork prices, with a -7.3% MoM slide resulting in a -11.5% YoY read for pork inflation. Typically, we would expect prices to bottom out this year, which should help push food inflation higher. One development that could throw a wrench in the works is potential deals between China and the US on soybean purchases. That could push pig feed prices relatively lower and limit a recovery in pork prices.

Other usual suspects for a price drop – fresh vegetables and fresh food prices – also saw clear sequential price drops of -10.1% MoM and -3.3%, respectively. Tourism prices fell sharply -12.9% MoM in the off-season as the country got back to work in March.

The substantive price drops are in line with China's typical seasonality around the Lunar New Year holiday. More importantly for the months ahead, we are starting to see the impact of higher energy prices in the data. The subcategory for transportation fuel costs surged 10.0% MoM in March, even as gasoline prices have risen much less than crude oil prices in China. This surge culminated in a YoY spike to 3.4%, after coming in at -9.7% YoY in the first two months of the year. Further upside looks likely as energy prices stay elevated.

Transportation fuel prices spiked at the start of the Iran war, with further upside likely



Sources: CEIC, ING

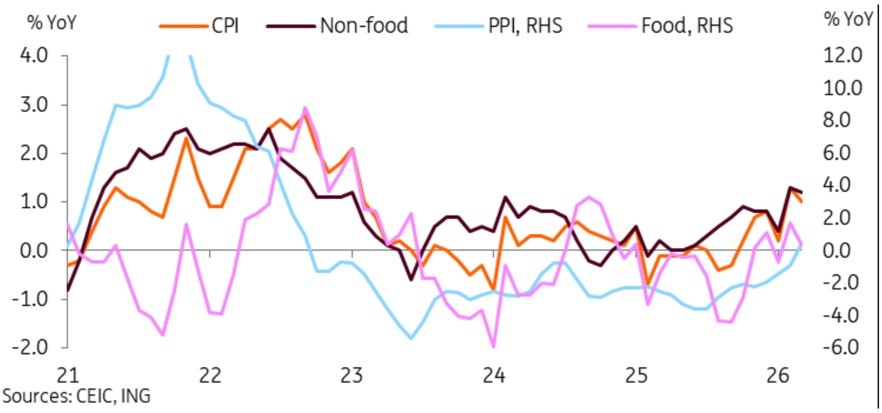
PPI inflation returned positive for the first time since 2022

Producer price index inflation bounced back solidly into positive territory in March, ending a 41-month streak of deflation. PPI inflation rose to 0.5% YoY in March, slightly higher than market expectations and slightly lower than our forecast.

Unsurprisingly, PPI inflation told the same story of higher energy prices. We saw a 15.8% MoM surge in the oil and gas extraction industry PPI. This led to a 5.2% YoY rate for the category, after seeing a -14.8% YoY drag in the first two months of the year.

As we've discussed in recent months' updates, the other key categories driving PPI recovery are non-ferrous metals mining (36.4%) and smelting and processing (22.4%), which continued to see PPI move higher on the month. Higher producer prices should eventually translate to reflationary momentum across the economy, which could help in the efforts to crack down on involution-type price competition.

China takes another step toward reflation



Sources: CEIC, ING

Implications of China's reflation theme

What does this all mean for China's economy?

China has been locked in deflationary expectations for the past several years, with CPI inflation ending the last 3 years at 0.2% YoY or lower.

This deflationary mindset has had several key consequences:

- Heavy price competition. Although not a deflation-specific phenomenon, China's price competition perhaps reached new peaks over the past few years, as margins narrowed and more companies operated at a loss.
- Soft investment and consumption appetite. The textbook impact of deflationary expectations is that when people expect prices to be lower in the future, there is limited impetus for investment and consumption. In China, sluggish fixed-asset investment and retail sales data suggest this may have been a factor.
- Excessive pessimism in asset allocation. The "Japanisation" theme and fear of a deflation doom loop contributed to too cautious asset allocation and heavy overweighting of Chinese government bonds.
- A boost to real GDP via a negative GDP deflator. The negative deflator contributed around 1pp of China's real GDP growth in 2025.

All these factors could be at risk for reversal this year.

Higher inflation in the near term could keep the People's Bank of China sidelined a little longer than expected, though growth is likely to outweigh inflation in the policymaking calculus. If domestic indicators continue to deteriorate, we don't think the recent reflation will prevent further rate cuts. Nonetheless, we moved our rate cut forecast from the second quarter to the third last month, with global central banks largely in a wait-and-see mode.

One of our key non-consensus calls at the start of the year was the possibility of higher long-end CGB yields this year. We've seen this play out in 30-year CGB yields, which have generally moved higher since the outbreak of the Iran war, while 10-year yields have been quite flat amid safehaven demand. Assuming a growing number of market participants become convinced of a reflationary story, the question is whether it makes sense for an economy expected to grow around 4% over the next decade to see 10-year yields below 2%. We think not.

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