

China: RRR cut in sight as inflation fears ease

Economics/Growth/Monetary/Rates

DBS Group Research

July 9, 2021

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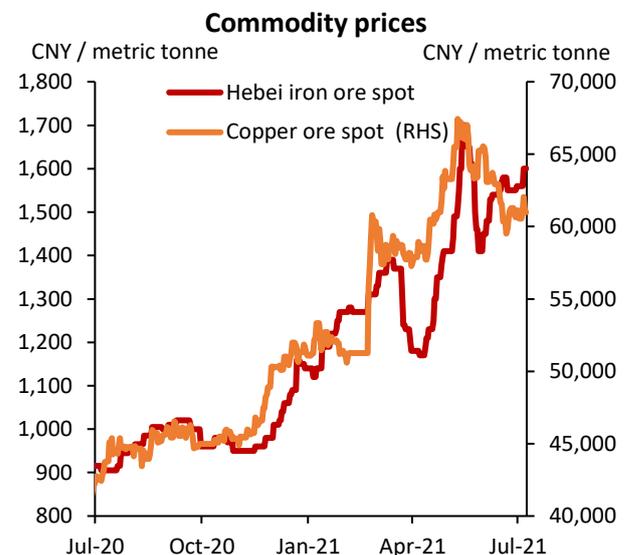
- *Factory-gate price inflation may have peaked*
- *Falling hog prices, stable housing rents and utilities costs will keep CPI inflation at bay*
- *State Council hinted at RRR cut to help bolster the economy as inflation concerns dissipate*
- **Implications for investors:** *Yuan weakens as the proposed cut contrasts with Fed talk of taper. CGB yields to fall amid more financial support for the economy*

China's PPI inflation came in at 8.8% YOY in June, down from a gain of 9% in May. On a sequential basis, producer prices decelerated notably to 0.3% MOM, from 1.6% previously. Today's print alongside certain high-frequency indicators suggest factory-gate price inflation may have peaked.

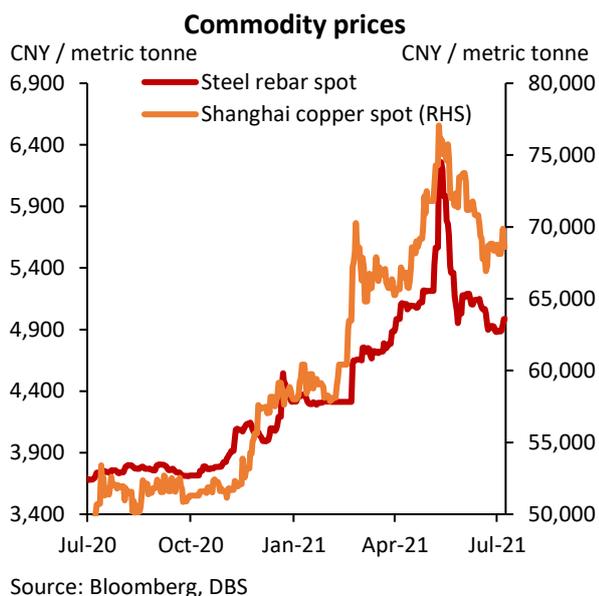
PPI peaked

Take iron ore, one of the biggest gainers among commodities this year. It has fallen more than 8% since May's peak alongside other key raw materials. Similar trends were evident in the midstream spectrum, with price gains of copper and rebar slowing from recent high.

The retreat can be attributed to the government's efforts to rein in high-flying input prices. Domestic firms, including steel mills, commodities merchants and brokerages, were requested to reduce bullish bets on local futures markets for highly volatile raw materials. State-owned enterprises were also ordered to control risks and limit their exposure to overseas commodities markets. Drawdown of strategic stockpiles by the Reserve Bureau also helped. All these will continue to weigh on the prices of commodities.

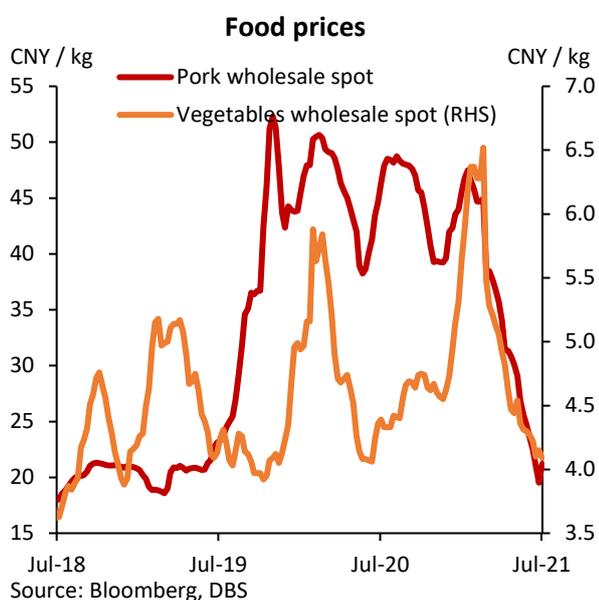


Source: Bloomberg, DBS

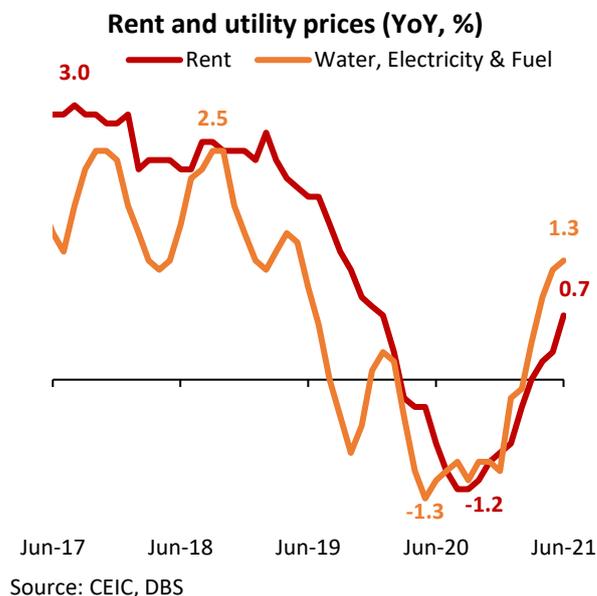


Limited pass-through

CPI inflation held steady at only 1.1% in June, a sign of a limited pass-through of factory-gate prices to consumers. Food inflation, which accounts for around 20% in the CPI basket, remained in check. Vegetable prices declined further in the first week of July. Pork prices fell deeper into deflation territory on recovering pig stocks in 2H.

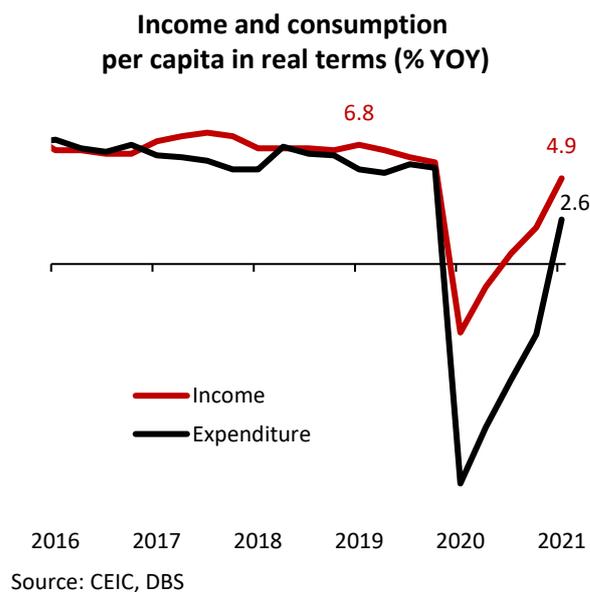
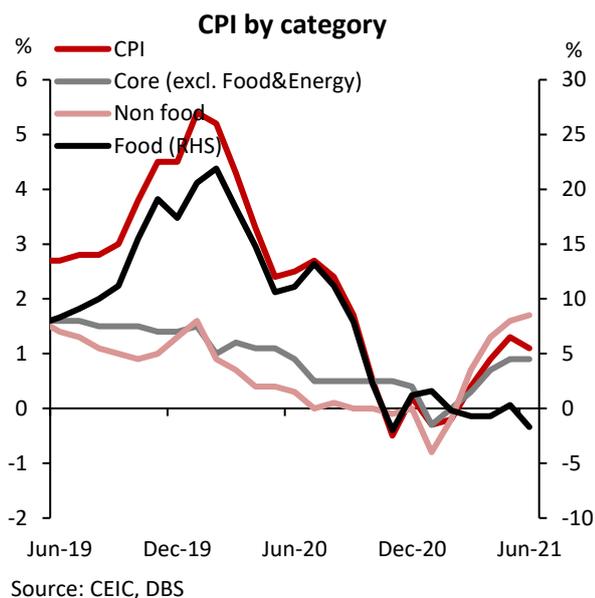


Housing rents and utilities also helped stabilize CPI. The former picked up by 0.7% last month and was still below pre-pandemic levels, while government controls limited rises in utility prices.



Transmission has weakened since 2013

Intense competition aside, an increase in the weight of services in the CPI basket softened services prices to 1.0% in June from an average 1.7% in 2019. A recovery in household consumption amid stunning vaccine surge could spur gains in service prices and headline CPI in the coming months (i.e. catering, travel, and entertainment). Even so, the process will be gradual and moderate, as evidenced by the still low core CPI reading. **Clouding the outlook is the softness in household spending power.** Real income per capita growth of 4.9% in 1Q21 (2-year average growth) was still 1.9ppts off the 1Q19 level.



“Pro-growth” shift

Against such a backdrop, PBOC will likely keep LPR steady as the commodity cycle plays out. **Meantime, we reiterate our view that the authority may step up liquidity injections in Q3 amid concerns over the faltering recovery and looming municipal bond supply.** (see [“China: Inflation and monetary policy outlook”](#), 27 May).

Echoing our call is the statement released Wednesday by State Council’s executive meeting chaired by Premier Li Keqiang – “authorities should use monetary policy tools,

including lowering the reserve requirement ratio, at an appropriate time to support the economy”. Arguably, State Council’s shift suggested subdued Q2 activities in next week’s data releases. A reduction in the RRR for the first time since mid-2020 could lower CGB yields. China’s easing to provide financial support for its economy amidst Fed taper talks should weigh on the yuan exchange rate.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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