



# Economic Observatory

12 November 2008

**China's CPI inflation fell to 4% in October; the risk of deflation has increased on a sharply falling external demand.**

China's October CPI inflation fell further to 4% yoy, while PPI inflation eased sharply to 6.6%, led by falling food, energy, and commodity prices.

We forecast the 2008 CPI inflation to be at around 6%. Our baseline CPI inflation forecast for 2009 is at 2% on a sharply falling external demand.

Looking forward, China's inflationary pressure is waning fast while the risk of deflation has increased.

- China's inflationary pressure eased further in October. CPI inflation fell to 4.0% yoy in October from 4.6% in September, the slowest rise in the recent 17 months (Chart 1). The fall in CPI was led by falling food prices while imported inflation from international energy and commodity prices eased sharply.
- Given the slower domestic demand and lower commodity price inflation, PPI inflation eased by 2.5 percentage points to 6.6% yoy in October from that in September.
- Given China's PPI inflation is highly correlated to price changes in international commodity prices, the pass-through effect on PPI inflation will attenuate in the near term (Chart 2). According to our estimates, 10 percent decreases in commodity prices will likely lead to a 1.2 percent fall in PPI inflation and a 0.22 percent fall in non-food inflation. As inflationary pressures originating from food and industrial commodities dissipate, we expect China's CPI inflation will fall sharply, thus raising the risk of

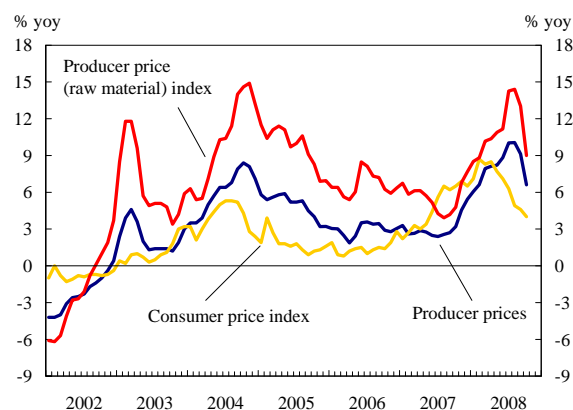
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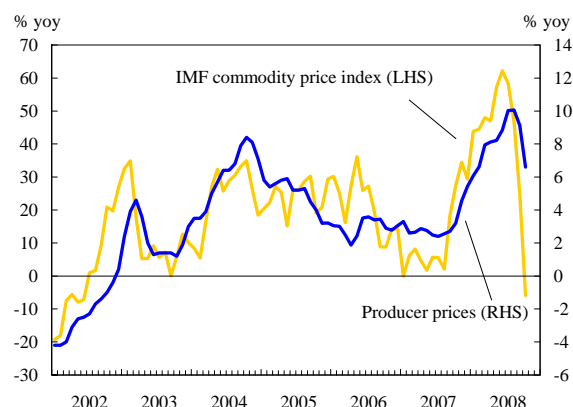
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**Chart 1: Inflation rates**



Source: CEIC.

**Chart 2: PPI and commodity prices**

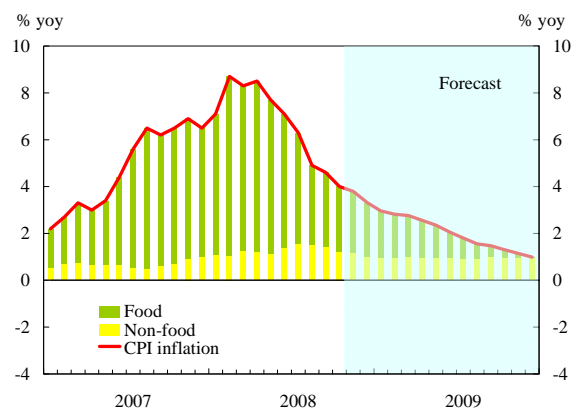


Sources: IMF and CEIC.

deflation.

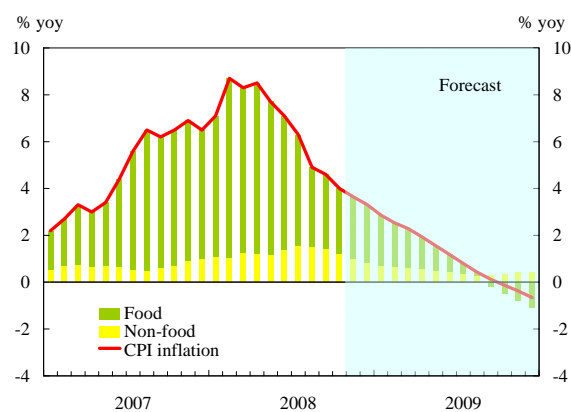
- Looking forward, a sharply falling external demand and a high base effect suggest China's inflation may fall faster than previously expected. Our forecast suggests that food price will fall to 5% by the end of 2008 and will stop rising by the end 2009, even after adjusting the expected up to 15% increase in grain purchase prices by the State in 2009. Meanwhile, we forecast non-food CPI inflation to reach 1.3%.
- Combining these two components, we forecast the 2008 CPI inflation is to reach at around 6%. Our baseline CPI inflation forecast for 2009 is at 2%, suggesting China's inflationary pressure is waning fast while the risk of deflation has increased (Chart 3).
- If external demand were to slide sharply, the risk of deflation will increase. As shown in Chart 4, falling external demand, together with falling food, oil and commodity prices, will accelerate the pace of disinflation process in China. In addition, the pace of disinflation will be accelerated by a technical factor. That is, inflation rates were quite high in the last quarter of 2007 and the first half of 2008. This high base effect may push CPI inflation into a negative territory in mid-2009, thus raising the fear of a return of deflation in China.

**Chart 3: Inflation forecasts (baseline)**



Sources: CEIC and BBVA estimates.

**Chart 4: Inflation forecasts (risk scenario)**



Sources: CEIC and BBVA estimates.