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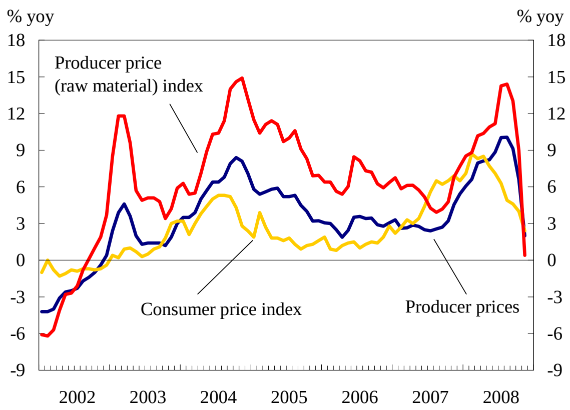
The risk of deflation in China is rising.

China's November CPI inflation fell further to 2.4% yoy, while PPI inflation eased sharply to 2%, led by falling food, and particularly faster decline in energy and commodity prices. If these price trends were to continue, China will enter deflation again in mid 2009.

Given the increasing risk of deflation, we expect more aggressive monetary eases and swift implementations of price reform down the road.

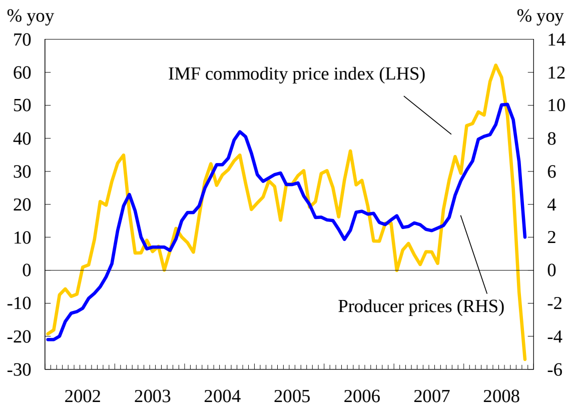
- China's inflationary pressure eased sharply in November. CPI inflation fell to 2.4% yoy in November from 4.0% in October, the slowest rise in the recent 22 months (Chart 1). The fall in CPI was led by falling food prices and a high base effect while imported inflation from international energy and commodity prices eased sharply.
- Given the slower domestic demand and lower commodity price inflation, PPI inflation dropped sharply by 4.6 percentage points to 2% yoy in November from that in October, an unprecedented fall since the PPI inflation data were published in 1996.
- Since 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 continue to fall sharply, thus raising the

Chart 1: Inflation rates



Source: CEIC.

Chart 2: PPI and commodity prices

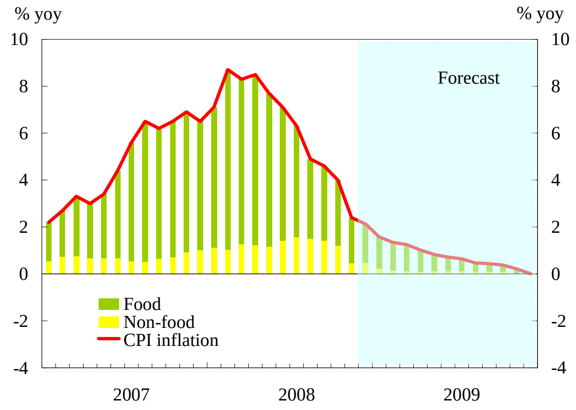


Sources: IMF and CEIC.

serious risk of deflation.

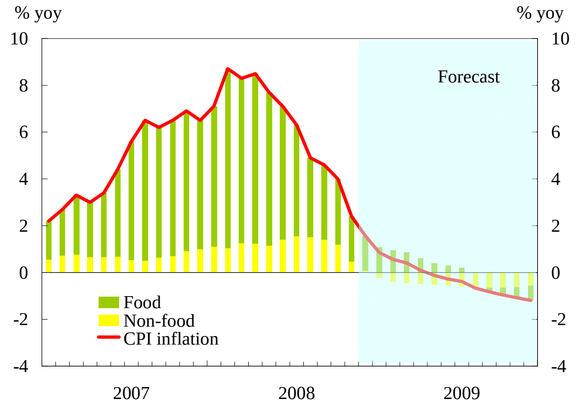
- Looking forward, a sharply falling external demand and a high base effect suggest China's inflation may fall faster than previously expected. Our forecast suggests that food price will fall to 5% by the end of 2008 and stop rising by the end 2009, even after adjusting the expected up to 15% increase in grain purchase prices by the State in 2009. Meanwhile, we forecast non-food CPI inflation will be around zero.
- Combining these two components, we revised the baseline CPI inflation forecast for 2009 downward by 1.3 ppt to 0.7%, suggesting China's inflationary pressure is waning faster while the risk of deflation has been increasing (Chart 3).
- In our October China Watch, we think the risk of deflation will be a serious risk facing the Chinese economy in 2009. Indeed, it appears that our concern has been increasingly vindicated. As shown in Chart 4, falling external demand, together with falling food, oil and commodity prices, will accelerate the pace of disinflation process further in China. In addition, the pace of disinflation will also 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 is likely push CPI inflation into a negative territory in mid-2009, thus raising the fear of a return of deflation in China.
- Looking forward, we expect more aggressive monetary eases and swift implementations of price reform down the road.

Chart 3: Inflation forecasts (baseline)



Sources: CEIC and BBVA estimates.

Chart 4: Inflation forecasts (risk scenario)



Sources: CEIC and BBVA estimates.