China Flash

June inflation falls below expectations, providing room for more policy easing

The first important release in a data-packed week was released this morning, showing a steeper-than-expected decline in June headline inflation to 2.2% y/y from 3.0% y/y in May (BBVA: 2.4%; consensus: 2.3%) on falling food prices (Chart 1). This is the lowest inflation rate January 2010, and well below the authorities' 4% comfort level. On current trends, we believe inflation will decline to around 2%, if not lower, in July/August before gradually trending up during the rest of the year to around 3% by December. Last week's interest rate cut – the second in a month – has generated market expectations that the current round of activity indicators may be weaker than previously expected. In this regard, the low inflation outturn should help alleviate concerns by providing scope for more policy easing. We expect up to two more 25bp cuts in interest rates and 150bp cuts in the RRR during the rest of the year. Market focus will now shift to the release of June trade data due out tomorrow, followed on Friday by Q2 GDP and June activity indicators including industrial production, investment, retail sales, and loan growth. While we see downside risks to these indicators, on balance we expect the data to show some stabilizing trends in the pace of the slowdown.

- **June CPI inflation eases on falling food prices.** Food prices fell by -1.6% m/m (but remained flat in seasonally adjusted terms), resulting in an increase of 3.8% y/y in June, down from 6.4% y/y in May. Non-food prices increased by 1.4% y/y, unchanged from the previous month. The declining trend in inflation is now well entrenched, down steadily from its peak of 6.5% y/y last July. However, some caution is in order about the outlook given that the decline is due to volatile food prices which could be reversed. Nevertheless, given the slowdown in growth momentum, we believe the inflation outlook for the rest of the year is relatively benign.
- **Producer price inflation (PPI) in June eased to -2.1% (Chart 2)** (Consensus: -1.9% y/y; BBVA: -2.4%), down from -1.4% y/y in May. Month on month (non-seasonally adjusted) the PPI decreased by -0.7% in June, on falling commodity prices. The decline in producer prices should, in principle, help ease inflationary pressures going forward.
- **The data calendar for the remainder of the week is packed with important economic indicators,** including Q2 GDP, industrial production, retail sales, trade, and credit aggregates. The indicators are likely to reveal further weakness, but on balance we expect them to show a stabilizing trend. In particular, we project Q2 GDP to slow to 7.4% y/y from 8.1% y/y in Q1. Meanwhile, we expect June industrial production (BBVA: 11.0% vs. May 9.6%) and urban investment, ytd (BBVA: 20.1% vs. May 20.1%) to show stabilizing trends.

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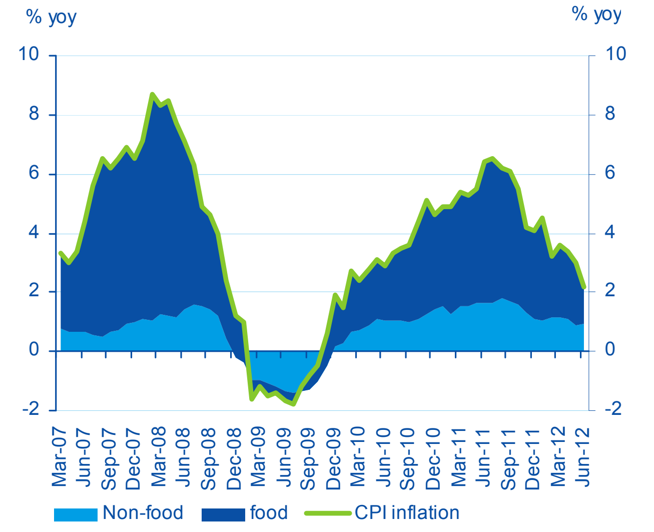
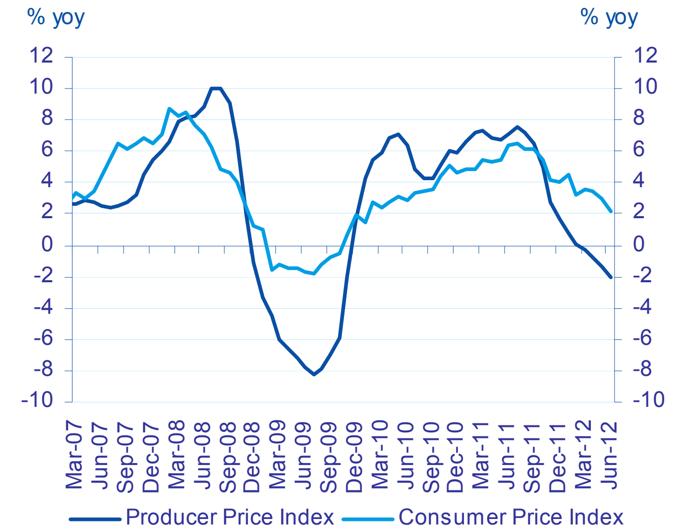
Chart 1
Headline CPI inflation continues to decline…



Source: CEIC and BBVA Research

Chart 2
…and PPI inflation has turned negative



Source: CEIC and BBVA Research

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