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June 23, 2026 04:38 PM GMT

Asia Economics | Asia Pacific

The Viewpoint: China – Tracking Progress on Reflation

Sustained strong exports growth will lift profit margins for the non-commodity sector, which will drive wage growth and a cyclical pickup in underlying inflation. But we don't expect a normalized inflation of 2-3% yet, given that policy measures to address structural issues are not as forthcoming.

Key Takeaways

- The recent positive PPI prints are not a sign of reflation as corroborated by the contraction in retail sales in May.
- But we do expect a cyclical pickup in underlying inflation as the Asia capex super-cycle drives a sustained improvement in China's exports.
- This in turn will lift margins for select non-commodity sectors, providing modest support to wage growth and consumption with a lag.
- However, we don't see a return to a normalized 2-3% GDP deflator yet.
- To achieve sustainable inflation, we will need policy measures to address the structural issues of property and social security support.

In this report, we address the cyclical and structural factors that will influence China's transition from deflation to sustainable and normalized inflation.

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Where we are in China's reflation journey

The recent positive PPI prints are not necessarily a sign of reflation: While the producer price index (PPI) has turned positive on a YoY basis after ~3.5 years in deflation, we have been arguing that it is not a sign of a sustainable transition to normalized inflation. It is increasingly clear that the upward momentum in headline PPI in recent months has been driven by higher oil prices, which will now move back to reverse mode as oil prices decline. The higher commodity PPI is leading also to higher non-commodity PPI and that will lift the GDP deflator into positive territory in 2Q26. But that is still not full-fledged reflation. Margins for the non-commodity sector have remained flat or, in other words, the non-commodity sector has not been able to regain pricing power.

Why reflation has been held back so far: A confluence of cyclical and structural reasons has been holding back reflation in China. Persistent deflationary pressures have been weighing on the non-commodity sector and in turn wage growth. This was then compounded by the slow pace of fiscal rollout since 1Q26 and higher oil prices – which affected consumer purchasing power and therefore weighed on consumption. Structurally, weaker demographic trends means that the structural demand for property is weak. This, coupled with the modest and reactive policy support for the sector, have kept property prices on a correction path. Meanwhile the lack of an adequate social security net keeps the household saving ratio high, especially for migrant workers.

Where are we headed – cyclical uplift but structural drag remains: Our chief China economist Robin Xing expects that inflation will rise modestly from here and remain structurally firmer than in 2023-25, as the improvement in exports amid Asia's industrial and capex supercycle supports a modest improvement in wage growth. However, the structural challenges we highlighted above are still in place, meaning that a sustained transition to a 2-3% GDP deflator is not yet in sight.

What we are tracking: To assess the progress on reflation, we are tracking the following indicators:

1. **Non-commodity industrial profit margins:** To assess if corporates will feel confident and have the room to increase wages.
2. **Wage growth:** A pickup in wage growth will help support consumption growth cyclically.
3. **Retail sales:** The key, comprehensive and high frequency indicator to track consumption growth.

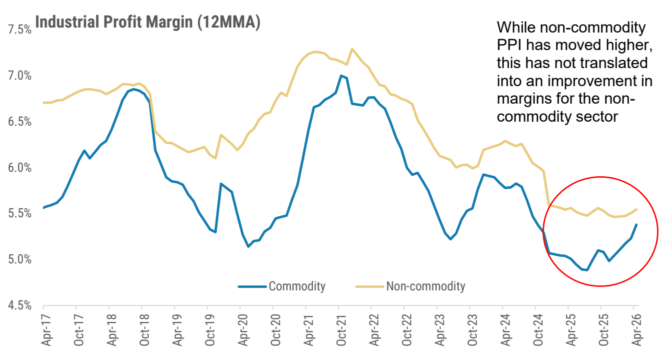
Cyclical factors holding back reflation

We see three cyclical factors that have weighed on reflation:

- Withdrawal of policy stimulus
- Impact of trailing weak wage growth
- Higher oil prices

Trailing wage growth has been weak, weighing on consumption: While industrial profit growth has picked up year-to-date, the uptick has been driven more by higher commodity prices. Non-commodity sector profit margins have stabilized but remain relatively weak given the persistent deflationary backdrop. This is also corroborated by still relatively weak consensus earnings growth of 6% for CSI300 in 1Q. Reflecting this, wage growth remains weak at 4.9%Y in 1Q. As a result, consumption growth momentum has been soft. Moreover, as the effects of the consumption trade-in program has faded, this has resulted into an outright contraction in headline retail sales. The latest datapoints we have on services consumption also exhibit similar weakness. Our hotel and transportation research teams note that June hotel revenue per available room growth and air passenger traffic growth around the Dragon Boat Festival remain weak.

Exhibit 1: Non-commodity sector profit margins have stabilized but remain relatively weak…

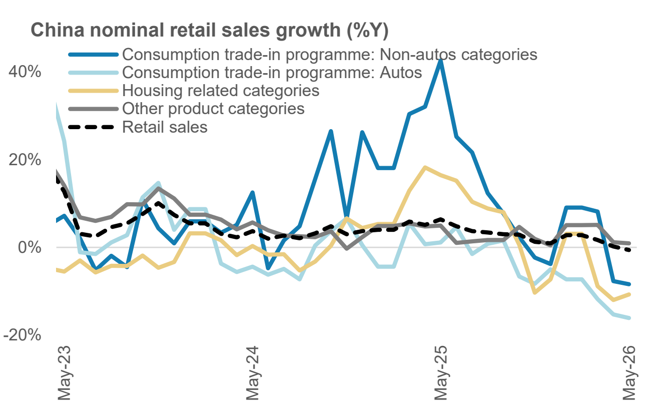


Source: CEIC, Morgan Stanley Research

Exhibit 2: …leading to subdued trends in wage growth

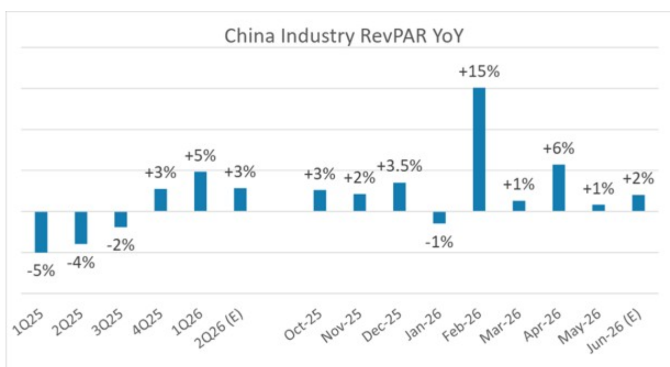
Source: CEIC, Morgan Stanley Research

Exhibit 3: As the effects of the consumption trade-in program have faded, this has resulted in an outright contraction in headline retail sales



Source: CEIC, Morgan Stanley Research

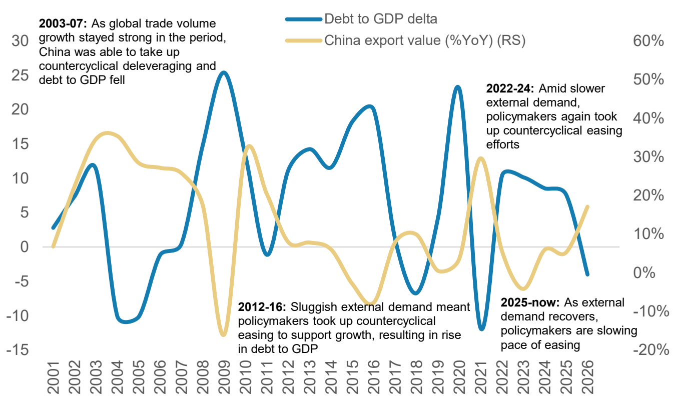
Exhibit 4: Hotel RevPAR indicates soft demand – June is tracking only 2% YoY despite a very low base in 2025



Source: STR, Jun-26 and 2Q26 numbers are Morgan Stanley Equity Research estimates

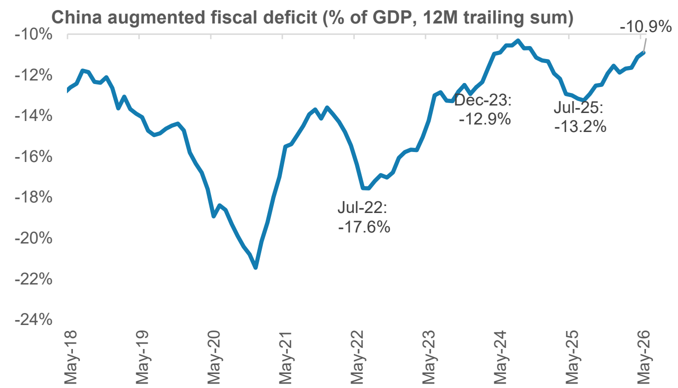
The withdrawal of stimulus – counter-cyclical growth model in action again: In past cycles, we have observed that policymakers in China tend to pull back on policy easing in a countercyclical manner when external demand is strong. We have seen this playbook again on the back of the stronger-than-expected 1Q real GDP growth and the robust momentum year-to-date in exports. The augmented fiscal deficit has narrowed from 11.9% of GDP in Jan-26 to 10.9% of GDP in May as policymakers slowed the pace of fiscal rollout in 2Q. Reflecting this, nominal FAI growth has slowed to a year-to-date low of -10.7%Y – with infrastructure FAI in particular slowing from 9.2%Y in 1Q26 to -10.8%Y in May. With 2Q GDP growth tracking at below the full-year growth target at 4.4%Y, our China economics team expects policymakers to step up the pace of fiscal rollout in 3Q26 to smooth growth (see China Economics: 2Q Tracking GDP Softens to 4.4% on Weak Domestic Demand, June 16, 2026).

Exhibit 5: Policymakers are following the countercyclical growth model of pulling back policy stimulus when external demand is strong



Source: CEIC, Haver, Morgan Stanley Research

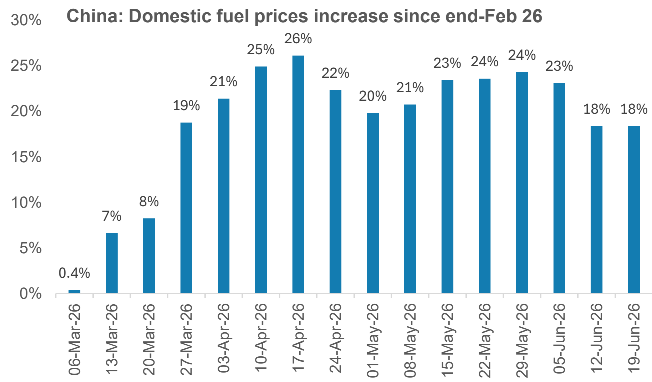
Exhibit 6: Augmented deficit has narrowed from 11.9% of GDP in Jan-26 to 10.9% of GDP in May



Source: CEIC, Haver, Morgan Stanley Research

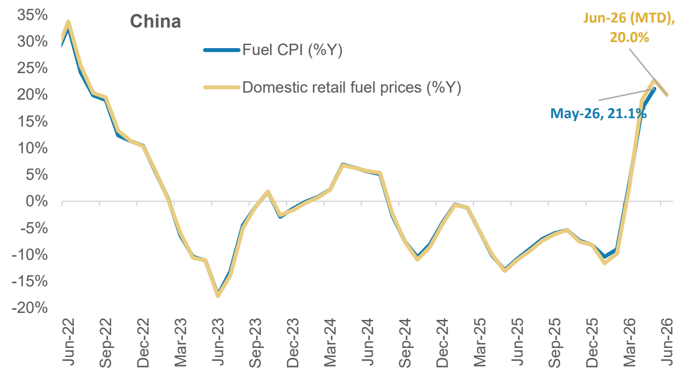
Higher oil prices had posed a near-term drag on consumption: Since the onset of the energy shock, domestic gasoline prices have risen by a peak of 26% and have remained 18% higher than end-February levels. Reflecting this, fuel CPI has accelerated to 21%Y in May, vs. -9%Y in Feb. Given fuel and electricity together account for about 11% of the CPI basket, this also likely posed a drag on consumption momentum in the past few months. The recent move lower in international oil prices will likely mean a reduced drag going forward.

Exhibit 7: Domestic gasoline prices have also risen by a peak of 26%, and have remained 18% higher than end-February levels



Source: CEIC, Morgan Stanley Research; Note: Domestic retail fuel prices are calculated as the average maximum retail price of RON95 gasoline across 84 cities.

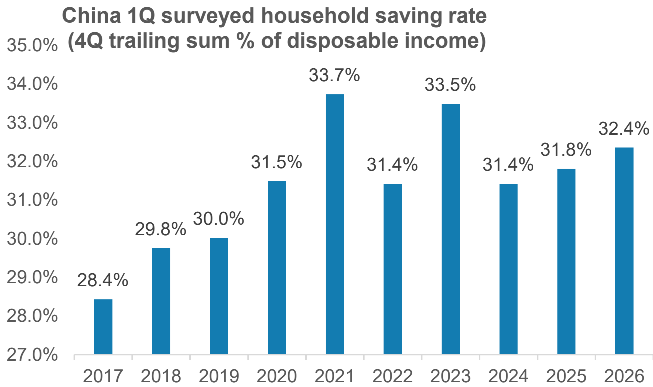
Exhibit 8: Fuel CPI accelerated sharply but has likely peaked in May



Source: CEIC, Morgan Stanley Research, Note: Domestic retail fuel prices are calculated as the average maximum retail price of RON95 gasoline across 84 cities. June MTD is as of June 19, 2026.

worker population, which will help manage aggregate demand and unlock precautionary savings (see China's 3D Journey: How China could avoid a 1990s Japan situation, August 2023).

Exhibit 11: Household savings rate remains elevated and has been rising



Source: CEIC, Haver, Morgan Stanley Research

What would we be watching to track China reflation?

Policy measures to address the structural issues are not likely to be as forthcoming: An increase in social welfare spending is seen to be a long-term commitment to raise spending permanently. Against this backdrop, policymakers remain hesitant to commit to large-scale social welfare reforms. This is especially as the government revenue to GDP ratio continues to decline and the outlook for public finances remains challenging. Moreover, our China economics team notes that the 15th Five-Year Plan has already affirmed that the growth model will remain tech-led and supply-centric, while policy support for consumption and social welfare reforms would remain gradual.

While policymakers have slowed new manufacturing investment growth, they are not taking aggressive steps to cut existing excess capacity due to concerns over the implications for the labour market.

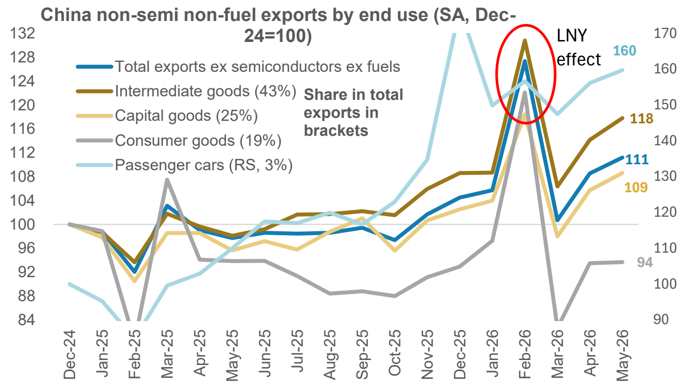
In this context, since we don't expect meaningful policy support measures, the cyclical improvement in exports will assume more importance in the reflation journey. To assess the progress, we will be tracking:

1. Exports
2. Non-commodity sector profit margin
3. Wage growth

Exports recovery is broadening out: We have been highlighting that Asia's industrial and capex supercycle – underpinned by multiple medium-term drivers - is driving a broadening out of Asia's export recovery from tech to non-tech. We see China as one of the key beneficiaries given it is positively levered to a pickup in export opportunities driven by capex in the rest of the world in areas such as energy, defense, AI and AI infrastructure, and industrial supply chain buildout. China's non-semis exports have only just recently posted stronger growth at close to double digits in the past two months.

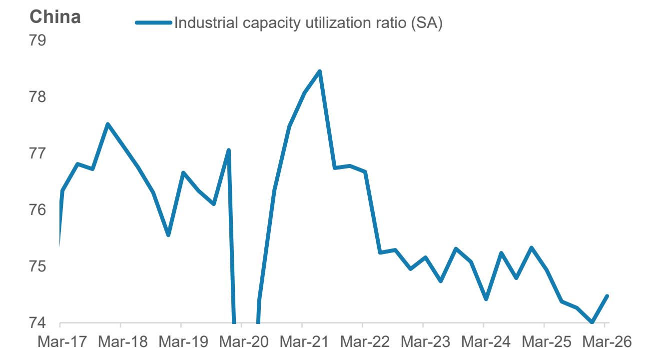
This will help non-commodity sector profit margins and wage growth with a lag: Given industrial capacity utilization has just started to improve from low levels in 1Q and progress on efforts to address excess capacity remains gradual, the improvement in exports would only translate to better non-commodity sector profit margin and hence wage growth with some lag.

Exhibit 12: China's non-tech exports showed broad-based improvement across passenger cars, intermediate goods and capital goods



Source: CEIC, Haver, Morgan Stanley Research

Exhibit 13: Sustained strong exports will lift capacity utilization



Source: CEIC, Haver, Morgan Stanley Research

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