WEEKLY COMMENTARY

Where China Has Turned an Ally: Combatting Inflation

By Jimmy Jean, Vice-President, Chief Economist and Strategist

When it rains, it pours in China. This week, we learned that the country's exports suffered a larger-than-expected drop in July. The 14.5% slide was also the biggest since February 2020, although this figure is a bit amplified by base-year effects. That was only the latest in a string of disappointing developments out of China. Q2 GDP growth missed expectations by a meaningful margin and the details were bad, showing ongoing deterioration in a wide range of subcomponents, including consumption and the property sector. And of course China is facing a host of other challenges, such as Western trade restrictions and climbing youth unemployment. Compounding these issues is the persistent downward trend in foreign direct investment inflows as multinationals reconfigure their supply chains. We were always skeptical of the narrative that China's reopening would save the global economy this year. So far, there isn't much proving us wrong.

But China's woes are ironically helpful in the fight against inflation. The unique inflation circumstances in China, where producer and export prices are in deflation, are reverberating externally. Since China is a major global manufacturing hub, the price decline is influencing import price indexes in countries reliant on Chinese imports. For instance, Canada's recent international trade report noted the largest monthly drop in import prices since 2017. This weakening trend now extends beyond just commodity components to also encompass consumer goods—the third-largest import category behind energy and vehicles. Between December and June, import prices in this category have declined by over 2%.

These shifts align with our findings that advanced economies' excess inflation is less driven by global factors and more influenced by domestic forces. Import price pressures are estimated to have accounted for up to half of domestic demand inflation for the most part of 2022. So it turns out that China is an ally in the inflation fight—or at least more than a federal government turning a deaf ear to calls for some moderation in the pace of newcomer admissions. While we agree that demographics matter for long-term public finance sustainability, we have argued that failure to put smart boundaries around non-permanent admissions comes at non-negligible short-term costs.

Be that as it may, the Bank of Canada is likely comfortable with the current degree of monetary tightening for the time being. Could the recent pickup in oil prices become the proverbial fly in the ointment? While central banks will keep the seven-week-and-counting oil price rally on their radar, we don't believe there is cause for significant concern yet. The move higher follows Saudi Arabia's extended output cut, coinciding with robust US economic data and the consequent bets of a soft US landing. Weaker backdrops in Europe and China tend to offset a more upbeat US outlook, however. Moreover, OPEC's oil supply management faces limits against US shale producers signalling higher production for the remainder of the year as they make productivity gains. As a result, the rally doesn't rest on a firm fundamental footing, and fears of a new leg of energy-driven inflation seem premature. In the case of Canada, there's some room to run before gasoline starts contributing positively again to year-over-year inflation. Base-year effects make this scenario unlikely before late 2023 at the earliest.

In the meantime, September will mark 18 months since the beginning of the current hiking cycle, meaning we're about to enter the period of peak tightening impact. As our analysis has shown (here and here), mortgage renewals will relentlessly erode households' discretionary spending capacity, further exacerbating the ongoing rise in financial strain.

Broadening weakness should catch up to wages, as July's surprise jump in pay growth raised chatter that another hike may be in play. A more accurate interpretation is that wages are lagging behind previous job market tightness. Against that noise, the true

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signal lies in job cuts—which in some cases are reversing prior excess hiring—along with falling overtime hours and fewer job openings. Employers are increasingly perceiving labour as less scarce, foreshadowing eventual wage growth moderation. All of this may hold promise for those longing for lower interest rates. But that's only because recession signs look likely to become more apparent going forward.

What to Watch For

By Randall Bartlett, Senior Director of Canadian Economics, Tiago Figueiredo, Associate – Macro Strategy, Marc Desormeaux, Principal Economist, and Marc-Antoine Dumont, Economist

UNITED STATES

TUESDAY August 15 - 8:30

July	m/m
Consensus	0.4%
Desjardins	0.4%
June	**0.2%**

Retail sales (July) – Retail sales likely rose 0.4% in July after growing 0.2% in June. Although falling energy prices have curbed the value of gasoline station receipts in recent months, the rebound in the US CPI's gasoline component should have provided some support in July. However, motor vehicle sales are under pressure amid declining prices and high financing rates. All in all, we expect 0.4% growth in retail sales excluding motor vehicles.

WEDNESDAY August 16 - 8:30

July	ann. rate
Consensus	1,450,000
Desjardins	1,440,000
June	**1,434,000**

Housing starts (July) – Housing starts have been volatile all year, with April's 2.3% dip followed by a 15.7% spike in May and an 8.0% decline in June. We think this volatility will continue with a modest increase in July. Construction employment increased 0.2% and the number of building permits issued likely rose. However, the MBA Purchase Index dropped 2.4% in July to a 28-year low. We think housing starts will come in at 1,440,000 units.

WEDNESDAY August 16 - 9:15

July	m/m
Consensus	0.3%
Desjardins	0.5%
June	**-0.5%**

Industrial production (July) – After declining 0.5% in both May and June, US industrial production likely returned to positive territory in July. However, this gain probably came largely on the back of strong growth in electricity generation due to July's heatwaves. The slowdown in manufacturing employment and the decline in the number of oil drilling rigs indicate lower manufacturing and energy production. Overall, we anticipate a 0.5% rise in industrial production for July. As such, production capacity utilization is also likely to increase.

CANADA

TUESDAY August 15 - 9:00

July	m/m
Consensus	n/a
Desjardins	-2.5%
June	**1.5%**

Existing home sales (July) – We're expecting Canadian Real Estate Association data to reveal a 2.5% decline in national home purchases in July. Based on early figures released by local real estate boards, large markets in Ontario and BC will report the largest month-over-month declines. Meanwhile sales momentum appears to have persisted in Calgary and Edmonton following the Bank of Canada's second interest rate hike in as many months. That regional divergence would be consistent with our latest housing market and provincial economic outlooks. The key question is what happens to new listings, particularly in high-priced Toronto and Vancouver. Tightness in this respect helped put upward pressure on prices in the early months of the year as the central bank paused its tightening efforts. Continued increases on the supply side of the market could reflect mortgage holders struggling with sharply higher borrowing costs and signal a potential tide shift for home prices.

TUESDAY August 15 - 8:30

July	m/m
Consensus	0.3%
Desjardins	0.2%
June	**0.1%**

Consumer price index (July) – The year-over-year pace of inflation likely rose incrementally from 2.8% in June to 2.9% in July. That would correspond to a 0.2% month-over-month increase in the headline index and represent the first re-acceleration in the 12-month pace of total CPI growth since October 2022. But that's just base effects and is nothing to worry about. As we often highlight, the important question for monetary policy is what happens to the more relevant three-month annualized rates of the Bank of Canada's underlying inflation measures. We see scope for modest improvement in these indicators, which have been stuck in the 3.5–5% range for several months now. That said, both headline and core inflation measures are likely to stay in the neighbourhood of 3% until the overall economy cools off further.

WEDNESDAY August 16 - 8:15	
July	**ann. rate**
Consensus	260,000
Desjardins	260,000
June	**281,400**

Housing starts (July) – Fundamental economic drivers suggest that housing starts slowed last month, and we anticipate a national-level figure of 260k. For one thing, construction industry employment has fallen in four of the past six months—including the worst monthly contraction outside of the pandemic in July 2023. And builders are still grappling with high input costs, labour shortages and the dampening effects of sharply higher borrowing costs. Building permits also weakened across unit types in June, though prior months' results suggest some upward movement in construction. As with home sales, we'll be watching for regional differences. To date in 2023, new home building in Ontario and BC has proved resilient to the softening construction backdrop on the back of strong multi-unit starts. Meanwhile starts in Quebec and Alberta have noticeably weakened. June building permit data suggest somewhat of a reversal in this trend in July, though construction employment results were less clear.

TUESDAY August 15 - 8:30	
June	**m/m**
Consensus	-2.1%
Desjardins	-1.5%
May	**1.2%**

Manufacturing sales (June) – Following May's increase, manufacturing sales are forecast to have decreased 1.5% in Canada in June—less than Statistics Canada's 2.1% flash estimate. The projected June decline is expected to be led by both prices and volumes. Car and truck production fell in June alongside the industrial producer price index. However, we anticipate a broad-based decline in manufacturing sales for June. The large trade deficit released last week is also an indicator of the current weakness in the manufacturing sector.

OVERSEAS

MONDAY August 14 - 19:50	
Q2 2023	**q/q**
Consensus	0.7%
Q1 2023	**0.7%**

Japan: Real GDP (Q2) – Japanese real GDP growth accelerated from a non-annualized quarter-over-quarter change of 0.1% at the end of last year to 0.7% in January–March 2023. The consensus is for a similar gain in the second quarter of 2023, but we're starting to see signs of a slowdown, particularly in consumer spending and global trade.

MONDAY August 14 - 22:00
July

China: Industrial production and retail sales (July) – After picking up in June, July's rise in industrial production is expected to be more modest. Manufacturing PMIs are under the 50 threshold, pointing to a slowdown in manufacturing activity. Plus, based on the fall in Chinese imports and exports last month, global trade is slowing. Meanwhile, domestic demand remains sluggish, which is likely to hobble growth in industrial production.

WEDNESDAY August 16 - 5:00	
Q2 2023 - 2nd est.	**m/m**
Consensus	0.3%
Q2 2023 - 1st est.	**0.3%**

Eurozone: Real GDP (Q2 – second estimate) – The preliminary flash estimate was surprisingly strong, with quarterly annualized growth of 1.1%, despite weaker performance in Italy (-1.4%) and Germany (0.1%). This print highlighted the difficulties facing the eurozone's largest economy since Russia shut down its natural gas pipeline. The second real GDP estimate will provide further insight into the path taken by the eurozone economy.

Economic Indicators

Week of August 14 to 18, 2023

Date	Time	Indicator	Period	Consensus		Previous reading

UNITED STATES

Date	Time	Indicator	Period	Consensus		Previous reading
MONDAY 14	---	---				
TUESDAY 15	8:30	Empire State Manufacturing Index	Aug.	-0.6	-0.4	1.1
	8:30	Export prices (m/m)	July	0.2%	0.5%	-0.9%
	8:30	Import prices (m/m)	July	0.2%	0.3%	-0.2%
	8:30	Retail sales				
		Total (m/m)	July	0.4%	0.4%	0.2%
		Excluding automobiles (m/m)	July	0.4%	0.4%	0.2%
	10:00	NAHB housing market index	Aug.	56	56	56
	10:00	Business inventories (m/m)	June	0.1%	0.1%	0.2%
	11:00	Speech by Federal Reserve Bank of Minneapolis President N. Kashkari				
	16:00	Net foreign securities purchases (US$B)	June	n/a	n/a	25.8
WEDNESDAY 16	8:30	Housing starts (ann. rate)	July	1,450,000	1,440,000	1,434,000
	8:30	Building permits (ann. rate)	July	1,470,000	1,460,000	1,441,000
	9:15	Industrial production (m/m)	July	0.3%	0.5%	-0.5%
	9:15	Production capacity utilization rate	July	79.1%	79.2%	78.9%
	14:00	Release of the Federal Reserve's meeting minutes				
THURSDAY 17	8:30	Initial unemployment claims	Aug. 7–11	240,000	239,000	248,000
	8:30	Philadelphia Fed index	Aug.	-10.0	-10.0	-13.5
	10:00	Leading indicator (m/m)	July	-0.4%	-0.4%	-0.7%
FRIDAY 18	---	---				

CANADA

Date	Time	Indicator	Period	Consensus		Previous reading
MONDAY 14	10:30	Release of the Bank of Canada's Senior Loan Officer Survey				
TUESDAY 15	8:30	Consumer price index				
		Total (m/m)	July	0.3%	0.2%	0.1%
		Total (y/y)	July	3.0%	2.9%	2.8%
	8:30	Manufacturing sales (m/m)	June	-2.1%	-1.5%	1.2%
	9:00	Existing home sales (m/m)	July	n/a	-2.5%	1.5%
WEDNESDAY 16	8:15	Housing starts (ann. rate)	July	260,000	260,000	281,400
THURSDAY 17	8:30	International securities transactions ($B)	June	n/a	n/a	11.16
FRIDAY 18	8:30	Industrial product price index (m/m)	July	n/a	n/a	-0.6%
	8:30	Raw materials price index (m/m)	July	n/a	n/a	-1.5%

NOTE: Each week, Desjardins Economic Studies takes part in the Bloomberg survey for Canada and the United States. Approximately 15 economists are consulted for the Canadian survey and a hundred or so for the United States. The abbreviations m/m, q/q and y/y correspond to month-over-month, quarter-over-quarter and year-over-year change respectively. Following the quarter, the abbreviations f, s and t correspond to first estimate, second estimate and third estimate respectively. Times shown are Eastern Daylight Time (GMT - 4 hours). Desjardins Economic Studies forecast.

Economic Indicators

Week of August 14 to 18, 2023

Country	Time	Indicator	Period	Consensus m/m (q/q)	Consensus y/y	Previous reading m/m (q/q)	Previous reading y/y
OVERSEAS							
MONDAY 14							
Japan	19:50	Real GDP – preliminary	Q2	0.7%		0.7%	
China	22:00	Industrial production	July		4.3%		4.4%
China	22:00	Retail sales	July		4.2%		3.1%
TUESDAY 15							
Japan	0:30	Industrial production – final	June	n/a	n/a	2.0%	-0.4%
United Kingdom	2:00	ILO unemployment rate	June	4.0%		4.0%	
Germany	5:00	ZEW Current Conditions Survey	Aug.	-63.5		-59.5	
Germany	5:00	ZEW Expectations Survey	Aug.	-15.5		-14.7	
New Zealand	22:00	Reserve Bank of New Zealand meeting	Aug.	5.50%		5.50%	
WEDNESDAY 16							
United Kingdom	2:00	Consumer price index	July	-0.5%	6.8%	0.1%	7.9%
United Kingdom	2:00	Producer price index	July	-0.2%	-13.%	-0.3%	0.1%
Eurozone	5:00	Net change in employment – preliminary	Q2	n/a	n/a	0.6%	1.6%
Eurozone	5:00	Real GDP – preliminary	Q2	0.3%	0.6%	0.3%	0.6%
Eurozone	5:00	Industrial production	June	-0.1%	-4.2%	0.2%	-2.2%
Japan	19:50	Trade balance (¥B)	July	-436.0		-553.2	
THURSDAY 17							
Japan	0:30	Tertiary Industry Activity Index	June	-0.2%		1.2%	
Norway	4:00	Bank of Norway meeting	Aug.	4.00%		3.75%	
Eurozone	5:00	Trade balance (€B)	June	n/a		-0.9	
United Kingdom	19:01	Consumer confidence	Aug.	29		-30	
Japan	19:30	Consumer price index	July		3.3%		3.3%
FRIDAY 18							
United Kingdom	2:00	Retail sales	July	-0.5%	-2.1%	0.7%	-1.0%
Eurozone	5:00	Construction	June	n/a	n/a	0.2%	0.0%
Eurozone	5:00	Consumer price index – final	July	-0.1%	5.3%	-0.1%	5.5%

Note: Unlike release times for US and Canadian economic data, release times for overseas economic data are approximate. Publication dates are provided for information only. The abbreviations m/m, q/q and y/y correspond to month-over-month, quarter-over-quarter and year-over-year change respectively. Times shown are Eastern Daylight Time (GMT - 4 hours).