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Economic Observatory

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Macro data in line with expectations: recovery on track with pick-up in inflation

- As scheduled, China released today a raft of monthly output and price data for January/February, with most indicators in line with market expectations.
- Of note, February CPI inflation came in higher than expected at 2.7% y/y, largely due to seasonal increases in food prices from the effect of the Chinese New Year (CNY). While y/y inflation is likely to rise in coming months due to base effects, underlying pressures remain subdued, consistent with our end-year projection of 3.1% y/y.
- On the policy front, the annual National People's Congress (NPC) concludes this week, with announcements so far emphasizing further near-term support for recovery, and a gradual exit from stimulus.
- Taken together, the policy announcements and data releases support our view of further gradual monetary tightening in the form of quantitative measures to rein in credit growth, followed by likely RMB appreciation and interest rate hikes beginning in Q2.

1. Inflation ticks up, but is distorted by CNY

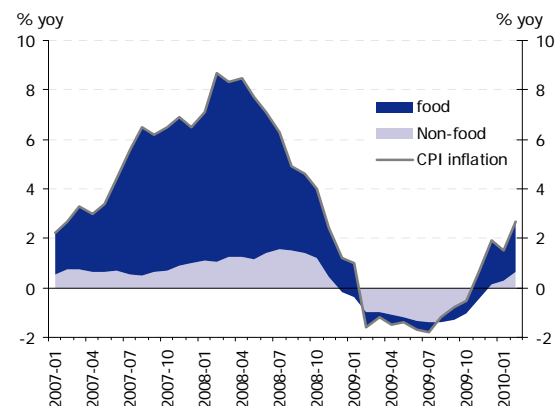
CPI inflation ticked up to 2.7% y/y (consensus 2.5%, BBVA: 2.3%), from 1.5% y/y in January. Meanwhile, PPI inflation rose to 5.4%, from 4.3% in January (Chart 1.1&1.2).

This rise in inflation is mainly due to the CNY effect and the low comparison base of a year ago (CNY occurred in February this year, in contrast to January last year). Among the components, food contributed 2.04 percentage points to the hike, while non-food price added the rest 0.66 percentage point. Excluding food inflation rose by 1.0%, edging up from 0.5% in January.

2. Exports jump as external demand recovers

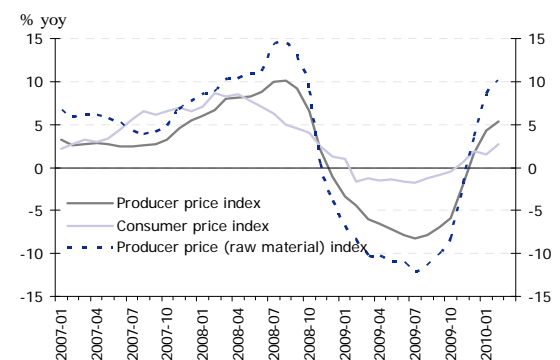
Export data released yesterday show an increase of 45.7% y/y in February from 21.0% in January. Import growth slumped to 44.7% y/y from 85.5% in January. The monthly trade surplus narrowed to USD 7.6bn from USD14.2bn in January. Given distortions from the CNY effect, it is more meaningful to compare data for the first two months of the

Chart 1.1: Consumer price index (CPI)



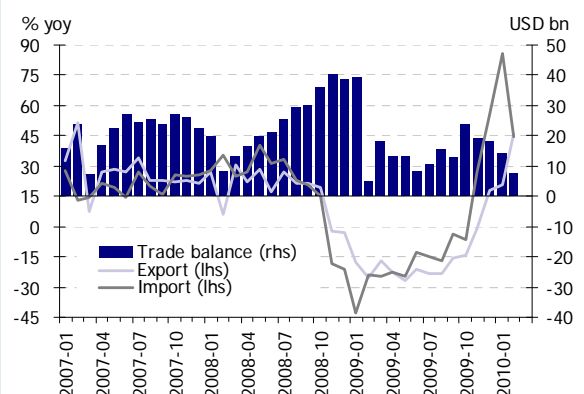
Source: CEIC.

Chart 1.2: Production price index (PPI)



Source: CEIC.

Chart 2.1: External Trade



Source: CEIC.

year. On this basis, exports surged 31.4% to USD 204 billion in the first two months over the same period last year, while Imports stood at USD 182 bn, up 63.6%. The trade surplus contracted 50.4% in the first two months to USD 21.8 billion. That said, sequential data (seasonally adjusted) indicated a moderation in export and import growth from their peak in December.

By destination, the EU and US remained China's largest trade partners, as ASEAN overtook Japan as the third largest. In the first two months, exports to the EU grew 34.4% y/y, and to the US by 20.8% y/y. while exports to ASEAN surged 52.9% (the China-ASEAN free trade area was launched on January 1).

3. Industrial output momentum further strengthens

Previously released February PMI was 52.0, down from 55.8 in Jan and 56.6 Dec, indicating industrial activities will slow its pace, but it should be intervened by the holiday effect. Despite the weaker PMI reading, industrial production still held up well in this first two months, up by 20.7% y/y (Chart 3.1). By category, heavy industry continued its strong momentum at 23.7% y/y in the first two months from 21.4% y/y in December. Meanwhile, light industry expanded by 14.5% y/y, accelerating from last December's 12.1% y/y, consistent with the notable recovery in China's exports (Chart 3.2).

4. Expansion in fixed asset investment (FAI) adjusted downwards

Fixed asset investment in China's urban areas rose 26.6% y/y during the January-February period in nominal terms, improved from the 20.8% y/y growth last December. Real FAI growth came in at 20.1% y/y in February and 21.4% y/y in January, up from 18.8% in last December. The accelerated growth was due to a re-start of investments backed by renewed banking credit at year beginning.

In coming months, we expect FAI growth to weaken as the authorities implement measures to slow loan and investment growth.

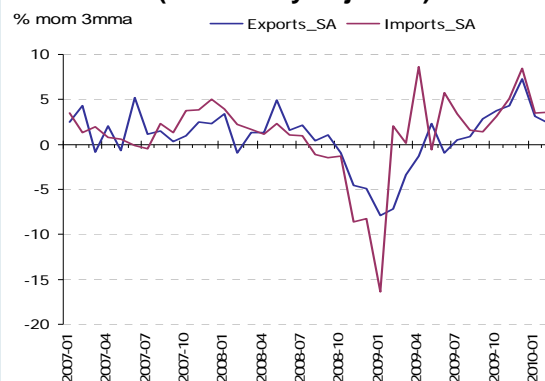
5. Retail sales grew robustly

Nominal retail sales climbed by 17.9% y/y in the January-February period. In real terms, retail sales increased 15.8% y/y from 15.3% y/y in December 2009. With on-going strength in consumption and extended favorable policies to boost consumption, such as tax cuts and subsidies to home appliances and automobile purchase in 2010, retail sales are expected to continue growing in the months ahead.

6. Slower loan and M2 growth

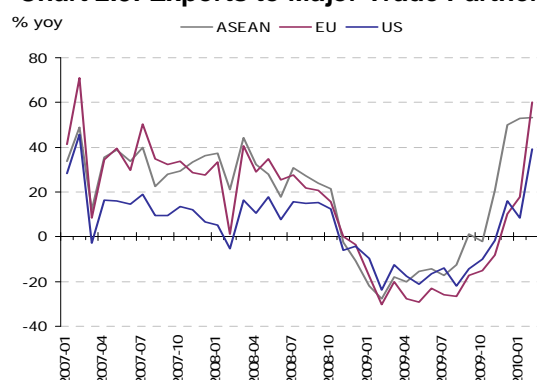
Banks extended new loans of RMB 700.1 billion in February, sharply down from RMB 1.4 trillion in January, in line with expectations amid government efforts to curb bank lending. Also, the CNY effect may have been at play, as business activity typically shuts down during the holiday period. The central bank's efforts to rein in property prices, through two hikes in the RRR by 50bps each so far, may also have limited the banks' capacity to issue new loans.

Chart 2.2: External Trade (Seasonally adjusted)



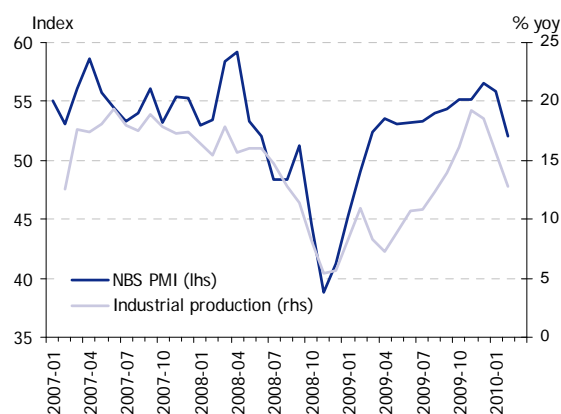
Source: CEIC.

Chart 2.3: Exports to Major Trade Partners



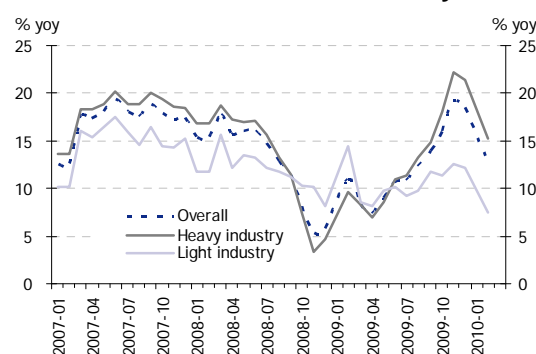
Source: CEIC.

Chart 3.1: Industrial production and PMI



Source: CEIC.

Chart 3.2: Industrial Production by sector

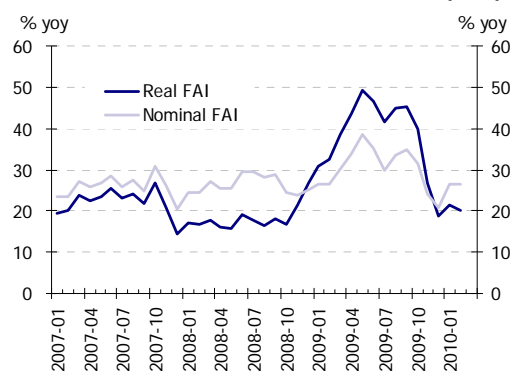


Source: CEIC.

As such, outstanding loan growth further eased to 27.3% in Feb 29.3% y/y. M2 growth slowed further to 25.5% y/y in February, slightly down from the 26.0% y/y rise last month (Chart 6).

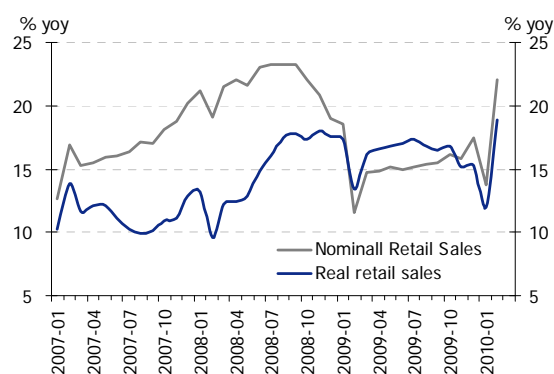
The authorities' overall target for bank lending in 2010 is set at RMB 7.5 trillion of new loans; thereby, M2 is placed at 17% yoy. To accomplish the target, we expect bank lending to be strictly managed. Thus, further quantitative tightening measures are expected with multiple RRR hikes and quotas on bank lending.

Chart 4: Fixed Asset Investment (FAI)



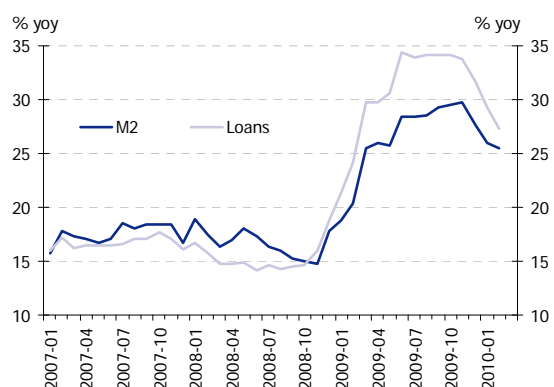
Source: CEIC.

Chart 5: Retail Sales



Source: CEIC.

Chart 6: M2 and Loans



Source: CEIC.