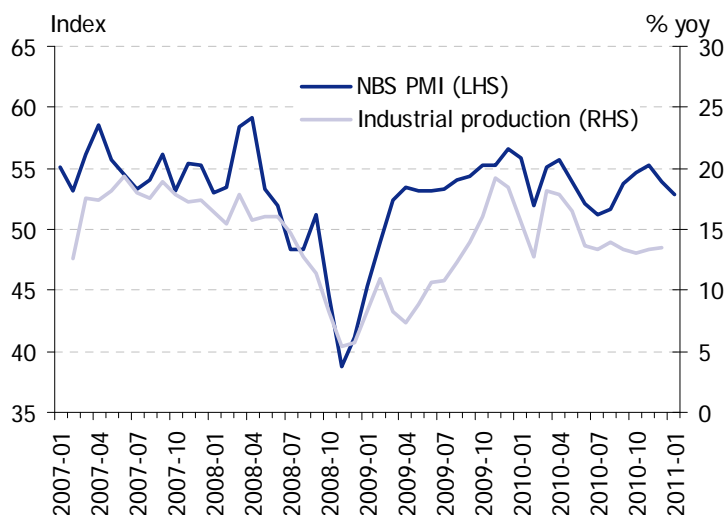


Summary: The January Purchasing Managers' Index (PMI) came out lower than expected, at 52.9% (consensus: 53.5%; BBVA: 54.0%), a second straight month of decline but still firmly in the expansion zone (+50). Caution is needed in interpreting the figures due to the seasonal effects of the Chinese Lunar New Year, which begins on Thursday. That said, the moderating trend is welcome news in view of concerns about overheating given a host of indicators showing stronger-than expected growth and inflation in the fourth quarter of 2010. Manufacturing trends are still robust, and we maintain our soft-landing scenario of 9.2% growth in 2011, accompanied by further monetary tightening measures

January PMI foreshadows a soft landing in the Year of the Rabbit

- China's official (NBS) PMI for January 2011 eased to 52.9% from 53.9% in December 2010, a second straight month of decline (Chart 1). However, manufacturing trends are still strong with the PMI reading firmly in the expansion zone (+50). Note that the reading stands in contrast to the previously-released private sector PMI (HSBC), which rose marginally to 54.5% from 54.4% in December 2010. The difference likely reflects variations in company coverage (the HSBC index covers a narrower set of firms), but may also highlight difficulties in interpreting data in January and February due to the Lunar New Year calendar--last year the New Year festival began on February 14. Companies tend to advance or postpone production around the holiday period, which runs from February 3-8 this year in China.
- The main contributors to the decline in the official index for January were the "production index" (with a weight of 25%) and "employment index" (with a weight of 20%), which dropped by 2.2 and 2.5 percentage points respectively. Within the "new order component" export orders showed a significant decline. Given risks of overheating, the moderation trends in these indices should be welcome news to the authorities, as they seek to tighten monetary policy to restrain credit growth and inflation. Once again, we caution that seasonality may be influencing the trends due to the Lunar calendar.
- While production indices showed some signs of moderation, other demand-side indicators continued to show strength. In particular, the "import index" jumped 2.6 percentage points to 53.0% from December's 50.4%; and the "new order" and "inventory" indices decreased by 0.5 percentage points and 0.8 percentage points respectively. Importantly, the input price index picked up again to 69.3% in January from 66.7% of last month, a sign that underlying inflationary pressures in producer prices have not yet subsided.
- Taken together, the PMI outturn reinforces our outlook for the year, with GDP growth projected at 9.2% (following 10.3% in 2010). We anticipate further monetary tightening measures, including up to 100bps in additional hikes in reserve requirements and three interest rate hikes for a total of 75bps. If inflation fails to subside in the coming months, we would expect monetary tightening to be front loaded, with a rate hike likely in the current quarter.

Chart 1 PMI eases for a second straight month



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