China's inflation eases as expected, keeping monetary policy on hold

China's headline inflation outturn for September eased slightly, in line with expectations, to 6.1% y/y (BBVA: 6.1%; Consensus: 6.2%). The outturn confirms our view that inflation has already peaked in year-on-year terms, having topped out at 6.5% y/y in July. Inflation continues to be driven by food price increases. Trade data were also released (yesterday), showing a greater-than expected slowdown for September (17.1% vs. consensus: 20.4%), as external demand weakened, especially to European and US markets. The combination of still high inflation and weakening exports presents a challenge to the authorities. On balance, we expect monetary policy to remain on hold in the near term to contain inflation expectations, with support for growth coming through targeted fiscal measures, including stepped-up spending on social housing. We expect inflation to ease during the remainder of the year, to around 4% by end-year, and our growth projection of 9.2% for 2011 remains intact, but with downside risks due to the weak external environment.

- As anticipated, headline CPI inflation eased slightly in September, to 6.1% y/y from 6.2% in July (Chart 1), in line with expectations (Consensus: 6.2%; BBVA: 6.1%). The main driver continues to be food prices, especially pork, which rose by 43.5% y/y in September, slightly down from 45.5% y/y in August. Month on month, food prices rose by 1.1%, up from 0.6% in the previous month, mainly driven by seasonal factors.

- Producer price inflation (PPI) in August also slowed to 6.5% y/y, slightly below expectation (Consensus: 6.7% y/y), down from 7.3% y/y in August. Month on month, PPI remains flat in September, as commodity prices decline slight by 0.1% month on month.

- The September inflation readings show continued declines in the CPI and PPI since July, and are consistent with our expectation that inflation has peaked. We project a moderation during the remainder of the year as food and commodity prices ease, and on base effects. On this basis, inflation should decline to around 4% by the end of the year.

- On the policy front, given the still elevated inflation, we continue to believe the authorities will keep the monetary policy stance unchanged in order to tame inflation. Our baseline incorporates no change in policy rate rates for the remainder of the year.

- Additional data is scheduled next week (Oct. 15-18) on a series of important economic indicators, including data on industrial production, investment, and retail sales for September, as well as the third quarter GDP outturn. We continue to believe that the economy is slowing in line with a soft landing, although there are now increasing downside risks to our full-year projections of 9.2% and 8.9% for 2011 and 2012 given global uncertainties.

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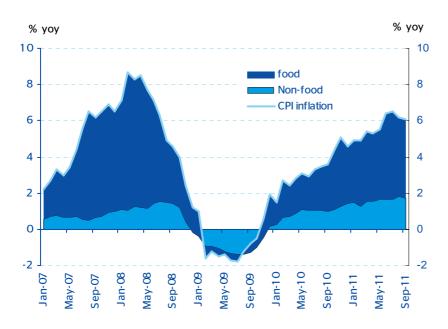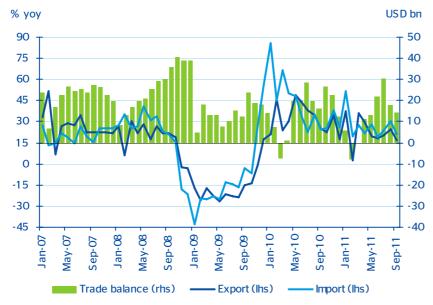+852 2582 3218

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Chart 1: Inflation eases slight in September

Chart 2: Export and import weaken more than expected