

China Flash

A healthy moderation in October inflation and activity indicators

China's headline inflation for October moderated to 5.5% y/y, after hovering above 6% for four consecutive months. The outturn was in line with expectations (BBVA: 5.4%; Consensus: 5.5%), and provides further evidence that inflation has passed its peak of 6.5% y/y reached last July. According to our projections, inflation should decline to around 4% y/y by end-December. The decline in October was driven mainly by a fall in food prices. There was also a notable decline in PPI inflation, to 5.0% y/y from 6.5% in September, as commodity prices eased. Meanwhile, a batch of activity indicators released today show that domestic demand and production eased in line with our soft landing scenario, and remain strong despite weakening exports. We continue to expect Q4 GDP growth of 8.4% y/y, which would bring full-year growth to 9.1% and 8.6% in 2012, although downside risks have increased due to the uncertain global outlook. The decline in inflation, along with recent signals of policy "fine tuning" have raised expectations of monetary easing in the months ahead. Indeed, a selective easing of liquidity conditions may already be underway, although with underlying demand still strong, we do not expect a broader change in the monetary stance until early next year.

- **As anticipated, headline CPI inflation eased significantly in October, to 5.5% y/y from 6.1% in July (Chart 1), in line with expectations (Consensus: 5.5%; BBVA: 5.4%).** The main driver of the decline continues to be food prices, especially pork, which rose by 38.9% y/y in October, down from 43.5% y/y in September. Base effects also contributed to the decline in y/y inflation, although prices eased m/m as well. The CPI rose by 0.1% m/m, down from 0.5% in September; food prices fell by -0.2%, down from 1.1% in the previous month.
- **Producer price inflation (PPI) in October also slowed sharply to 5.0% y/y, well below expectations (Consensus: 5.8% y/y; BBVA: 5.4%), down from 6.5% y/y in September.** Month on month, PPI declined by 0.7% in October, after remaining flat in September. The sharp decline in the PPI reflected mainly falling commodity price, -0.8% month on month in October (Chart 2). The decline in producer prices should help reduce headline inflation in the months ahead.
- **The activity indicators for October show moderating but still robust growth. On the demand side October retail sales growth declined to 17.2% y/y (consensus: 17.6%; BBVA: 17.4%), down from 17.7% y/y in September (Chart 3).** Urban fixed asset investment (YTD) grew by 24.9% y/y (consensus: 24.7%; BBVA: 24.5%) the same as in September (Chart 4). On the supply side, industrial output eased to 13.2% y/y in October (consensus 13.4%; BBVA: 13.4%), from 13.8% y/y in August, quite likely due to weakening export orders.
- **Given the fall in inflation and moderating but still strong activity data, we believe the authorities will still maintain the current monetary policy stance, while selectively easing credit flows to SMEs and ensuring that liquidity conditions do not become too tight.** Measures could include some cuts in required reserve ratios for small banks. Our baseline incorporates no significant changes to monetary policy for the remainder of the year, with broader cuts in required reserve ratios possible in the first quarter of 2012 (we do not anticipate interest rate cuts at this stage).

Chart 1

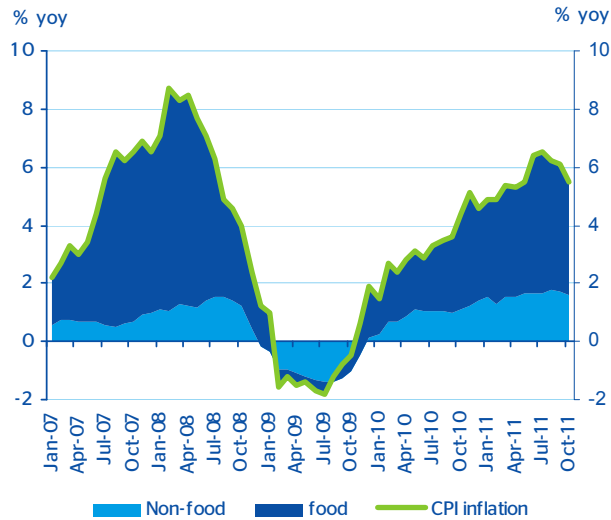
CPI continued an easing trend after peaking in July

Chart 2

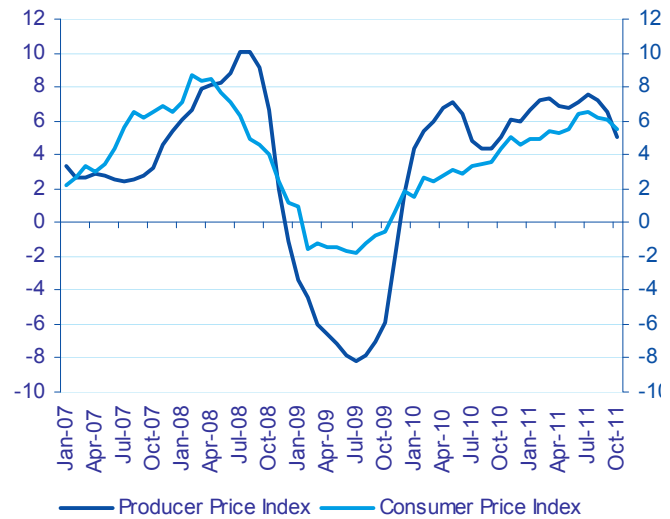
Both CPI and PPI eased in October

Chart 3

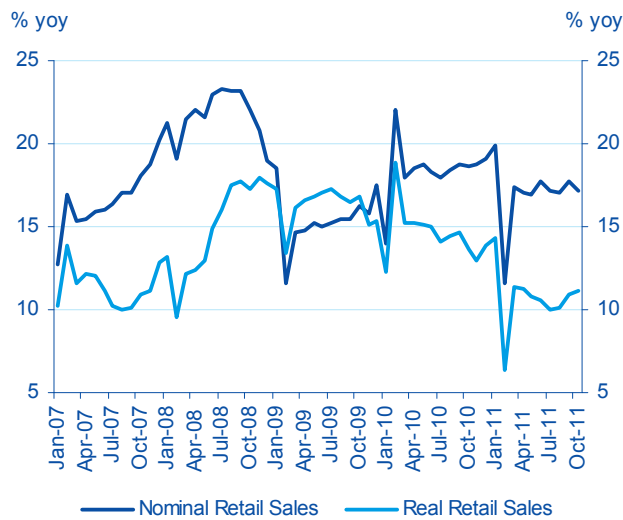
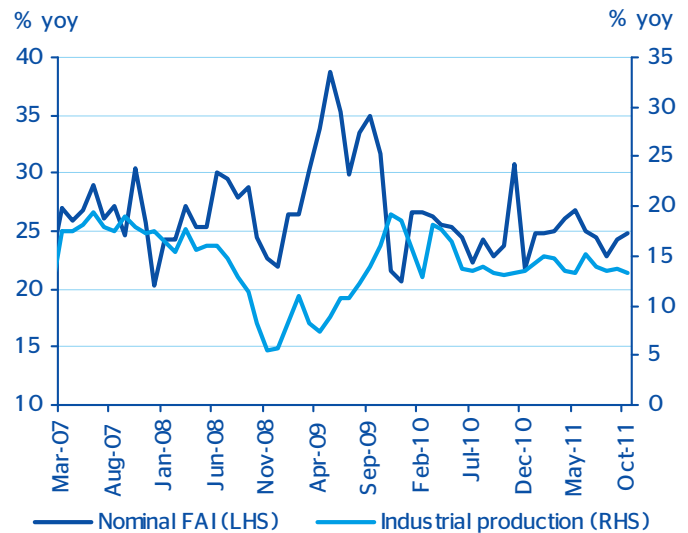
Retail sales remain robust

Chart 4

Industrial production and nominal FAI sustain their momentum

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