

China Flash

China: Inflation eases as growth continues to moderate

China's November inflation eased significantly to 4.2% y/y in November from 5.5% in October, somewhat below expectations (BBVA: 4.3%; Consensus: 4.5%). Meanwhile, a batch of monthly activity indicators, also released today, show that domestic demand continues to moderate in line with a soft landing, while production is declining somewhat more rapidly, possibly due to weakening external demand. The CPI inflation outturn is consistent with our end-year and 2012 projections of 4% y/y, while the activity indicators and last week's lower-than-expected PMI reading suggest some modest downside risk to our growth projections (9.1% for 2011 and 8.6% for 2012). Clearly, the scope for policy easing has increased, and we expect at least 100bp cuts in the RRR in Q1 2012, with possible interest rate cuts and further reductions in the RRR to follow, depending on the outlook for the global economy.

- **Headline CPI inflation eased significantly in November, to 4.3% y/y from 5.5% in October (Chart 1), slightly below expectations (Consensus: 4.5%; BBVA: 4.3%).** The main driver of the decline continues to be a moderation in food prices, especially pork, which eased to 26.5% y/y in November, from 38.9% y/y in October. Base effects also contributed to the decline in y/y inflation, although prices eased m/m sequential basis as well. The CPI eased by -0.1% m/m seasonally adjusted, down from +0.1% in October. In non-seasonally adjusted terms, food prices fell by -0.8% y/y, while non-food prices rose by 0.1%.
- **Producer price inflation (PPI) in November also slowed notably to 2.7% y/y, well below expectations (Consensus: 3.4% y/y; BBVA: 3.0%), and down from 5.0% y/y in October.** Month on month, the PPI declined by 0.4% in November m/m seasonally adjusted, following a decline of 0.2% in October. The easing PPI reflected mainly falling commodity price, -0.8% m/m in November. The decline in producer prices should help reduce headline inflation pressures in the months ahead.
- **Activity indicators for November show moderating, but still robust domestic demand.** On the demand side November retail sales growth increased slightly to 17.3% y/y from 17.2% y/y in the previous month, above expectations (consensus: 16.8%; BBVA: 17.0%) (Chart 2). Urban fixed asset investment (YTD) rose by 24.5% y/y (consensus: 24.8%; BBVA: 24.8%), from the outturn of 24.9% in October (Chart 3). On the supply side, however, industrial output eased to 12.4% y/y in November (consensus 12.4%; BBVA: 12.0%), from 13.2% y/y in October, quite likely due to weakening export demand. Taken together, the moderation in economic activity, while meaningful, is not as severe as suggested by the weak PMI outturn for November (49.0, below the 50-level indicating contraction).
- **Given the fall in inflation and moderating activity data, we believe the authorities will continue to adjust monetary policy to a more expansionary stance.** Measures are likely to include further cuts in required reserve ratios in the first quarter of 2011 and, if the external environment weakens more abruptly, cuts in interest rates by Q2. In this regard, next week's Central Economic Work Conference of top policy makers (December 12-14) will be important for signs of the authorities' policy intentions. We will also watch for tomorrow's release of export data to gauge the pace of decline in external demand.

Chart 1

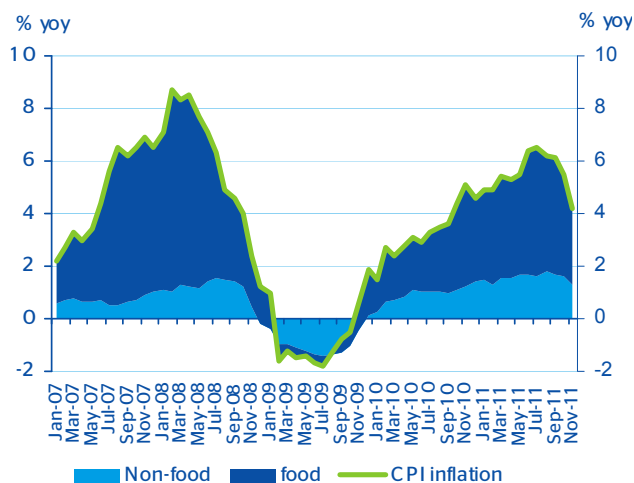
CPI inflation is moderating significantly

Chart 2

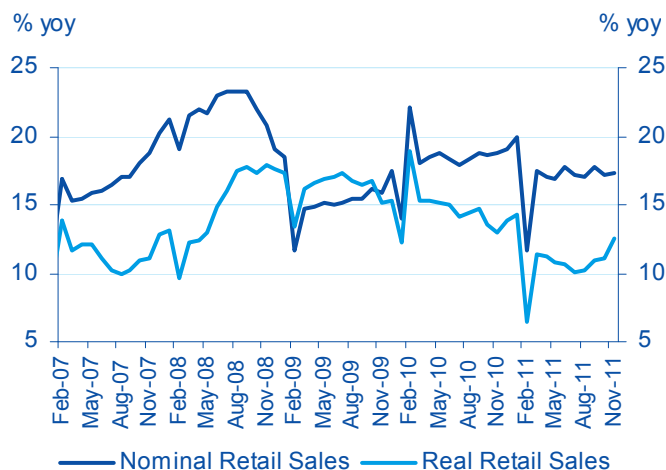
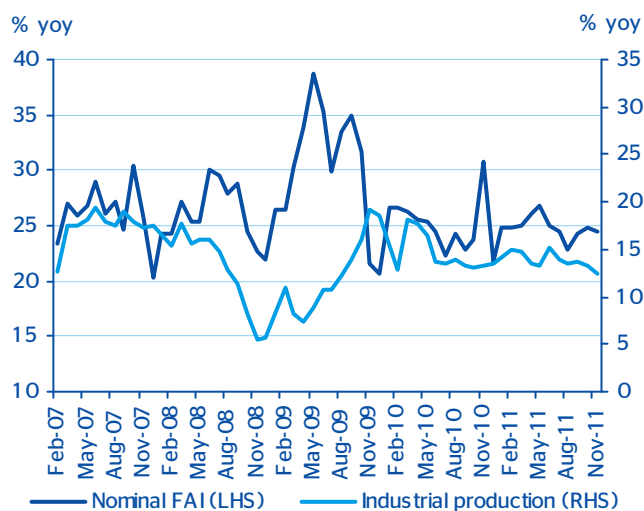
Retail sales remain robust

Chart 3

Industrial production and nominal FAI

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