China Flash

January 4.5% y/y uptick in inflation should not be a concern

January headline inflation ticked up by more than expected, to 4.5% y/y (BBVA: 4.3%; Consensus: 4.0%) from 4.1% y/y in December (Chart 1). However, the increase should not be a concern given the presence of strong seasonality due to the Chinese New Year effect, when demand for various food items is high. Indeed, food prices increased by 10.5% y/y in January, while non-food inflation eased to 1.8% y/y (-0.2% m/m). We had anticipated an upturn in inflation due to seasonality (the Chinese New Year occurred in January this year, versus February last year, resulting in an exaggerated y/y inflation rate). We expect the moderating trend in inflation to resume in February (BBVA: 3.2%), and to decline to around 3% by mid-year. This would pave the way for an additional 150-200bp cuts in the RRR in the coming months, along with up to two interest rate cuts (50bps in total), depending on the external environment. China's equity markets took the outturn in stride, falling on impact but gaining ground before mid-day.

- **The pick-up in January CPI inflation is due to higher food prices on demand from the Chinese New Year.** The 10.5% y/y increase in food prices from 9.1% y/y in December was a bit higher than expected given relatively modest weekly food price inflation data tracked in January. Nevertheless, the upturn can be attributed to high seasonal demand during the Chinese New Year. Importantly, non-food price inflation moderated to 1.8% from 1.9% y/y in December, a decline of -0.2% for January.
- **Producer price inflation (PPI) in December continued to slow**, to 0.7% (Chart 2) (Consensus: 0.8% y/y; BBVA: 0.3%), down from 1.7% y/y in December. Month on month (non-seasonally adjusted) the PPI declined by -0.1% in January. The decline in producer price inflation was attributed to falling commodity prices.
- **We continue to expect policies to be eased in the months ahead to support growth**. Markets have been disappointed in recent weeks by an apparent delay in the next RRR cut, especially after the better-than-expected PMI outturn for January was interpreted by some market participants to mean that the authorities would be more cautious with policy easing. The latest inflation outturn could similarly generate expectations of some delay. However, we believe further RRR cuts will be forthcoming, given weakening trends in external demand and expected further decline in inflation. Moreover, lower capital inflows, all else equal, are resulting in tighter liquidity conditions that would warrant some RRR cuts.
- **Markets will be watching for tomorrow's trade data, credit aggregates due out next week.** We expect exports to decline, by -3.0% y/y, on both seasonal effects from the Chinese New Year and the weakening trend in external demand. We expect new loan growth to pick up (RMB 850 billion from RMB 640.5 billion in December) given the typical pickup in credit growth at the beginning of the year and from the authorities' efforts to accelerate loan growth in support of domestic demand.

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Chart 1
CPI inflation picks up in January on higher food prices

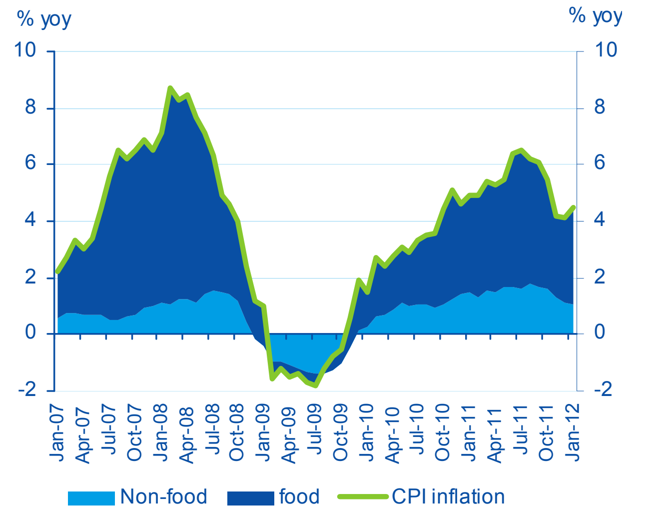
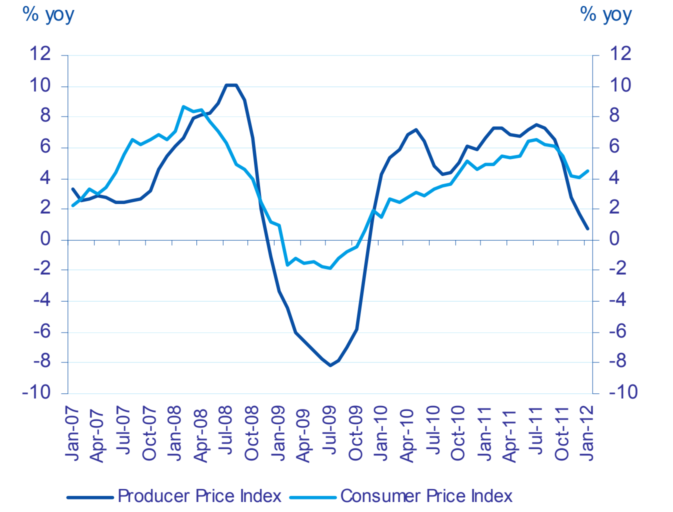


Chart 2
Falling PPI reduces inflationary pressure ahead



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