

China: the essentials

- With Q1 GDP growth accelerating to a two-year high of 11.9% y-o-y and inflation picking up strongly, China faces overheating and inflation risks, which call for more tightening measures over the months ahead

Overheating growth calls for further tightening

Beating our and market expectations, China's Q1 GDP growth accelerated to a two-year high of 11.9% y-o-y from 10.7% y-o-y in Q4 2009. Although the low base of the cyclical trough (6.2% y-o-y in Q1 2009) matters, the sequential growth for Q1 stayed at a similar pace of Q4 at around 11% in q-o-q seasonally adjusted, annualised terms by our calculation. Domestic demand stayed strong thanks to fixed asset investment growth and robust retail sales, and quickly recovering exports growth added fuel to output growth – industrial production growth jumped to 19.6% y-o-y in Q1 from 17.9% in Q4 2009. With GDP growth exceeding the potential growth of around 9.5-9.8%, China faces a widening positive output gap, which experience suggests is likely to lead to higher inflation.

The latest data point to overheating and inflation risks. This is likely to prompt more decisive steps to unwind fiscal stimulus from new infrastructure projects and to tighten credit. We expect the central authorities to curb new infrastructure projects by local governments through both administrative measures and credit tightening over the months ahead. Monetary tightening is likely to focus on quantitative tools such as reserve ratio hikes, bill issuance and window guidance on new lending. China is also likely to raise interest rates by 27bp in 2Q to anchor inflation expectations. And strong data releases also set the stage for the renminbi to return to the earlier managed floating system in the months ahead.

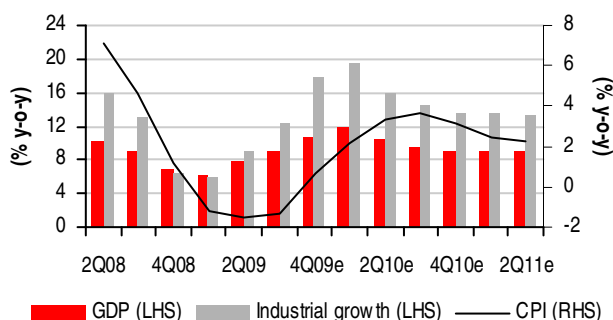
	Q1 2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010	Q2 2010e	Q3 2010e	Q4 2010e	Q1 2011e	Q2 2011e
GDP (% y-o-y)	6.2	7.9	9.1	10.7	11.9	10.5	9.5	9.0	9.1	9.0
Industrial production* (% y-o-y)	6.0	9.0	12.3	17.9	18.0	16.0	14.4	13.5	13.6	13.2
CPI, end quarter (% y-o-y)	-1.2	-1.7	-0.8	1.9	2.7	3.9	3.4	2.8	2.2	2.4
PPI, end quarter (% y-o-y)	-6.0	-7.8	-7.0	1.7	5.2	6.4	5.5	5.0	4.3	4.0
Trade balance (% GDP)	6.5	1.7	1.2	1.2	1.3	1.6	0.9	1.0	2.6	1.2
International reserves (USDbn)	1,953.7	2,131.6	2,272.6	2,399.2	2,447.1	2,474.4	2,496.9	2,538.6	2,562.4	2,586.9
Policy rate, end quarter (%)	5.3	5.3	5.3	5.3	5.3	5.6	5.8	5.8	5.8	5.8
5-yr lending rate, end quarter (%)	5.8	5.8	5.8	5.8	5.8	6.0	6.3	6.3	6.3	6.3
CNY/USD, end quarter	6.83	6.83	6.83	6.83	6.83	6.70	6.60	6.50	6.40	6.31
CNY/EUR, end quarter	9.07	9.58	9.98	9.79	9.24	9.04	9.24	9.43	9.28	9.15

Note: * Industrial production is measured as the output of the companies with annual sales over CNY5m

Industrial production accelerating on recovery in exports

Q1 industrial production growth jumped to 19.6% y-o-y in Q1 2010 from 17.9% y-o-y in Q4 2009, the fastest quarterly growth since the series began in 1995. March IP sequential growth strengthened to around 18% in annualised terms from 16%-17% in the January-February period, by our calculation. On top of robust domestic demand, the strong rebound in industrial sectors is mainly due to a faster-than-expected recovery of manufacturing for export (accounting for around 30% of industrial production) and restocking activities (in contrast to destocking in Q4 2008-Q1 2009, when GDP growth decelerated to less than 7%) in anticipation of a demand recovery warming up in both domestic and internal markets.

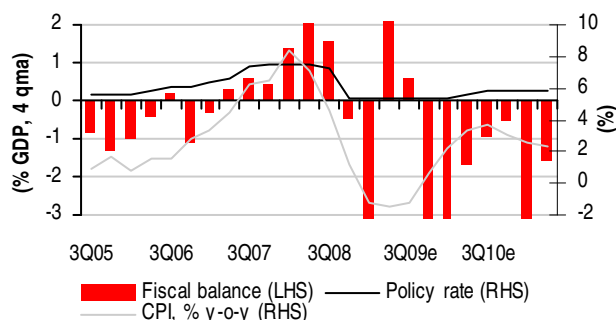
Activity & inflation



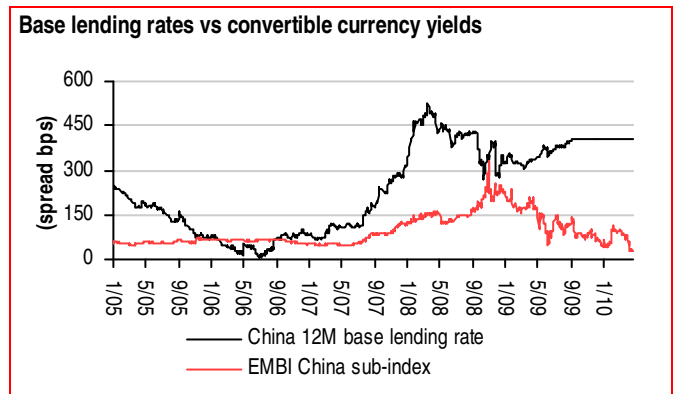
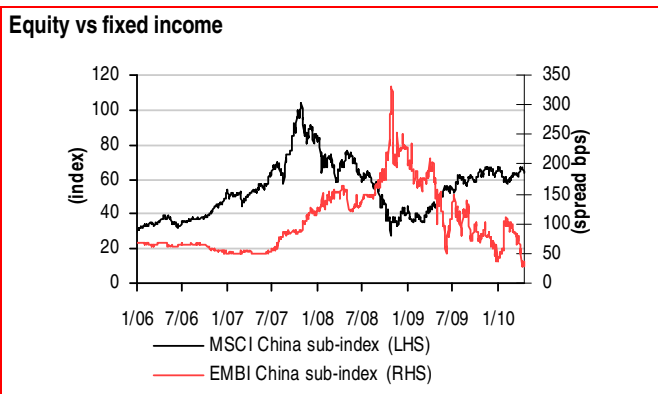
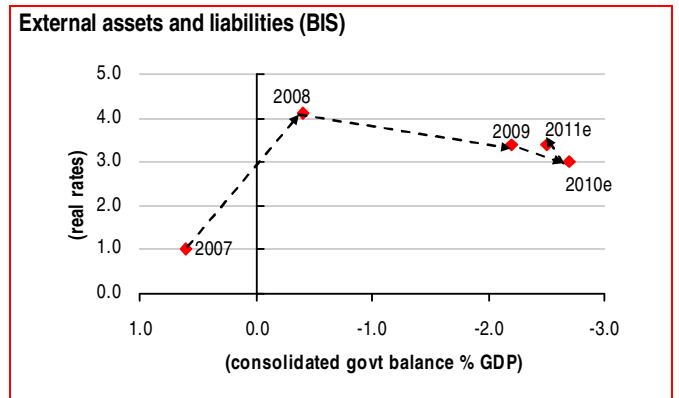
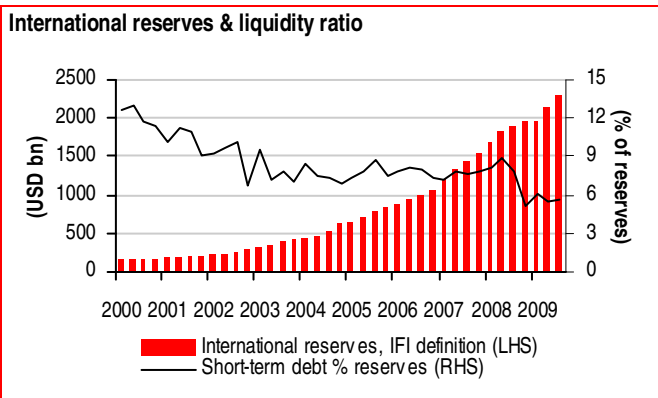
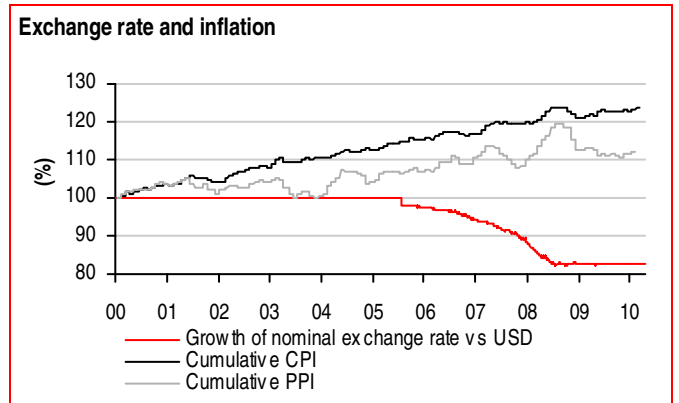
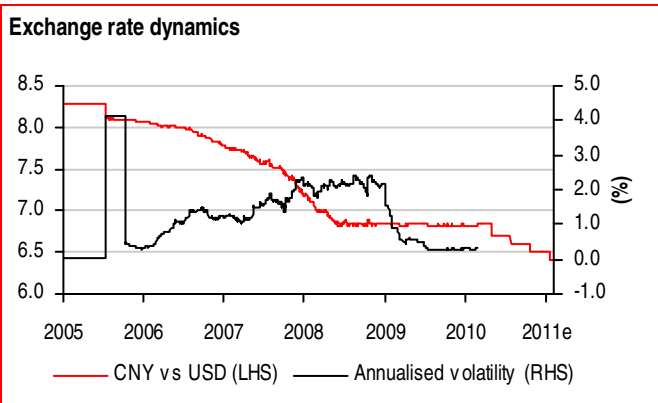
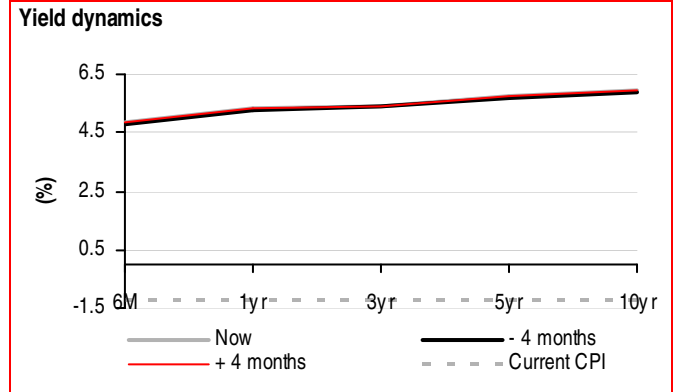
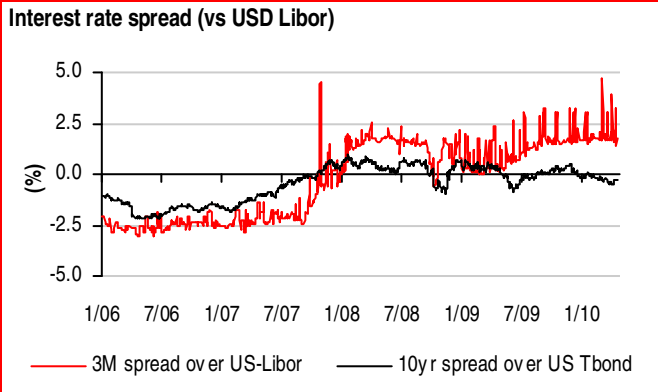
Monetary tightening focusing on quantitative measures

After 100bp reserve-ratio hikes and intensified open-market operations, the authorities' monetary tightening has brought credit growth down to around 22% from over 30% last year. That is still above the target of around 17% growth, so China is likely to tighten monetary policy further in the coming months, mainly through quantitative tools such as the reserve ratio, PBoC bill issuance and lending curbs (RMB7.5trn quota for this year). But rate hikes are also needed to prevent the real interest rate from falling too fast and anchor inflation expectations. We expect the first 27bp rate hike in Q2 and another 27bp in Q3 this year.

Policy stance



China: at a glance



Source: Central Bank, Thomson Reuters Datastream, Bloomberg, HSBC estimates and forecasts

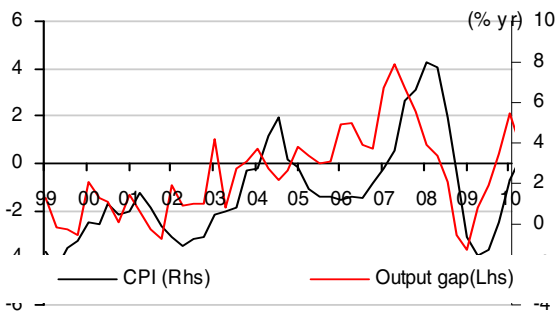
China: local knowledge/global drivers

- ▶ **Despite the slower headline March CPI, inflation is set to rise rapidly amid the widening positive output gap, credit overhang and higher commodity prices. Rate hikes are also needed in 2Q to anchor inflation expectations**

Inflation is set to pick up strongly

Inflation is rising and underlying inflationary pressures have intensified, despite the moderation in March headline CPI. With 11.9% y-o-y GDP growth surpassing potential growth, overheated demand not only exhausts spare resources but also overstretches the supply capacity of raw materials, energy and infrastructure, leading to rapid upward pressure on prices. This is likely to be exacerbated by the fast export recovery given that growing global demand depletes spare manufacturing capacity and ultimately puts pressure on consumer goods prices. Accelerating PPI thanks to higher international commodity prices is likely to translate into greater upward pressure on downstream product prices if overheated demand persists.

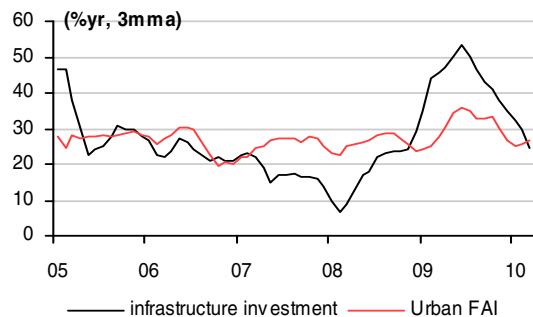
Output gap vs. inflation



Unwinding infrastructure boom

China has already started withdrawing stimulus for new infrastructure projects, reflecting Beijing's concern about overheating and inflation. The central government plans 6.3% fiscal spending growth this year, down from 24% last year, and the focus will shift from infrastructure projects to healthcare, education and other pro-consumption areas. Meanwhile, banks are cutting lending to new construction projects by local governments, although they continue to finance existing projects. All this implies a slowdown in infrastructure investment this year. Since infrastructure accounted for nearly 60% of growth in total fixed asset investment last year, such a slowdown should lead to slower growth in total fixed asset investment in H2 2010.

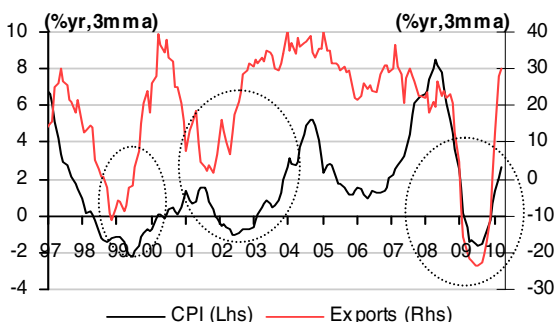
Infrastructure investment starting to slow down



Exports recover faster than expected

Exports surged 28.9% y-o-y in Q1 from 0.2% in Q4 last year on the back of global demand, in particular the recovery in emerging markets. We believe China's exports recovery is still on track, as suggested by the sustained expansion in new export orders in the HSBC manufacturing PMI data series. China's manufacturing capacity is built to meet both domestic and global demand. So it takes a simultaneous boom in both internal and external demand to exhaust the sector's spare capacity. Since the country's export-oriented manufacturing sector is dominated by consumer goods, strong exports make it easier for the overheating pressure to be passed through to domestic consumer price inflation.

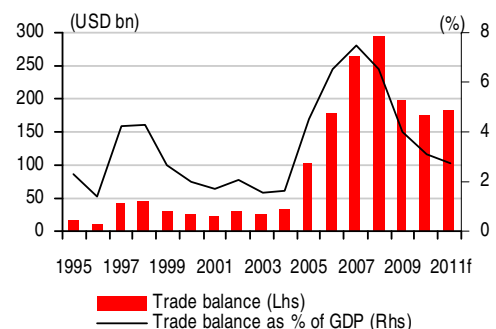
Surging exports vs. inflation



RMB appreciation case weakened by falling trade surplus

The March trade deficit of USD7.2bn is expected to be temporary. Policy-tightening measures are likely to slow growth in infrastructure investment, cooling down imports for commodities in H2. That said, there is an underlying trend of falling trade surplus from the peak of 7.5% of GDP in 2007 to around 4% last year. A shrinking trade surplus is likely to weaken the case for the renminbi's undervaluation. That, plus Premier Wen's recent statement that the renminbi is not undervalued, is likely to close off the possibility for any significant appreciation in the near term. But assuming exports recover to pre-crisis level, we believe the exchange rate policy will exit the de facto dollar peg — a special policy to fight the crisis — and return to the earlier managed floating exchange rate scheme in the coming months.

Falling trade surplus



China: macro framework

	2004	2005	2006	2007	2008	2009	2010e	2011e
Production, demand and employment								
GDP growth (% y-o-y)	10.1	10.2	11.6	13.0	9.6	8.7	10.0	8.9
Nominal GDP (USDbn)	1,931.7	2,260.1	2,716.4	3,497.8	4,523.5	4,912.7	5,683.9	6,727.2
GDP per capita (USD)	1,495	1,739	2,077	2,661	3,424	3,699	4,259	5,015
Private consumption (% y-o-y)	7.2	8.5	8.7	9.0	8.9	8.0	9.5	9.2
Government consumption (% y-o-y)	8.6	12.9	11.7	12.0	9.8	20.7	16.0	15.0
Investment (% y-o-y)	27.6	27.2	24.5	25.8	26.1	29.5	26.0	20.0
Industrial production* (% y-o-y)	16.3	15.9	16.2	16.0	12.9	12.9	15.5	13.3
Gross domestic saving (% GDP)	45.7	48.2	50.1	51.0	51.4	50.0	50.5	50.0
Unemployment rate, average (%)	4.2	4.2	4.1	4.0	4.2	4.3	4.6	4.5
Prices & wages								
CPI, average (% y-o-y)	3.9	1.8	1.5	4.8	5.9	-0.7	3.1	2.5
CPI, end-year (% y-o-y)	2.4	1.6	2.8	6.5	1.2	1.9	2.8	2.4
PPI, end-year (% y-o-y)	7.1	3.2	3.0	5.4	-1.1	1.7	5.0	4.2
Manufacturing wages, nominal (% y-o-y)	12.3	12.3	14.0	16.2	15.8	9.0	13.0	11.5
Money, FX & interest rates								
Broad money supply M3 (% y-o-y)	16.2	16.0	18.1	17.5	16.7	26.5	22.3	16.0
Real private sector credit growth (% y-o-y)	16.2	16.0	16.0	17.0	15.0	13.0	15.5	13.3
Policy rate, end-year (%)	5.6	5.6	6.1	7.5	5.3	5.3	5.8	5.8
5-yr lending rate, end-year (%)	5.8	5.8	6.5	7.7	5.8	5.8	6.3	6.3
CNY/USD, end-year	8.28	8.07	7.81	7.31	6.82	6.83	6.50	6.12
CNY/USD, average	8.28	8.07	7.81	7.31	6.82	6.83	6.50	6.12
CNY/EUR, end-year	11.25	9.52	10.30	10.68	9.49	9.79	9.43	8.87
CNY/EUR, average	11.25	9.52	10.30	10.68	9.49	9.79	9.43	8.87
External sector								
Merchandise exports (USDbn)	593.3	762.0	969.0	1,218.6	1,428.5	1,201.7	1,502.1	1,802.5
Merchandise imports (USDbn)	561.2	660.0	791.5	956.0	1,133.1	1,005.6	1,327.3	1,619.3
Trade balance (USDbn)	32.1	102.0	177.5	262.7	295.5	196.1	174.7	183.1
Current account balance (USDbn)	68.7	160.8	253.3	371.8	426.1	284.1	250.0	260.0
Current account balance (% GDP)	3.6	7.1	9.3	10.6	9.4	5.8	4.4	3.9
Net FDI (USDbn)	60.6	72.4	72.7	83.5	108.3	90.0	86.0	98.9
Net FDI (% GDP)	3.1	3.2	2.7	2.4	2.4	1.8	1.5	1.5
Current account balance plus FDI (% GDP)	6.7	10.3	12.0	13.0	11.8	7.6	5.9	5.3
Exports (% y-o-y)	35.2	27.6	26.9	26.4	17.8	-17.9	23.0	18.0
Imports (% y-o-y)	35.1	17.4	19.8	21.3	19.1	-16.3	27.0	17.0
International FX reserves (ex gold) (USDbn)	609.9	818.9	1,066.3	1,528.2	1,946.0	2,399.2	2,538.6	2,700.0
Import cover (months)	12.1	13.8	15.0	17.7	18.9	27.9	23.3	21.1
Public and external solvency indicators								
Commercial banks' FX assets (USDbn)	129.7	169.3	200.3	188.4	180.9	211.6	248.2	302.8
Gross external debt (USDbn)	247.5	281.0	323.0	373.6	374.7	350.0	330.0	360.0
Short term external debt (% of int'l reserves)	20.2	19.1	17.2	14.4	10.8	6.3	4.7	4.8
Consolidated government balance (% GDP)	-1.3	-1.2	-1.0	0.6	-0.4	-2.2	-2.7	-2.5
Central government balance (% GDP)	-1.3	-1.2	-1.0	0.6	-0.4	-2.2	-2.7	-2.5

Note: * Industrial production is the output of all industrial companies

Source: Central Bank, Thomson Reuters Datastream, Bloomberg, HSBC estimates and forecasts