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Markit Economic Research

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China

China begins fine-tuning monetary policy amid overheating concerns

- **PMI data signal accelerating growth and rising inflation.**
- **Overheating fears prompt monetary tightening.**

China moves to mop up excess liquidity as overheating concerns mount

China continued to spearhead the global economic recovery in the final quarter of 2009, supported by rising exports, ultra loose monetary policy and unprecedented fiscal stimulus measures. Gross domestic product (GDP) rose by 10.7% on an annual basis, surpassing official growth targets.

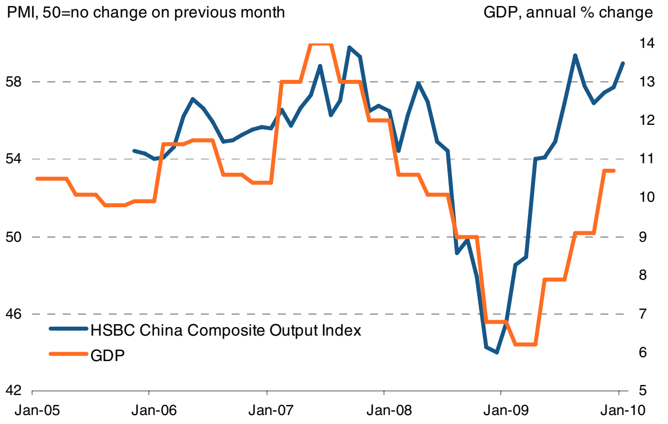
The HSBC China PMIs had signalled a strong recovery last year in advance of the GDP data, and indicated a further surge in growth at the beginning of 2010. The headline manufacturing index rose in January to its highest level since the series started in April 2004, while the HSBC Composite Output Index (which covers services as well as manufacturing) struck a near-record high, suggesting that economic growth is looking broad-based. The Composite Index has now signalled increased private sector activity for ten successive months.

Inflationary pressures rise, driven by supply-side factors

The PMI data also suggest that price pressures intensified at the start of 2010, with input and output price measures in the manufacturing sector both climbing to levels last seen before the onset of the financial crisis.

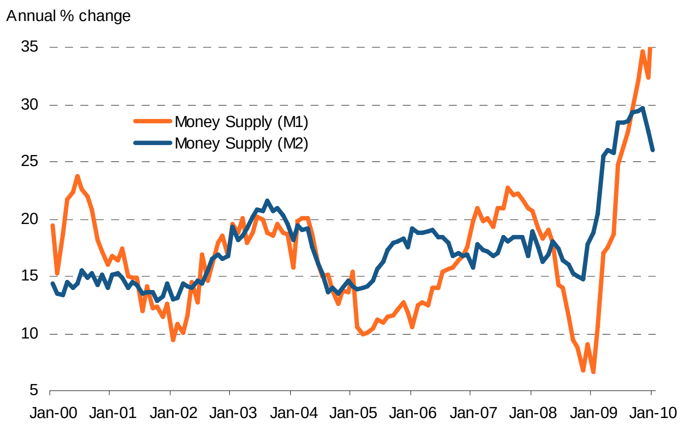
The upward trajectory of the Input Prices Index reflects rising commodity prices, but also supply chain factors. After destocking rapidly at the height of the financial crisis, manufacturers have responded to firmer demand by rebuilding inventories. The PMI index relating to the amount of inputs purchased by manufacturers posted its highest reading in almost three years in January. However, reduced stock at vendors has led to

Chart 1: China Composite PMI and GDP



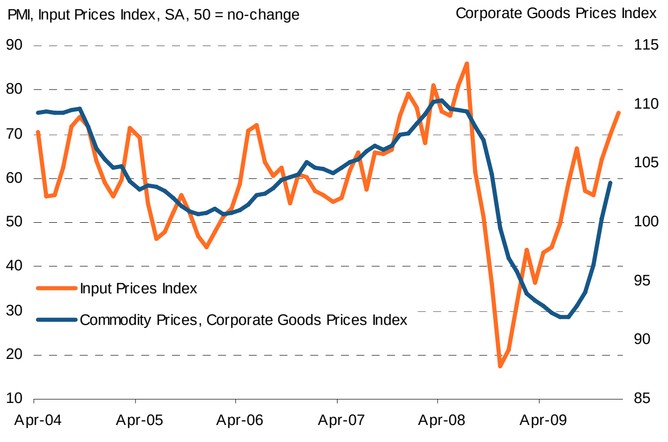
Sources: Markit, NBS.

Chart 2: Money Supply (M1 and M2)



Sources: Markit, People's Bank of China.

Chart 3: PMI Input Prices vs. Commodities



Sources: Markit, People's Bank of China.

widespread shortages and delivery delays. The average time taken by suppliers to deliver inputs to manufacturers lengthened for the sixth successive month at the start of 2010. With demand exceeding supply, suppliers have been increasingly able to raise their prices.

This suggests that the inventory cycle is playing an important role in stimulating inflationary pressures, sparking concerns that the Chinese economy is at risk of overheating. Higher goods and services charges are feeding through to consumers. Despite easing on the month, consumer price inflation (CPI) of 1.5% in January was much faster than that seen in November. Meanwhile, the producer price index (PPI) rose 4.7% on an annual basis, up from 1.7% in December.

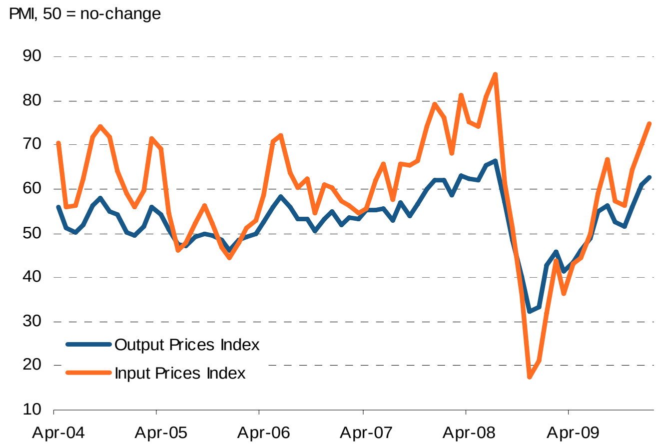
China has already taken steps towards cooling the economy by raising the reserve requirement ratio by half a percentage point and increasing rates on three-month and one-year sterilisation bills. The move towards a more neutral policy stance has sent tremors through the Asian stock markets, amid fears that slower growth in China could threaten nascent recoveries in other nations. The Shanghai Stock Exchange (SSE) Composite Index, which rose by 80% in 2009, has fallen approximately 10% since the turn of the year.

China faces policy dilemma

The quandary that China now faces is in stark contrast to those seen in other leading global nations, such as Japan and the US. China must successfully manage monetary policy in an attempt to control growth of the money supply, prevent the development of asset price bubbles and curb inflation, while at the same time promoting economic growth. Further monetary tightening is expected in the coming months as inflationary pressures build.

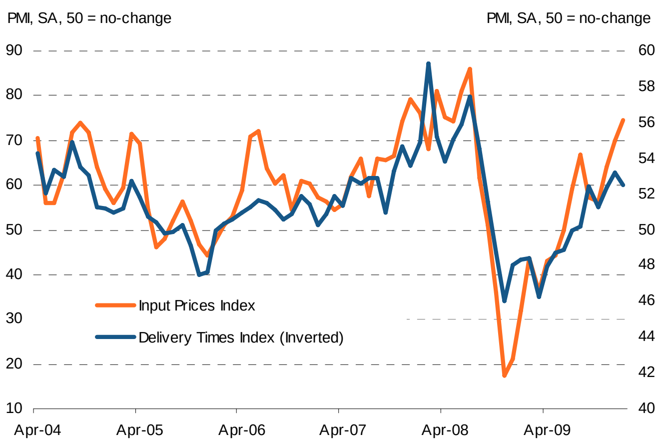
The first insight into the performance of China's economy for February will be provided by the HSBC China manufacturing PMI, released 1st March, followed by the HSBC China Services & Composite PMI on the 3rd March. To find out how to receive PMI data for China, please contact **economics@markit.com**

Chart 4: Output and Input Prices (PMI)



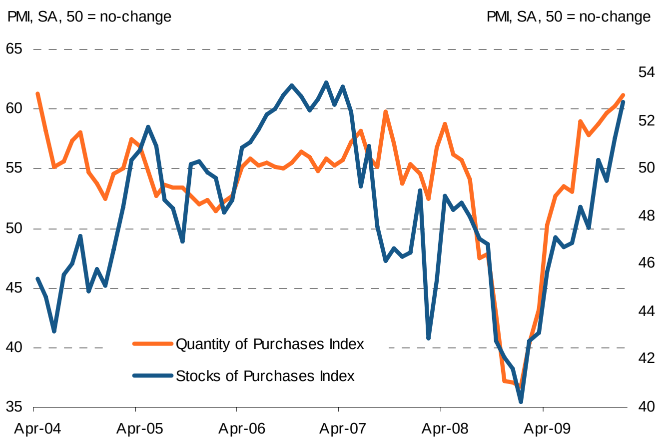
Sources: Markit.

Chart 5: China PMI Prices vs. PMI Delivery Times



Sources: Markit.

Chart 6: China PMI Purchasing vs. PMI Stocks



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