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Markit Economic Research

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China

China's monetary tightening starts to bite

HSBC PMI survey data, compiled by Markit, signalled that China's private sector economy continued to expand at a strong pace at the start of 2011. However, growth eased further from October's peak as the authorities continued to tighten monetary policy in an attempt to rein in inflation and mop up excess liquidity. China's service sector has generally felt the brunt of these measures, with PMI data released today showing service sector activity growth easing to a near-record low. The survey findings follow manufacturing PMI data released 1 February, which showed activity rising strongly across China's factories and workshops, albeit also down slightly on the robust pace recorded in December.

China ramps up monetary tightening

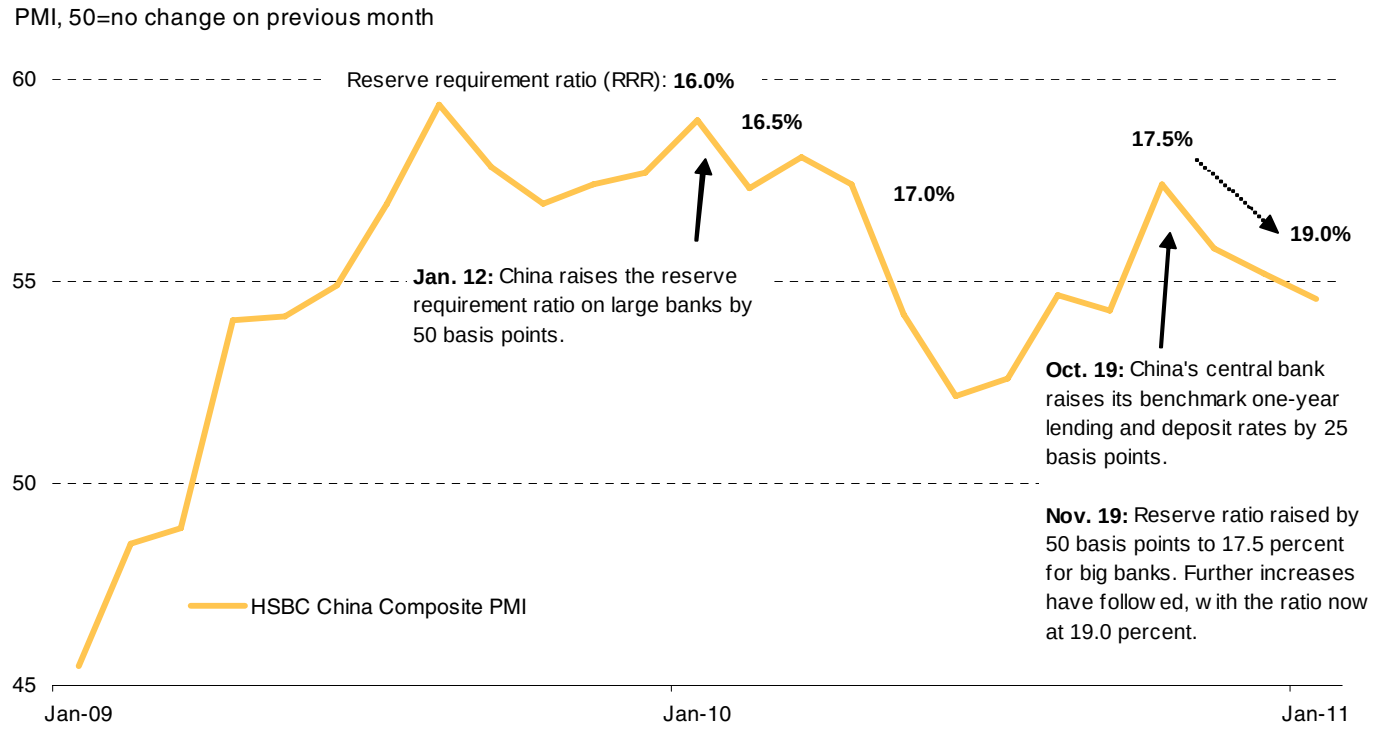
China increased its benchmark lending and deposit rates by 25 basis points yesterday, 8 February, as policymakers continued to tighten policy in an attempt to combat above-target inflation. The timing of the hike indicates that Consumer Price Inflation (CPI) for January has likely re-accelerated after December's slowdown, in line with analysts' expectations.

Many analysts expect a further rate hike in Q1, as the People's Bank of China has shown no signs of relaxing their stance on monetary policy. The Bank has now increased its benchmark lending and deposit rates three times since the start of 2010 and raised the minimum reserves each bank must hold to customer deposits, known as the reserve requirement ratio (RRR), on seven separate occasions.

The first tightening of policy occurred back in January 2010, when the Central Bank raised the reserve ratio by 50 basis points. Similar hikes followed in February and May, as official data showed that the economy was showing signs of overheating, with economic growth running at an annual rate of 11.9% in Q1 2010.

PMI survey data indicated that this initial phase of monetary tightening had the desired cooling effect, with the headline HSBC Composite PMI (covering manufacturing and services) falling from a near-record

China Monetary Tightening



Sources: Markit, HSBC.

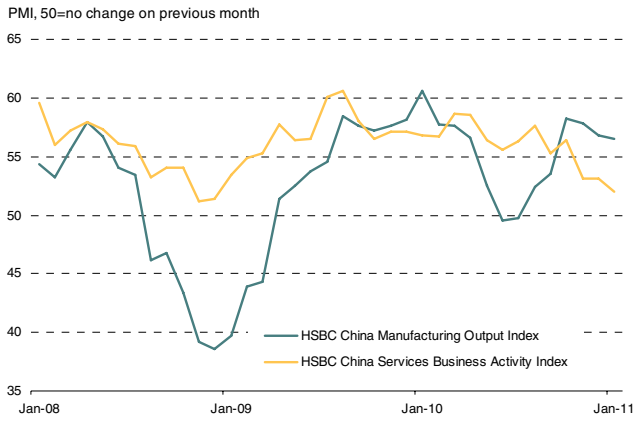
high of 59.0 in January to 52.2 by June, as service sector growth eased and manufacturing output fell for the first time since March 2009. However, the moderation also reflected a slowdown in worldwide economic growth, particularly in manufacturing, as world trade flows eased.

In the second half of last year, PMI figures showed a rebound in private sector activity, with growth hitting a six-month peak in October. That month also saw the start of a far more sustained wave of tightening by the People's Bank of China, with the benchmark lending and deposit rates rising for the first time since 2007. More reserve ratio hikes followed, cumulating in a second interest rate rise on Christmas day.

Since the first rate hike on October 19, PMI survey data have shown the economy cooling, with the composite PMI falling to a four-month low of 54.6 at the start of 2011.

Unlike the slowdown of summer 2010, the moderation in private sector growth appears to have been driven by internal policy rather than external factors. This is highlighted by the PMI data showing services activity growth easing to a far greater extent than manufacturing, which remains relatively robust in comparison. While the performance of the manufacturing industry is highly reliant on external demand, the service sector is dependent on the domestic market and, as a result, more prone to changes in monetary policy.

Manufacturing & Services PMI



Source: Markit, HSBC.

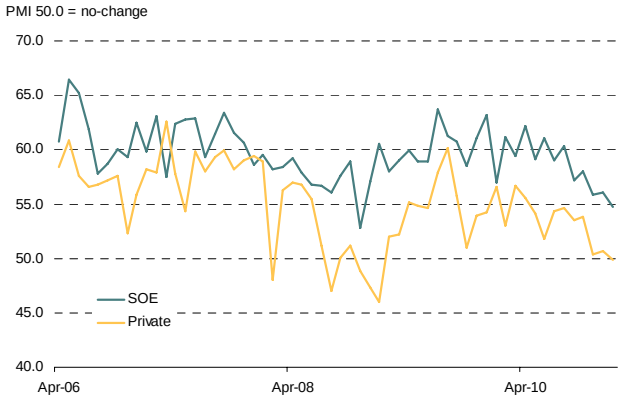
Deeper analysis of the PMI data suggest that lacklustre service sector growth in part reflects a slowdown in China's real estate sector, as state-led polices aimed at curbing the overheating property market continue to inhibit activity growth across the industry. Anecdotal evidence provided by respondents to the PMI survey also suggest that the end of the 2010 Shanghai Expo has dampened both activity growth and service providers' business expectations, with data released today showing confidence at the fourth-lowest since the start of the monthly series in November 2005.

Meanwhile, manufacturers have benefited from stable external demand in recent months, which has helped offset the impact of monetary tightening somewhat. PMI data suggest that global trade flows will continue to support steady growth in the export sector, with worldwide exports growing at the fastest rate for eight months at the start of the year.

State-run firms outperform private sector

PMI survey data also show that state-owned service providers have outperformed their private sector counterparts since the start of the services PMI, but both have seen rates of activity ease since mid-2010, as tighter policy has restricted a host of activities ranging from property investment to bank lending.

State-owned enterprises



Source: Markit, HSBC.

Prospects for further monetary tightening

Before Tuesday's rate hike, analysts polled by Reuters had forecast another two rate rises by the end of H1 2011. However, a slowdown in growth such as that signalled by the PMI data may cause the authorities to be cautious in timing future policy tightening, pushing back rate hikes in order to sustain robust economic growth.

The Flash China Manufacturing PMI™, released 21 February, will provide the first gauge of China's economic performance for February. This advance estimate will be published on a monthly basis

approximately one week before final PMI data are released, making the HSBC PMI the earliest available indicator of manufacturing sector business conditions in China.

To find out how to receive PMI data, please contact **economics@markit.com**

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