Sujet: **L'inflation n'est pas problèmatique en Chine. / China's inflation under control.**	**Source:** **Capital Economics** **Date:** **07.06.2010** DalpéMilette Conseillers en placement — Desjardins Valeurs mobilières, Membre FCPE	Info DalpéMilette

CHINA ECONOMICS UPDATE

7th Jun. 2010

CAPITAL ECONOMICS

Inflation Monitor (May)

Inflation continues to rise, but slowly

beaucoup mieux que ce que le marché anticipe.

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- **Inflation probably rose to 3% in May, but the bigger picture is that the threat of overheating already appears to be dissipating. We now expect inflation for the year as a whole to come in below the government's 3% annual target.**
- Headline consumer price inflation bounced back to 2.8% y/y in April. Core inflation continues to edge up, although it remains at a historically-low level. (See Chart 1.) Looked at in 3m/3m terms, non-food price pressures seem to have eased. (See Chart 2.)
- The same is true for food prices, which have been in decline since February. (See Chart 3.) Commerce ministry data show that vegetable prices fell 18% in May relative to April. This returns them to their level in November, before winter storms forced prices higher. Despite this, y/y food price inflation will almost certainly rise further as prices were even weaker a year ago.
- Apart from food, the only CPI component making a significant contribution to the rise in headline inflation over the past six months is that for residential costs. (See Chart 4.) This is due to increases in prices of water, electricity and fuel (collectively up 6.5% y/y in April). Utility and fuel prices are set by the government, which has embarked on a policy of raising them closer to their would-be market levels. In other words, **inflation in utility prices is a policy decision rather than a sign of underlying price pressures**.
- Looking ahead, the more rapid pace of producer price inflation might signal stronger consumer price inflation to come, but we are not convinced. The relationship between the two measures is loose and producer prices have tended to follow rather than lead consumer prices. (See Chart 5.) Chinese producers typically absorb input cost changes rather than raise their output prices.
- Growth of broad money (M2) has dropped to an annualised 20% pace, approaching the 17% that the People's Bank is targeting for the year as a whole. Growth of M1 has not fallen as far, as firms have shifted funds out of time deposits (included in M2 but not M1) into easier-to-access accounts to fund investment. **This monetary growth remains a potential source of inflationary pressure.** However, shifts in M1 do not always feed changes in inflation and the link has looked weaker than ever recently. (See Chart 6.)
- **The economy may now be running close to potential and a positive output gap will soon appear**. (See Chart 7.) In principle, this makes a pick-up in inflation more likely. But it would still take a while to generate a sizeable positive output gap at the current rate of GDP growth. Instead, we expect the pace of growth to slow of its own accord. Indeed, by our reckoning, the pace of growth has already dropped back to not far above the economy's sustainable rate in q/q terms.
- **The price of China's exports is unchanged relative to a year ago, despite the rise in headline consumer price inflation.** (See Chart 8.)
- **Overall, our assessment is that inflation dangers have diminished over the last few months. We expect inflation finally to reach 3% in May and to stay close to that level over the summer. The headline rate should peak below 4% early in Q4. We have cut our inflation forecast for 2010 from 3.7% to 2.8% accordingly. Our 2011 forecast is unchanged at 3%.**