

MARKET INSIGHTS

November 2010

Is inflation a problem in China?

Introduction

After a surprise rise in CPI in October, investors have become concerned about inflationary pressures in the Chinese economy. In this piece, we look at the drivers of Chinese inflation, examine the policy response so far and explain why we believe inflation will remain under control in the short to medium term.

Inflationary pressures appear to be mounting

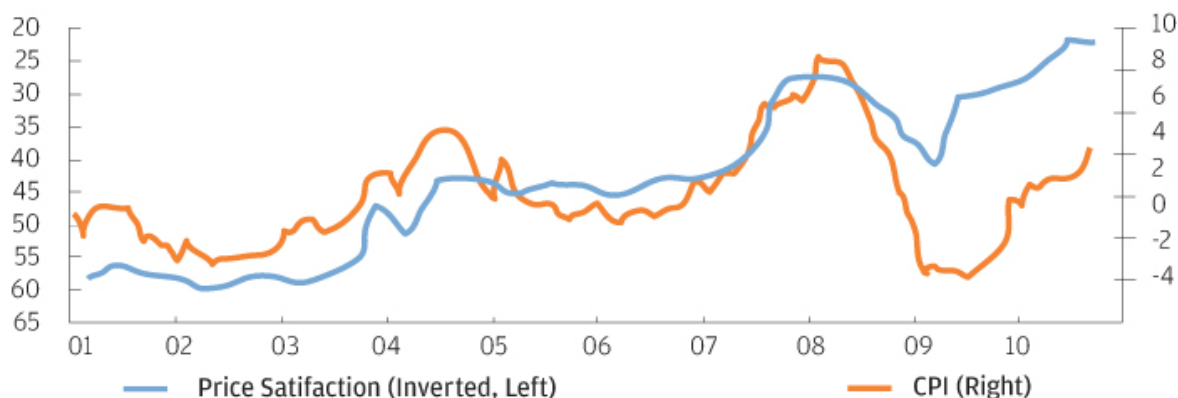
China's consumer price index (CPI) inflation came in at a 25-month high of 4.4% in October, above the consensus forecast of 4.0%, after reaching 3.6% in September. Two days before the September inflation figures were announced, the People's Bank of China (PBoC) unexpectedly raised interest rates by 25 basis points (bps), and a day before the October CPI data was released, the PBoC raised the reserve requirement ratio for all banks by 50bps. After the CPI figures were announced, certain banks were also instructed to raise their reserve ratio by a further 50bps.

It is widely believed that the central bank measures were in response to the rising inflationary pressure in China, as well as to the US Federal Reserve's announcement of a second round of quantitative easing, which could add to pricing pressures in Asian economies.

Beijing's perennial inflation target is 3%. However, CPI inflation is likely to stay above the target and even climb further for the rest of the year, given uncertainty about fresh food prices going into winter, as well as expectations for higher global commodity prices, which have also been exacerbated by the Fed's quantitative easing announcement.

A recent central bank survey showed that consumers felt far more inflation than the actual CPI figures. The price satisfaction measure was even worse than last time inflation peaked, in early 2008, while the future price expectation measure hit 2007-08 levels (see **Exhibit 1**). Hence, the risk of inflation expectations feeding through to realised inflation is getting higher.

Exhibit 1 – Inflation expectations are rising



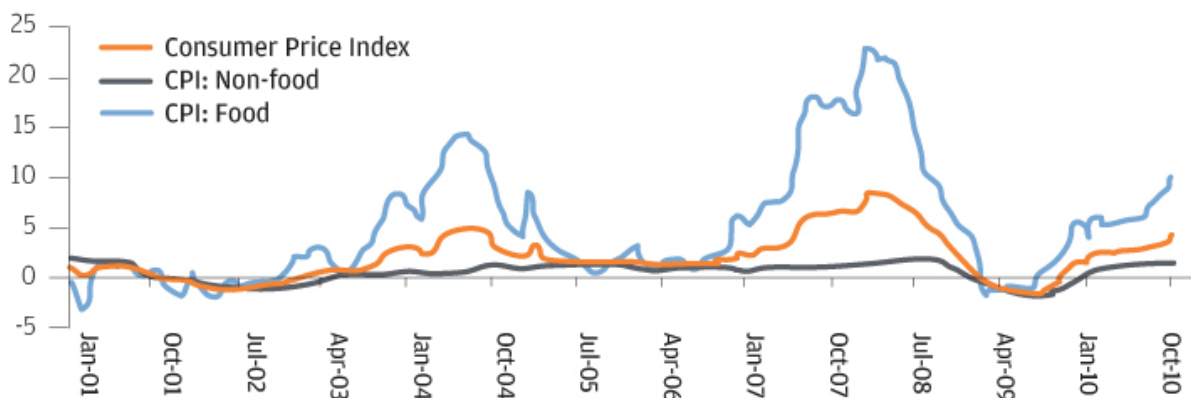
Source: Citi Investment Research and Analysis, 11 November 2010

With economic indicators showing that China's domestic growth remains strong, we believe that the Chinese authorities will be more comfortable to push through further monetary tightening, using rises in interest rates and the reserve requirement ratio to manage inflation expectations. In addition to monetary measures, the Chinese authorities have also announced administrative measures to combat inflation, including price controls on food and other basic necessities.

Food prices: The key driver of CPI inflation

The rising headline inflation recorded in recent months has been almost entirely attributable to higher food prices, which contributed three quarters of the increase in CPI in October. The CPI food index, which accounts for a third of households' consumption basket, rose to 10.1% year on year in October, up from 8.0% in September and 7.5% in August. Non-food inflation has remained relatively tame, increasing by 1.6% in October versus September's 1.4% and August's 1.5% (see **Exhibit 2**).

Exhibit 2 – Food prices



Source: NBS, CEIC, Morgan Stanley Research, 11 November 2010

The situation now could be similar to the relatively high inflation period of 2007 to early 2008. Food price inflation back then peaked in February 2008 at 23.3%, mainly driven by higher pork prices amid the outbreak of blue ear disease in domestic hogs. Core CPI (ex food and energy), meanwhile, hovered around 1%.

Amid the drop in Chinese economic activity during the global recession, headline inflation (including food inflation) eased (and even dipped into deflation for several months) in late 2008 to 2009.

However, the CPI food price index has been rising again this year, mostly driven by vegetables, fresh fruits and grain due to poor weather conditions, hoarding by farmers/retailers in anticipation of rising prices, and global speculation on soft commodities.

The Chinese State Council announced several administrative measures last week in an attempt to stabilise food prices and anchor inflation expectations. These included: temporary price controls (if needed); a crackdown on hoarding and speculation activities in agricultural products; the release of state reserves of staple foods such as grain, edible oil and sugar; a reduction in the transportation cost of agricultural goods; and an increase in subsidies to low-income groups. The impact of these supply-side measures is yet to be seen, but they may be more effective than monetary measures in helping to solve the problem.

Exhibit 3 – Pork was the main source of food inflation in the previous cycle...

Wholesale pork prices in China



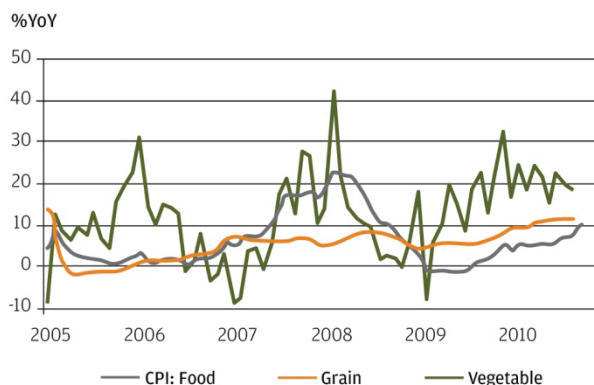
Source: CLSA, 5 November 2010

Before the announcement of the new administrative measures, price controls had already been put in place in some Chinese cities. For example, Fuzhou has imposed wholesale and retail price control over four types of vegetable, cutting retail prices by 15-50%. The local government has subsidised the supermarkets and cut rents for wholesalers to moderate the negative impact on margins. It is likely that more interventions of this kind will be announced in different cities/provinces in the near term.

China's inflation is unlikely to get out of control

Despite the possibility that headline CPI could creep up further in the next couple of months given the higher food prices, we believe the risk of a runaway inflation scenario is low. Headline inflation of around 4-5% is still a reasonable level, well below the high single-digit readings in the previous peak cycle. Meanwhile, a period of economic growth moderation is now unfolding. Fixed asset investment growth has already moderated over the past couple of quarters. Given that capital expenditure growth was the key driver of 2009's dramatic economic turnaround, a slowdown should help cool overall business activity as well as inflationary pressure.

Exhibit 4 – ... now it's vegetables



Source: Source: CEIC, NBS and BofA Merrill Lynch Global Research, 11 Nov 2010. Note: grain and vegetable data are as at Sept 2010

“...the authorities have demonstrated that they are willing and capable of responding through monetary and administrative policy...”

The government has also already imposed measures to control both credit and money growth. For example, the new renminbi loan quota (the amount that banks are allowed to lend) is much lower than last year's and the PBoC has kept raising the reserve requirement ratio for commercial banks this year. History tells us that slower monetary and credit growth leads to a fall in inflation with around a six-to-nine-month lag. If further measures are needed, the authorities have demonstrated that they are willing and capable of responding through monetary and administrative policy, as discussed above.

Furthermore, both real urban income and real rural cash income rose 7.5% and 9.7%, respectively, in the first nine months of 2010. Persistent strong real income growth in both rural and urban areas implies that higher food prices are still manageable by the consumers at this point of time.

Further sharp increases in food prices would undoubtedly be a significant social issue given the large weighting of food in household consumption. A continued rise in staple food costs may reduce consumers' discretionary spending power, and would therefore be disinflationary on other sectors. Hence, if food prices continue to intensify, we expect policymakers to impose more controls on prices and provide more subsidies to households to ease the pressure on the cost of living.

Price dynamics suggest non-food inflation is under control

Nathan Porter's 'Price Dynamics in China', an IMF research paper published in September 2010, shows that the main drivers of non-food CPI inflation in China are: cost pressures, as reflected in domestic and foreign commodity and producer prices; foreign demand for Chinese products; lagged (past) inflation; and inflation expectations.

Surprisingly, the study indicates that domestic demand pressures have little direct impact. This possibly reflects a large domestic output gap generated by many years of high investment. However, domestic demand does have an indirect influence through its impact on domestic producer prices.

Nominal US dollar appreciation also has little effect on non-food CPI inflation, reflecting the fact that Chinese imports are dominated by intermediate goods, while the proportion of imports made up by consumer goods is relatively small.

Interest rates, meanwhile, have little impact on non-food inflation, but do affect food inflation within one-to-two years. This could possibly be explained by the impact of rate rises on bringing down food inflation expectations. Speculation as well as hoarding may decline as a result of interest rate increases as credit cost is higher and Chinese investors and consumers do not want to bet against their government's intentions.

As mentioned above, an increase in world commodity prices appears to have a significant impact on non-food CPI. However, rising commodity prices only have a small impact on food price inflation. Economists often worry about the spillover effect of food inflation to non-food inflation. What this study seems to be telling us is that the impact is limited and relatively short-lived.

Therefore, unless commodity and raw material prices increase sharply, non-food inflationary pressure in China should remain modest over the next few years as foreign demand is expected to remain weak and the government has started to manage the public's inflation expectations through interest rate rises and administrative measures.

Conclusion

In the longer term, slower expansion in supply (due to consolidation of industries with excess capacity) and faster expansion in demand (due to the government's intention to rebalance the economy to a consumption-driven economic growth model), combined with persistent strong wage growth, are likely to have a lasting impact on the structural inflation outlook in China.

At present, inflationary pressure in China is largely concentrated in food and commodity prices. There have been no signs yet that inflation is becoming more widespread. Hence, we expect inflation to remain at reasonable levels.

Furthermore, the Chinese authorities will keep a close eye on inflationary pressures, delivering tightening and administrative measures as necessary to curtail the risk of significant deterioration in short- to medium-term inflation.

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