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China: A Gangbuster 1Q GDP Report And Its Implications

China's Key Macro Data										
%y/y change	2006	2007	2008	2009	4Q09			1Q10		
Real GDP Growth	11.6	13.0	9.6	8.7	10.7			11.9		
	2006	2007	2008	2009	Oct-09	Nov-09	Dec-09	Jan-10	Feb-10	Mar-10
Industrial Output	16.6	18.5	12.9	11.0	16.1	19.2	18.5	-	12.8	18.1
CPI	1.5	4.8	5.9	-0.7	-0.5	0.6	1.9	1.5	2.7	2.4
PPI	3.0	3.1	6.9	-5.4	-5.9	-2.1	1.7	4.3	5.4	5.9
Exports	27.2	25.7	17.3	-15.9	-13.7	-1.2	17.6	21.0	45.7	24.2
Imports	19.9	20.8	18.4	-11.3	-6.8	26.3	55.6	85.6	44.7	66.4
Trade Balance (USD bn)	177.5	262.0	297.3	198.2	24.0	19.1	18.4	14.2	7.6	-7.2
New Loans (RMB bn, y/y chg)	3065.7	3634.4	4170.4	9629.0	253.0	294.8	380.0	1399.5	702.0	508.5
M2	16.9	16.7	17.8	27.7	29.5	29.7	27.7	26.1	25.5	22.5
Urban FAI (YTD)	24.5	25.8	26.1	30.5	33.1	32.1	30.5	26.6	26.6	26.4
Retail Sales	13.7	16.8	21.6	15.5	16.2	15.8	17.5	14.0	22.1	18.0
Source: CEIC, National Bureau of Statistics; UOB Estimates. All data for individual months except noted										

- China issued a strong set of 1Q GDP report, with headline growth above expectation at 11.9%. Of more significance, domestic demand accounted for all the expansion in the quarter while external demand weakened, suggesting some rebalancing may have occurred, even without currency adjustment.

- China's growth momentum is likely to continue into 2Q (and into 3Q), which traditionally are stronger parts of the year. While we expect 2Q growth rate to stay in double digit, second half growth could slow due to base comparisons. We maintain our projection for China's GDP growth at 9.5% for 2010.

- Interest rate hike may not be an appropriate response at this point, with one consideration being differential with USD interest rate. We expect any interest rate hike to be in tandem with, or after a change of the RMB policy. We still look for PBoC to hike interest rates in 2H10, with 1Y lending rate at 5.85% by end-2010, from 5.31% currently.

- The alternative of reserve requirement ratio could be more attractive and immediate and there is a risk of another 50bps hike, possibly as soon as this evening. We are anticipating another 2 times of RRR increases to 17.50% by end-2Q10, from 16.50% currently.

- RMB outlook remains murky but a one-time reval is a low risk event for now, with higher probability of a band widening and resumption of appreciation in 2H10. Rather than a radical move, "gradual and moderate" is likely to be the key words in the break of the peg. We expect the USD/RMB to gradually rise to 6.77/USD by end-2010.

After Singapore's robust set of 1Q advance estimates yesterday (14 Apr) and the accompanying monetary policy normalization, China this morning issued its own set of 1Q GDP report and remainder of data for Mar that showed growth momentum unabated as the economy continued to recover from the depths of global recession.

China's 1Q10 GDP growth surged 11.9%y/y from 10.7% pace in 4Q09, above consensus forecast of 11.7%. This is the strongest growth rate since 2Q07, and one factor is the low base at the depth of the global recession in early 2009. More importantly, another factor is that there are signs that domestic demand continues to be entrenched, as fixed asset investment rose 26.4%y/y in 1Q vs. 30.5% in 4Q09, while retail sales growth averaging about 18%y/y in 1Q10, vs. 16.5% in 4Q09. In contrast, external demand has actually declined, with trade balance coming in at just US$14.5bn in 1Q10, more than ¾ down from US$62.5bn in 1Q09. According to the stat bureau, capital formation accounts for 6.9%pt and consumption 6.2%pt of the headline growth of 11.9%, with net exports accounting for -1.2%pt. This means that some "rebalancing" may already have occurred -- at least temporarily -- even without adjustment on the RMB.

Inflation risk remains a concern but the outturn for CPI in Mar was below expectation at 2.4%y/y, and producer price index accelerated at 5.9%y/y, suggesting the flow through to consumer prices may be imminent. Nevertheless, inflationary pressures may be more apparent in the second half of the year, as we expect headline figures could hit as much as 5% by end of the year, with food-related prices the key driver. For the full year, we expect China's inflation rate at about 3.9%, vs. target of 3%.

Aside from the fact that China's external balance has contracted in 1Q10, one should also be cautious of the strong y/y readings from external trade data due to the low base in early 2009. China's exports growth in Mar continued with its double-digit streak, expanding 24%y/y, largely in line with the 28% pace in the prior three months. Beyond the strong headline figures, it should be noted however, the average export value of US$105bn in 1Q10 is still some 12% below the monthly average in 2008, the peak year of China's external trade. This means that it is important to watch exports demand in the months ahead to determine the extent of external demand recovery and to assess the possibility on a change in RMB policy.

Implications

With the strong set of 1Q GDP report, China's growth momentum is likely to continue into 2Q (and possibly into 3Q), which traditionally are stronger parts of the year as exports and factory orders accelerate. In addition, policy measures remain supportive of domestic spending, as normalization remains slow and gradual, and likely to only take place in second half. While we expect 2Q growth rate to stay in double digit, the headline figure could decelerate in the second half due to base comparisons. **We maintain our projection for China's GDP growth at 9.5% for 2010, with bias towards the upside.**

While interest rate hikes may appear to be the response after the blockbuster 1Q GDP data and potential inflationary pressures, it is not as straight forward as one might think. This is because RMB's de facto peg with USD essentially limits the ability of PBoC to conduct its interest rate policy. As the Fed continues to hold down its benchmark rate, a widening interest rate differential in favour of China will pressure on the RMB as capital inflows take the yield advantage and potential capital gains. The 2006 China rate hike cycle is one example of interest rate move following the 2005 reval. **This means any interest rate hike is likely to be in tandem with, or after a change on the RMB policy. We still look for PBoC to hike interest rates in 2H10, with 1Y lending rate at 5.85% by end-2010, from 5.31% currently.**

This brings us to the alternative policy tool of liquidity tightening via bill sales and reserve requirement ratios (RRR), which could see another 50bps hike post-1Q GDP report, possibly as soon as this evening. We are anticipating another 2 times of RRR increases to 17.50% by end-2Q10, from 16.50% currently, and to 19.50% by end-2010, or 2%pt above the record high of 17.50% prevailing at the end of the last tightening cycle in second half of 2008.

On the currency front, China has been keeping the market guessing as to when and how much it would move. It is likely that China would resume on its appreciation path soon, while official pronouncements so far have pretty much ruled out a one-off revaluation. With respect to the much-reported March trade deficit, it should be noted that China's trade balances are seasonally weak in early part of the year before picking up in the second half. It is very likely the trade deficit is Mar is likely to reverse into surpluses during the second half, which would put additional pressures on China's FX policy stance. As noted above, trade balance has actually fallen in 1Q this year and that export levels remain below the levels in 2008, thus weakening the argument for a stronger RMB.

Nevertheless, the strong 1Q GDP report has raised pressure on China to make changes to the FX regime. **While a reval cannot be ruled out, we see the probability as relatively low, and the bias is likely towards band widening and a resumption of appreciation from mid-2010.** Rather than a radical move, "gradual and moderate" is likely to be the key words in the break of the peg. Given above, we expect the USD/RMB to gradually rise to 6.77/USD by end-2010, which is close to 1% gain from current level. NDF prices are factoring about 3.2% appreciation for the RMB over next 12 months, vs. peak of 3.3% on 9 Apr.

Key events ahead could provide hints on the RMB policy: IMF/WB/G20 spring meetings (20-25 Apr), US-China Strategic Dialogue (late May), and G20 Summit (late Jun). In addition, IMF's Article IV consultations with China, which have typically occurred in the second half of the year since 2000, may yet be another catalyst for RMB policy change.