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China Stokes Liquidity, Risking 2011 Inflation Spike (Update1)
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(Adds report on GDP skepticism in 10th paragraph.)

By Bloomberg News

Dec. 7 (Bloomberg) -- China's reluctance to allow a stronger exchange rate has hamstrung its efforts to rein in inflation and endangered a campaign to shift the economy toward domestic demand.

The central bank continues to add liquidity, with money supply rising 19 percent in November from a year ago, according to the median estimate of 29 analysts in a Bloomberg News survey before a government release this month. That needs to be curbed to 15 percent to 16 percent to rein in inflation, said Fred Hu, the former Goldman Sachs Group Inc. chief China economist who has founded financial advisory firm Primavera Capital Group.

China has held off executing a series of interest-rate increases in part because that would put pressure on a currency officials have kept down to shelter exports. The strategy will leave inflation accelerating past 4 percent for 2011, a three- year high, according to a separate survey. The cost: diminished consumer spending and narrower margins for domestic industries.

"China is behind the curve" on reining in the monetary measures adopted during the global financial crisis, said Hu, 47, who is based in Beijing and gives talks to Communist Party members on the economy. "Policy makers have been complacent and failed to anticipate the inflationary consequences of the massive stimulus program."

2011 Forecasts

Economists anticipate a 1 percentage point rise in the benchmark one-year lending and deposit rates by the end of next year, according to the medians of 13 forecasts in the Bloomberg survey taken last week. Gross domestic product will rise 9.2 percent in 2011, the median projection shows, compared with the 10 percent gain estimated by the World Bank for 2010.

The PBOC boosted the rates by a quarter point each in October, to 5.56 percent and 2.5 percent, leaving it lagging behind counterparts from Malaysia to Thailand, Taiwan and South Korea in boosting borrowing costs this year.

Inflation will average 4.2 percent in 2011, the survey indicated, little changed from the two-year high of 4.4 percent reached in October. That would leave a negative so-called real rate for deposits, meaning households' purchasing power is eroded by the increases in consumer prices.

"This is like adding fuel to the fire," said Hu, referring to negative real interest rates.

Politburo's Shift

The Communist Party's Politburo, meeting Dec. 3, signaled it plans to tighten monetary policy in the coming year while sustaining a fiscal boost to growth. Officials "will adopt proactive fiscal policies and prudent monetary policies," the state-run Xinhua News Agency said. Policy makers had previously used the term "moderately loose" for the central bank's stance.

A candidate to succeed Premier Wen Jiabao, Li Keqiang, viewed Chinese GDP figures as unreliable, the Telegraph reported, citing a 2007 diplomatic cable that was published by Wikileaks.
Li, then leader in Liaoning province, told the U.S. ambassador at the time that he relied instead on electricity consumption, rail cargo volume and loan disbursement tallies to gauge the local economy, the newspaper reported.

Electricity and new-loan figures have indicated a slowing in China's expansion this quarter, with electricity-production growth moderating to an 8.9 percent pace in October from 13.4 percent in September, according to China Economic Information Net. Credit growth probably eased to 500 billion yuan in November from 587.7 billion in October, according to the median estimate ahead of a release this month.

Move 'Gradually'

The People's Bank of China will raise rates "gradually" as a more aggressive policy would risk unsettling the stock and property markets, PBOC adviser Li Daokui said in a Dec. 3 interview.

While China's officials have faulted the U.S. Federal Reserve's plan to purchase $600 billion of Treasury securities for the risk of a wave of capital flooding into emerging markets and pushing up asset prices, there's little sign yet of a jump in American liquidity.

The U.S. M2 measure rose 3.2 percent in October from a year before. Consumer prices in the U.S., excluding food and fuel, gained 0.6 percent in October from a year before, the least in records going back to 1958.

"If anyone is printing money it is China's central bank, not the U.S.," said Stephen Green, head of research for Greater China at Standard Chartered Plc. in Shanghai. Actual price increases faced by Chinese consumers and businesses are probably even higher than official reports, and pushing up rates now "is the wisest course of action," he said.

Equities Strategy

Slowing growth may itself help damp price pressures, along with diminished credit expansion, said Qu Hongbin, co-head of economic research at HSBC Holdings Plc in Hong Kong. Qu sees just one quarter-point move before the PBOC finishes its job for the duration through 2011.

HSBC analysts said last month investors should sell stocks likely to be more affected by a rate rise, such as banks and developers, and instead buy stocks of higher value-added manufacturers such as makers of precision machinery.

Wal-Mart Stores Inc. and Carrefour SA are among the international companies that may be affected as the government threatens price controls in an effort to rein in food inflation that reached 10 percent in October.

Wal-Mart, Carrefour

The southwestern city of Kunming, has asked five retailers including Bentonville, Arkansas-based Wal-Mart and Paris-based Carrefour to give reasons for planned price increases two days in advance of any alterations, the National Development and Reform Commission's local branch said on its website Dec. 3.

China's non-manufacturing industry, incorporating services, saw input costs outpace prices charged in November, shrinking profit margins, the Federation of Logistics and Purchasing said last week. Consumer confidence is also weakening, with a sentiment index falling for the first time in six quarters, a survey by Nielsen Co. and the Chinese statistics bureau's Economic Monitoring and Analysis Center showed last month.

President Hu Jintao's five-year plan, starting in 2011, is aimed in part at buttressing domestic demand and reducing reliance on exports, which tumbled during the contraction in global trade because of the financial crisis. Domestic consumption has shrunk to about 35 percent of GDP from 45 percent a decade ago, Societe Generale SA has calculated.

Trade Tension

Little of such rebalancing is evident in economists' 2011 forecasts, with China's trade surplus seen at $183 billion next year, according to the median projection. The surplus was $148 billion in the first 10 months of 2010, fueling charges China's currency policy provides a subsidy to its exporters. President Barack Obama said last month that "China spends enormous amounts of money" keeping the yuan undervalued. The nation's foreign-exchange reserves were a record $2.6 trillion in September.

"China can't have its own independent monetary policy" as long as it manages the exchange rate, Federal Reserve Chairman Ben S. Bernanke said in a excerpts of an interview released by CBS Corp.'s "60 minutes" program Dec. 5.

Authorities have let the yuan rise less than 3 percent against the dollar since allowing greater flexibility in June, with the currency at 6.6488 at 10:55 a.m. in Shanghai. It will reach 6.25 by Dec. 31, 2011, the Bloomberg survey indicates.

Investors should bet on yuan gains through six-month non-deliverable forwards because officials will recognize the need for a stronger currency to fight inflation, said Mitul Kotecha, head of global foreign exchange strategy at Credit Agricole CIB in Hong Kong. Forwards are pricing in a yuan rise to about 6.58 against the dollar in six months. Kotecha estimates the currency will rise to 6.43 by the end of June.

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