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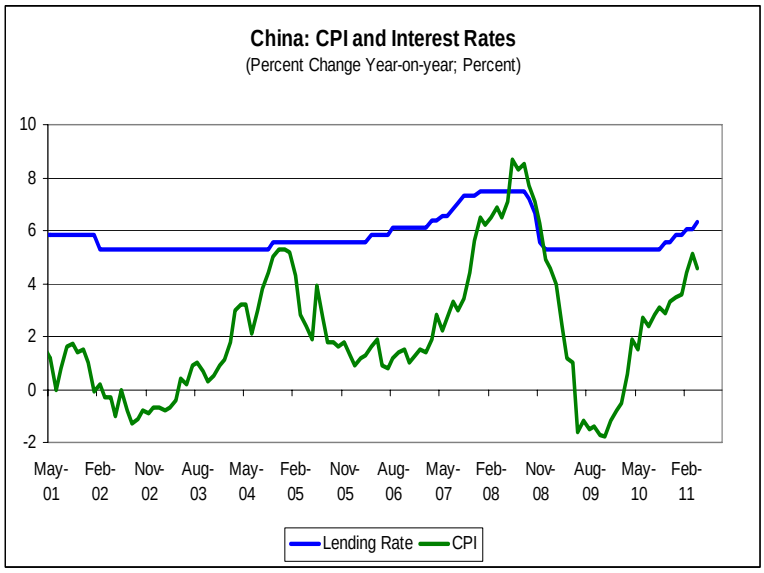
China: Tightening Continues, Pause Likely in Second Half of 2011

Unsurprisingly, the People's Bank of China (PBOC), China's central bank, raised the lending rate by 25 basis points, to 6.31 percent. As we have argued earlier (see our note of March 23rd), policymakers perceive their tightening process as effective, and are likely to test a pause during the second half of the year, when the disappearance of adverse base effects may lead to lower annual rates of inflation.

In the meantime, interest rates will continue to be raised and reserve requirements will be raised further, and attempts to control the flow of new lending—seemingly progressing in the early months of 2011—will proceed.



One or two more interest rate increases are indeed possible before the middle of the year. Tactically, it seems as though the PBOC is engaged in a very determined effort to shape market expectations, announcing rate increases prior to data releases that could indicate inflation-resilience. Thus market participants focus on the tightening efforts rather than on the higher-than-target inflation result.

Meanwhile, the nominal exchange rate remains on its modest up-trend: it has risen 4.4% since June of 2010; a roughly 6% per-year gain appears in the horizon, while the real trade-adjusted exchange rate gains on the basis of substantial wage increases in the export sector. There is no indication that this strategy will change in the near future, as it is consistent with the government's goal to rebalance the economy towards consumption.