THE WALL STREET JOURNAL.
WSJ.com

ASIA NEWS | FEBRUARY 9, 2011

# Inflation Worries Spread

*China Raises Rates Amid Hit to Wheat Crop; Treasury Yields at 9-Month High*

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China's central bank warned before the Lunar New Year break that it would focus on inflation, which has been forecast to top 5% in January. Above, passengers waited for trains Tuesday at a railway station in Jiujiang City in eastern China at the end of the holiday.

Inflation jitters spread through emerging markets on Tuesday, prompting China's central bank to raise interest rates for the third time in four months amid worries that a drought threatening the country's wheat crop will put further pressure on global food prices.

With fireworks still echoing from China's Lunar New Year holiday, its central bank said it is raising rates by one-quarter percentage point. It was just the latest move by an emerging-market government—several of which are deploying a panoply of policies to battle inflation fueled by rising food and commodity prices and growth that is threatening to outstrip their productive capacity.


WSJ's John Shipman reports on how markets might react to China's interest rate hike. Also, indications of optimism by small business groups.

In Brazil, Latin America's largest economy, the government reported Tuesday that inflation is accelerating, leading markets to expect its central bank to increase its overnight rate, already at 11.25%.

Few emerging-market countries have a firm grip on the inflation problem. Just last week, John Lipsky, the International Monetary Fund's No. 2, said many emerging economies are running out of excess capacity "and yet most of them still have in place the expansionary...monetary and budgetary policies." The cure is clear, he said. "Everybody is going to need to tighten monetary policy, reduce budgetary stimulus and continue with the process of structural reforms."

In contrast to emerging markets, inflation in the U.S. remains low—below the Federal Reserve's informal 2% target—despite rising commodity prices. But an improving growth outlook for the U.S. and the risk that rising food and energy

China's latest interest-rate increase to tame inflation is likely to spur stronger Asian currencies. WSJ's Jake Lee and Hong Kong Bureau Chief Peter Stein discuss.

prices will spill over into other goods and services have bond markets pushing up long-term rates and moving up their expectations for a Federal Reserve rate increase. Yields on U.S. Treasurys have been rising, and on Tuesday hit 3.721%, the highest since April.

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Trading in futures markets indicates that the market, listening carefully to the latest words of Fed bank presidents, now puts the odds of a Fed rate increase in December at close to 100%, up from just 25% a week ago. The Fed has been holding short-term rates near zero since December 2008 and hasn't finished a $600 billion bond-buying effort aimed at keeping long-term rates down.

Further central bank rate hikes in emerging markets are widely anticipated. Those expectations—along with a flood of money fleeing low interest rates in the U.S., Europe and Japan—are contributing to upward pressure on emerging-market currencies. Several currencies have rallied to multiyear highs. Authorities in South Korea and Malaysia recently have intervened in foreign-exchange markets to slow the appreciation of their currencies.

Inflation fears intensified Tuesday after the U.N. Food and Agriculture Organization said drought in the five Chinese provinces that account for two-thirds of China's wheat production is endangering this year's crop. U.S. wheat futures surged Tuesday to a fresh 30-month high on fears of further strains on global supplies. The current wheat contract rose 1.8% to $8.7425 a bushel in Chicago, up 81.3% from a year ago.

In Brazil, higher bus fares and food prices boosted inflation in January. The government said Tuesday that its main consumer-price index in January was 5.99% above year-earlier levels, well above the official year-end 2011 target of 4.5%. The data add to pressure on Brazil's central bank to raise rates.

Inflation is up in the U.K. and price acceleration in Europe is now running ahead of central bankers' targets. But in the U.S., inflation remains below the Fed's informal target despite rising food and energy prices, in part because businesses haven't been able to pass along rising costs and because still-high unemployment is holding down wages. While some saw last Friday's Labor Department report that wages spurted 0.4% in January as a danger signal, the Fed and many private forecasters see little risk of a worrisome rise in wages and prices while unemployment remains high.

### Icing Inflation

China raised interest rates in an effort to stem inflation, which has been fueled by growth in its money supply and other factors. Click to enlarge graphic.


Reuters

A supermarket in Hangzhou.

The People's Bank of China said Tuesday evening, as many businesses prepared to open after a weeklong holiday, that it would lift its benchmark lending and deposit rates by 0.25 percentage point. That would bring the one-year yuan lending rate to 6.06% from 5.81%, and the one-year yuan deposit rate to 3% from 2.75%, effective Wednesday.

The rate on deposits remains well below inflation rates, which does little to encourage Chinese households to put their money in banks rather than more speculative investments like real estate. The lending rate is only slightly above anticipated inflation.

The Chinese also have been working hard to limit overall growth of credit in the economy. After expanding at a nearly 30% clip last year, the money supply is now rising at around 19%. While that's slower than last year's peak, the rate has been accelerating lately. The more money flowing in the economy, the more inflation may rise.

Qu Hongbin, co-head of Asian economics research at HSBC, said he expects another quarter-point rate increase in China and "at least" another 1.5 percentage-point increase in bank-reserve requirements—the share of deposits banks set aside and thus cannot lend—by the end of June.

Marc Ostwald, an analyst at London-based Monument Securities, said that while the rate increase may lead to temporary jitters that growth will be slowed in China and other emerging economies, underlying momentum for those economies remains strong. "While equity markets may continue to correct, at some stage it will dawn on many investors that their worst fears for developing-market assets due to policy tightening are not being realized," he said.

So far the tightening hasn't hurt China's growth much. The country's economy grew by 10.3% in 2010, although there are some signs that growth is beginning to slow from recent torrid levels. Credit Suisse estimates that China will grow at a still-impressive 9.2% in 2011, even with further tightening of credit by the central bank.

Shortly before the Lunar New Year break that began last Wednesday, PBOC Gov. Zhou Xiaochuan said the central bank would focus on inflation. In a Jan. 30 interview, he noted that while the pace of Chinese price inflation slowed slightly in December, it was faster than many had forecast.

In recent days, Morgan Stanley and Goldman Sachs economist have warned that China's inflation—4.6% year-over-year in December—was likely to top 5% in January, largely because of rising food and housing prices. Some analysts expect inflation may reach 6% in the first half of 2011, compared to year-earlier levels.



With the government reluctant to allow a sharp increase in the value of its currency, the yuan—which would tend to brake the economy and reduce the price of imported goods and thus dampen inflation—the PBOC relies mainly on two anti-inflationary tools: interest rates and bank reserve requirements. Since the start of last year, China has lifted reserve requirements seven times to a level of 19%. More increases are expected in coming months.

Because China relies less on markets than some other emerging economies, PBOC rate changes tend to have less impact than in other big emerging markets. Some China experts say China's government relies too heavily on its ability to control the banking sector—almost all of which is state-owned.

Interest rates do play an important symbolic role in China. "They are an important signal of the government's intentions but do not have a significant practical effect, especially when inflation-adjusted lending rates are so low," said Eswar Prasad, a China scholar at the Brookings Institution in Washington. That's because much lending is done to large state-owned enterprises, which aren't especially sensitive to changes in interest rates, he said, and small firms can't get much lending from banks anyway.

Despite exhortations from the U.S., Europe, Brazil and others that it let the yuan move higher faster, Chinese officials are reluctant. They worry that too rapid a rise could undermine the country's export sector and be destabilizing. On Wednesday, the central bank set the yuan's reference rate for daily trading at a new high of 6.5850 per dollar. It has now gained more than 3.5% since June—a much slower pace than Washington and others have urged.

—Paulo Prada, Ian Talley and David Wessel contributed to this article.

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