China’s Countermeasures against Imported Inflation, and Economic Forecast

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Outline

- The difference between the inflation nowadays and that in 1993
- Major drivers behind price increases
- China’s countermeasures against imported inflation
- Forecast on China's economy
1. Though China has seen serious inflation during 1993-1995, that inflation was completely different from the one we are facing nowadays. The 1993-1995 inflation resulted from fast economic development reflected by a boost of new industries such as real estate, which resulted in short supply and surging prices of steel, cement and other building materials.

   Short of industrial raw materials is the main reason for the inflation during 1993-1995.

2. The inflation seen in China nowadays is a result of higher prices of agricultural products and imported inflation.

   With world bulk commodities futures at high levels, surging prices of crude oil, iron ore and agricultural products are exerting upward pressure on China’s pricing system through globalization.

   Higher costs have also pushed up prices.
II. Major drivers behind price increases

During Jan-Feb 2011, price increase rate hit a new high, with CPI index up by 4.9%, a growth of 2.8 percentage points on year, and 0.9 percentage point higher than the expected 4% of the year. Meanwhile, the PPI index rose by 6.9%, a higher rate than previous estimation. It indicates that prices in 2011 will be driven up further by various reasons.

1. Imported inflation is growing
   - Ever since the start of 2011, there have been a series of issues enlarging the impact from imported inflation on China. For example, the turmoil in Middle East is pushing crude oil and gold prices sky high, while the earthquake and tsunami in Japan have brought expectations of higher building material prices. During Jan-Feb, China saw average import price for crude oil up by 19.4% on year, reaching $663/ton, with that for iron sand up by 62.2% on year, reaching $154/ton.
II. Major drivers behind price increases

Global agricultural products’ prices are hiking due to natural disasters around the world. According to latest statistics of the World Bank, global food prices in Jan 2011 rose by 15% from Oct 2010, and by 29% on year, close to the record high seen in 2008 when the world was in a “food crisis”. China’s domestic food prices also surged as a result.

II. Major drivers behind price increases

2. Agricultural products’ prices are rising

Recent hikes of agricultural products are a result of both limited availability and rising costs. From a long-term perspective, it’s inevitable for agricultural products’ prices to rise due to the following reasons:

(i) Higher Rural Labor Costs: With many young workers leaving rural areas for urban areas in recent years, agriculture is seeing labor drain in many areas. In 2010, the average salary of rural migrant workers rose by around 20%, twice of the GDP growth rate.
II. Major drivers behind price increases

- (ii) Higher Production Costs: According to statistics, current fertilizer prices in most areas are 10-20% higher as compared with those of the same period last year. Higher cost pressure pushed agricultural product prices up.

- (iii) Higher Rent of Farmland: Farmland rents have been rising in line with the rocketing real estate values, thus adding more cost pressure on agricultural production.

- (iv) The Necessity of Increasing Farmers’ Income: Nowadays, the Chinese government has been constantly raising the minimum acquisition price of agricultural products and providing subsidiary to farmers. It is part of the state policy to allow reasonable increases in agricultural product prices so as to motivate farmers to engage in agricultural production.

II. Major drivers behind price increases

CPI and Food Prices during 2001-2010

![Graph showing CPI and Food Prices from 2001 to 2010]
II. Major drivers behind price increases

3 Monetary basis: Quantitative Easing Policies

Taking a look at global financial market, the excess liquidity, caused by QE policies adopted by developed countries, is driving the inflation in developing countries, and its impact is not likely to wear out in the near future thanks to greatly boosted money supply.

As for domestic money supply in China, with deposit reserve ratio rising to an all-time high of 20%, there is still ample money supply in China in spite of huge expansion in bank loans. The changes in currency structure allowed prices to hike. The proportion of civilians’ current deposit in the total deposit amount has been rising in recent years, from 53.5% in Jan 2006 to 63.6% in Jan 2008, and 62.1% in Jan 2010, and then hitting a historic high record of 66.2% in Nov 2010. Such an momentum is attributed to expectations of higher inflation, and it in turn helps to push prices higher. According to the target set in the 12th Five-Year Plan, civilians’ income should grow at the same rate of GDP increase, which indicates that the government will face greater pressure from rising CPI.
II. Major drivers behind price increases

4. Costs

- China’s economy development is facing grave pressure from high costs. Demographic dividend is replaced by labor shortage, thus resulting in high labor costs, while limited land availability has pushed real estate values up. As China carries on with the reform of income distribution system, the salaries of low-income population will surely grow higher. As a result, cost-driven price increases will continue for a relatively long period.

II. Major drivers behind price increases

In 2010, an average 22.8% wage increase was implemented in 30 provinces of China, and the state will continue to raise the minimum wage standard and establish systems of regular wage increase. It is stipulated in the 12th Five-Year Plan that to ease the pressure from cost-driven inflation, enterprises should resort to innovation and technology advancement rather than lower labor and estate costs.
II. Major drivers behind price increases

5. Inflation Expectation

Inflation expectation has played an important role in recent inflation. It generally does more harm than inflation itself, for it sends inflation spiraling up by changing consuming and investing behaviors. Inflation expectation will strengthen and enlarge the pressure on inflation, while price hikes will lead to further inflation expectations, thus increasing pressure of inflation. Such role of inflation expectation is fully reflected in the buy-panic in 1988 and the surge in stock and real estate market in 2007.

6. No Clear Signs of Real Estate Cool-down

Despite a handful of regulations implemented by the state government to curb the speculation in real estate market, such as higher down payments and interest rates, there is no clear sign that the real estate market is cooling down. Statistics show that, in February 2011, only one city out of 70 medium- and large-size cities saw house prices down on year, and only 3 saw second-hand house prices down on year, while prices in other cities continued to firm up.
II. Major drivers behind price increases

- Rigid demand for house and faster currency liquidity are the major drivers behind high-level estate prices. Meanwhile, huge amounts of foreign investment has also boosted the confidence of real estate developers. During Jan-Feb 2011, China’s real estate industry utilized 8.6 billion yuan of foreign investment, up by 61.5% on year and accounting for 48.3% of the total foreign investment utilized in China. With housing prices weighting more this year in China’s CPI basket, price control is facing greater difficulty.

III. China’s countermeasures against imported inflation

1. To Ensure Demand-supply Balance of Agricultural Products and Stabilize Food Prices

- China has always been self-dependent in food supply, and its food output has been rising for 7 successive years. There should be no difficulty for China to maintain stable food prices as long as we can effectively control food export, breeding and planting, stocking and farm land allocation. According to the data issued by the Ministry of Agriculture, in 2011, the planned planted area of grains, cotton and vegetables will increase by 1.2%, 5.4% and 1.9% respectively. More supply of major agricultural products will help to stabilize food prices.

- Meanwhile, the state government has also imposed responsibility on provincial and municipal governors with regard of food supply, which is of great significance to stabilizing food prices.
III. China’s countermeasures against imported inflation

2. To Increase Overseas Acquisition, and Search for More Pricing Power on International Resources

Since China depends more and more on imported energy, raw materials and certain agricultural products, China should take multiple measures to curtail imported inflation, including: (1) to take more control on production and pricing of important resources such as crude oil and iron ore, through acquisition and direct investment; (2) to strengthen the coordination among domestic enterprises so as to increase their collective influence in pricing; (3) to take an active role in establishing an international pricing system.

3. To Reduce Consumption of Fossil-based Energies by Developing New Industries

To weaken the impact of imported inflation and maintain the momentum of economy development, China should encourage the use of clean energies and accelerate R&D of energy utilization technologies and new materials, meanwhile developing new industries with high energy efficiency and low emission. In the long term, rising crude oil costs will accelerate industry restructure and reduce carbon emission in a world scope, thus bringing about a new round of industrial revolution.
III. China’s countermeasures against imported inflation

The 12th Five-Year Plan proposes to raise the proportion of non-fossil energies in primary energy consumption to 11.4%, to cut energy consumption per unit of GDP and CO₂ emission by 16% and 17% respectively, and to reduce the emission of principal pollutant by 8%-10%. To reach those targets, China should make great efforts to develop new industries and explore green energies and promote the upgrading and optimization of industrial structure, thus becoming less dependent on fossil-based energies.

III. China’s countermeasures against imported inflation

4. To Accelerate RMB Internationalization

Currently the global political environment is favorable to the process of RMB internationalization, which will provide China with the right to issue and adjust a world currency, thus reducing the negative impact on RMB from world monetary system and preventing RMB from passive appreciation. Stable exchange rate will help to stabilize commodity prices in domestic market, while PPI will also be stable on lower risks of enterprises when foreign trade and investment are settled in RMB.
III. China’s countermeasures against imported inflation

5. To Provide More Economically Affordable Houses

It is a more urgent and effective measure for the government to provide more small- and mid-size affordable houses rather than limit purchasing, for it is the rigid demand for house that is supporting the surge in real estate prices. Real estate developers’ profit margins should be restricted at around 10% in order to make houses more affordable.

IV. Forecast on China Economy

1. 9.2% GDP Increase in H1 and 9.5% throughout 2011

Global: In 2011, major developed economic entities will see better performance than in 2010, although they will stick to easing monetary policies given high unemployment and public debt. On the other hand, emerging economy entities will maintain fast growth and adopt tight monetary policies under inflation pressure. The progressive global economic recovery provides a favorable environment for economic growth of China.

Domestic: Economy is expected to see moderate growth during the 12th Five-Year Plan period given the necessity of curbing housing prices, increasing civilian’s income and reducing emission. In 2011, economic growth in China is expected to see an uptrend, with a GDP increase at 9.2% in H1, and 9.5% for the whole year, 0.7 percentage point lower on year, but such growth will be characterized by better quality and stronger coordination.
IV. Forecast on China Economy

2. Industry Will See Stable-to-fast Growth

China’s industry saw faster growth during Jan-Feb 2011, and is expected to maintain the momentum in the next few months. Behind the speed-up are three major factors. The first is fast development of high value-added industries, including equipment manufacturing and e-communication. The second is the increase of new order-intakes. Despite a slight decrease in PMI recently, new order index has picked up to 54.3% in Feb, 0.5 percentage point higher than PPI. In Jan-Feb, China’s shipping industry has received 8.26 million tonnages of new orders, an 44.3% increase on year. And the third is the ongoing strength in prices for industrial raw materials.

IV. Forecast on China Economy

Negative Influences on Industrial Growth

1. The growth of industries with high energy consumption will be restrained. Though the enforcement on energy consumption and emission reduction softened a bit in early 2011, further expansion of industries with high energy consumption will continue be restricted.

2. Tightening monetary policies will pose challenges to financing. By 18 Mar, the state government had raised deposit reserve ratio for three times since 1 Jan, with the rate of major banks raised to a historic high 20%. In Feb, the growth rate of loans in RMB fell to 16%, 3.3 percentage points lower on year. With liquidity of funds slowing down, industrial growth will be affected.

3. Slower export growth will lead to slower industrial development. During Jan-Feb 2011, China’s industry export delivery value of industrial enterprises increased by 20.2%, 2.3 percentage point lower on year.

In H1 2011, IAV of enterprises above designated size is expected to increase by 13.8%, with light industries and heavy industries seeing increases of 13.4% and 14.7% respectively. Heavy industries will continue to see faster growth than light industries.
IV. Forecast on China Economy

3. Import Will Continue to Grow Faster than Export, with Trade Surplus Shrinking

- China will continue to pursue a balance between import and export. By early March 2011, China had seen constant deficit in foreign trading. Chen Deming, China’s Minister of Commerce estimates that the proportion of trade surplus in GDP will continue to fall from last year’s 3.1%, indicating that import and export of China are getting more balanced.
- Forces behind foreign trade growth: 1. Stable international trade. According to IMF, in 2011 global trade will grow by 7.1%. 2. Economic growth in major trade partners is faster than expected. For example, FED has adjusted the expected economic growth rate in 2011 upwards to 3.4%-3.9%. 3. Reconstruction in Japan will boost China’s export to and investment in Japan. 4. Under the guidance of “stable export, more import, smaller trade surplus”, import plans of mechanical and electrical products will help to increase the import volume of related products.

Factors That Curb Foreign Trade Growth:

1. RMB appreciation that has weakened the competitiveness of Chinese products in world market. 2. High prices of global bulk commodities that have raised costs of Chinese products. 3. Trading barriers overseas. 4. Rising labor costs and financing costs in China.

To conclude, in H1 2011 China will continue to see import growing faster than export, with growth rates at around 28% and 20% respectively. Cumulative surplus will amount to $14.4 billion, down by $40 billion on year.
IV. Forecast on China Economy

4. Prices Surged Higher than Expected and Is Expected to Reach a Year High in H1 2011

- Chinese government takes on price and inflation control as its major task in 2011, and it has turned out a necessity to carry on countermeasure of inflation given the price trend in Jan-Feb and unexpected events around the world.

Forces behind price surge:

1. Agricultural products will remain in an uptrend. Food prices have been rising for two successive months, on both a monthly basis and a yearly basis, and they account for more than 65% in CPI, playing a key role in the overall price hike. 2. Rising bulk commodity prices have received much upward pressure from imported inflation, conflicts in North Africa, earthquake and nuclear crisis in Japan and easing monetary policy adopted by the US. 3. The carryover effect in H1 will be strong. 4. Fast increases in industrial producer prices will also pass on some strength.

Measures to Curb Price Surge

(i) The state government, as well as many local governments, has settled the targeted CPI increase rate at 4% for 2011. It has also laid greater responsibility on local governments with regard of food supply. (ii) In 2011 the planned planted area of grains, cotton and vegetables will expand to help stabilize food prices. (iii) National Development and Reform Commission has imposed strict restriction on the price increase of commodity houses. (iv) Loan tightening. In Feb 2011, bank loans increased by 535.6 billion yuan, much less than the 1,040 billion in Jan. The y-o-y increase rate of broad money M2 fell to 15.7%, the lowest since Dec 2008 and lower than the targeted 16% in 2011.

To summarize, the overall price increase rate in H1 2011 will be higher than that in H2. The CPI increase is estimated at 5% in Q1 and at 5.3% in Q2. The CPI increase is estimated at 5.1% in H1, and at 4.5% for the whole year.
Thank you