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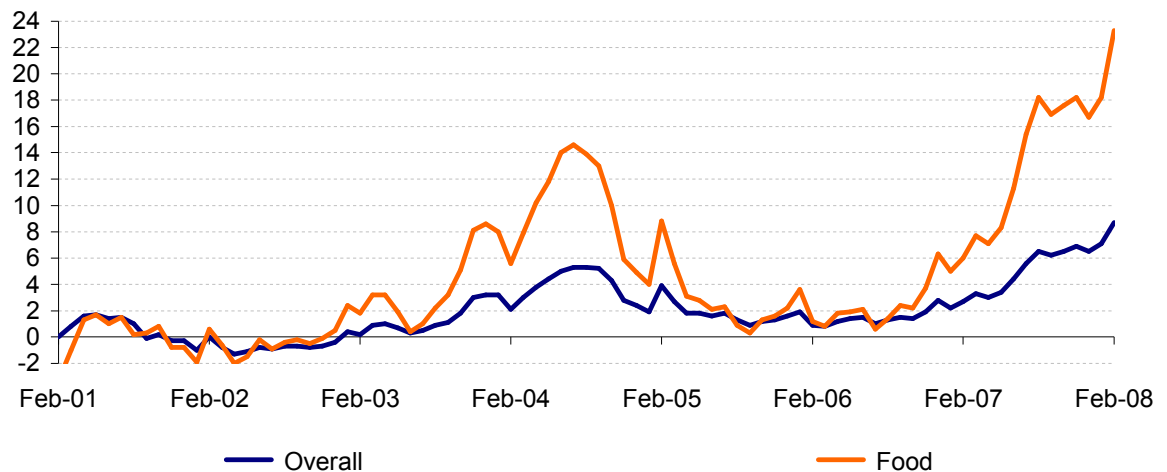
China's ominous winter inflation

WE SUGGEST: Base effect of winter jump means tightening is more urgent

SUMMARY: The Chinese economy is already overheating. On LSR estimates, there is a substantial positive output gap. With food inflation already rampant, the severe winter storms in February were the last thing the authorities needed. It is not only that the February number (8.7%) itself was bad, but also that it sets a high base for inflation throughout the rest of 2008.

Chinese inflation jumped to 8.7% from 7.1% in the year to January, up 2.6% in the month and the highest twelve-month rate since August 1996. The rise was not unexpected. China was battered by severe winter storms in February, which added to the difficulties in distributing food, pushing up already rampant food inflation. In addition, the Lunar New Year always throws early year data around. According to the National Bureau of Statistics, the effect of the New Year and the storms accounted for 2.56 percentage points of the twelve-month total. Moreover, food accounts for between 35% and 40% of the total CPI. Excluding food, therefore, other prices changed in a range from +0.5% to -0.5% in the year to February.

Chinese inflation, 12-month change, %



But excluding food from any measure of consumer prices is debatable at best. In the case of China it is patently ridiculous. With a weight between 35% and 40%, food is obviously not only **one**, but **the** core item. One might as well exclude any item that rises above the desired target.

But if not unexpected, the rise was still ominous. In the first two months of the year, consumer prices have risen by 3.8%. This provides a very elevated base for the rest of year, well after February storms are forgotten. To take but one example: the average monthly increase in inflation over the past 12 months has been around 0.7%. Assuming

that the monthly rate would revert to this average would still take the twelve-month rate above 9% by March and above 9.5% by April.

Things may not go quite so badly. The Chinese authorities are (obviously!) aware of the economic and not least also social and political costs of rapid inflation. The current session of the National People's Congress has adopted a 4.8% inflation target for 2008. Last year's repeated increases in interest rates and in the central bank's reserve requirements ratio are likely to be continued in 2008. The government has also released part of the strategic pork reserve in order to bring down pork prices, which are one of the main causes of higher food prices (pork is almost as much a staple of Chinese food as rice or noodles). However, in order to get headline inflation back to 4.8% in the year to December (which is a lesser target than an annual average of 4.8%), the monthly change would have to average 0.2%. This is not impossible – but it would entail a severe slamming on the brakes as far as activity is concerned.

Part of the problem for the authorities is that while a stronger yuan would have a benign effect on some prices, eg commodities, it would be less effective against high food prices. Close to 30% of Chinese imports are non-food raw material (13.2% oil etc and 15.2% non-oil). By contrast, food imports are only 1.3% of the total. So while letting the yuan appreciate would raise Chinese households' overall purchasing power, food inflation would only be affected indirectly.

In addition, much as the Chinese authorities are trying to cool down an overheating economy, they are also acutely aware of the problems with slowing activity too fast or too much. It is impossible to know whether they will err on the side of caution or of boldness. But with inflation still accelerating, it does look as if both growth and inflation will overshoot the latest targets (4.8% for inflation, see above, and 8% for growth). Unless the Chinese economy comes to a very rapid halt, monetary policy is likely to remain tight until the end of the year. This also means continued yuan appreciation.

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