China Views

May 14, 2008

GAO HUA ECONOMIC WEBSITE
Economic Research from the Gao Hua Portal
at **https://portal.ghsl.cn**

Hong Liang
hong.liang@gs.com

852 2978 1941

Thoughts on China's macro outlook after the earthquake

1. The severe earthquake in Sichuan earlier this week has resulted in a massive loss of lives and properties in the affected areas. Our thoughts go out to the thousands of people who have lost dearly in this natural disaster, and to those who are working hard in the rescue mission.

2. No doubt that a severe natural disaster of this magnitude will likely have a negative impact on the real economy, but the impact is likely to be limited and short-lived. Sichuan province constitutes about 4% of national GDP, and the heavily-damaged counties are mostly in the remote mountain areas. Therefore, the earthquake-induced short-term loss of production is likely to be very limited. There could be renewed pressures on food inflation because of Sichuan's relative importance in agricultural production and the damage to the transportation system. But these inflation pressures tend to be short-lived spikes if monetary policy does not accommodate them.

3. There will clearly be added demand for investment when the affected areas rebuild their damaged homes and infrastructure from highways to power plants. **However, supporting reconstruction investment in a few counties in Sichuan does not imply China should ease its macro policy for the broad economy**. To the contrary, macro policies will likely keep its tightening stance given the elevated and persistent inflation pressures.

4. In our view, macro stability has been one of the key factors behind China's rapid and sustained growth. With both the CPI and PPI above 8%, GDP deflator and the central bank's corporate price index above 10%, and a looming energy price crisis, we believe the central bank does not have room to "trade off" inflation for growth any more. The central bank also clearly sees inflation as the major macro risk this year, as evident by their immediate hike in the reserve requirement ratio right after the release of April CPI.

5. Therefore, we believe expectations of a policy easing on the back of the severe earthquake are misplaced, as similar expectations were disappointed after the severe snow storm in late-January. While more investment will surely go to rebuild the earthquake-affected areas, we believe the broad macro policy stance will continue to be preoccupied by the task of controlling inflation in the near term. Consequently, we see monetary policy will likely remain tightened by frequent reserve requirement ratio hikes, stringent controls on bank lending, an appreciating CNY, and two more 27-bp interest rate hikes.