Chinese earthquake threatens wider economic dislocation

John Chan
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There was a sense of relief in international financial circles after it became clear that the destruction from China's earthquake on May 12 was confined largely to the mountainous areas of Sichuan province, leaving the country's major industrial centres untouched.

The *Financial Times* wrote on May 20: "Despite the huge loss of life, economists expect the overall impact on the economy to be relatively small, in large part because the stricken area is one of the nation's poorest." Other commentators pointed to the geographical limitations of the quake as compared to the snow storms earlier this year that paralysed the national transport system and affected the coastal industrial regions.

Statistically, Sichuan only accounts for 2.5 percent of China's manufacturing output and 4.2 percent of its gross domestic product (GDP). Economists estimate that production losses in Sichuan will result in a fall of 0.2 percent in economic growth this year. China's stock markets have barely reacted to the calamity.

The earthquake has exposed the gulf between the country's economically developed south and east, and backward inland regions such as Sichuan province where infrastructure is poor and industry limited. Even within Sichuan, there is a disparity between major urban areas that emerged relatively unscathed and the rural towns and villages near the epicentre that were devastated.

The economic impact, however, may be greater than first appeared. Sichuan is no longer an isolated region but is a component of an increasingly integrated Chinese economy with its innumerable ties to global production processes.

China's leading financial magazine, *Caijing*, warned on May 16 that the disruption of food production in Sichuan may further fuel inflation, which is already at an 11-year high. Other inflationary pressures include "a potential shortage of certain natural resources and industrial labour, since Sichuan is a major provider of each. Some analysts point to upward price pressure for building materials that will be needed for post-disaster reconstruction."

Sichuan is one of China's largest sources of cheap labour, providing 20 million migrant workers to other parts of the country. If they return home to work on the reconstruction effort, it will exacerbate labour shortages in coastal areas and increase the pressure for wage rises.

Sichuan is also one of China's main "food baskets", producing 11.6 percent of the country's pork, 7.32 percent of rice, 4.2 percent of wheat and 8 percent of cooking oil. Although the areas hit by the earthquake only account for a small portion of agricultural production, the disruption to transport and fertiliser output, and damage to the irrigation system will affect output and food prices.

China's Consumer Price Index rose by more than 8 percent in April on a year-on-year basis, with pork prices jumping 68.3 percent, cooking oil 46.6 percent and vegetables 13.6 percent. Beijing is concerned that the rising cost of living will provoke social and political unrest.

Caijing reported on May 19 that local governments in the quake areas had imposed price controls on basic necessities to try to stem hoarding, speculation and panic buying. Lehman Brothers analyst Sun Mingchun warned in a recent report that the Sichuan earthquake could "exacerbate panic on rice supply problems, given recent shortages in the global rice market".

Concern about the impact of the Sichuan disaster is contributing to rising commodity prices. Crude oil prices in New York exceeded $130 per barrel last week, partly due to concerns that China, the world's second largest consumer of oil, will need more energy for Sichuan's reconstruction, further tightening the global supply.

Sichuan and other quake-hit provinces such as Gansu are major sources of minerals. Around 11 percent of China's zinc production has been shut for safety concerns, pushing up the international price for zinc. Coal production has stopped in Sichuan, adding to the pressure on energy supplies. The province produced 95.6 million tonnes of coal last year.

The impact of post-quake reconstruction is yet to be felt. The *Bloomberg* website on May 19 pointed out: "Rising building demand in China and higher costs have already driven up commodities prices. The average domestic price of rebar steel, used in construction, is up 55 percent in the past year, and global copper prices reached a record this year."

The Chinese government has mounted a carefully managed campaign involving top leaders to demonstrate its concern for the welfare of survivors. Last week, an unprecedented threeday national mourning period was held for the victims. Beijing is also seeking to demonstrate to international financial circles that it is capable of responding rapidly and efficiently to any dislocation in production.

Property losses from the earthquake are estimated at $20 billion, including $9.6 billion to businesses. The transport ministry reported that road damage in Sichuan amounted to 15 billion yuan, which could hamper economic activity and tollway operators. The Agricultural Bank of China reported 8.5 billion yuan losses related to loans to businesses in power, manufacturing and real estate. Far higher economic losses will result from lost industrial production.

The *Washington Post* on May 19 cited the example of Shifang Anda Chemical Co., which exports to the US and Europe. While the plant suffered little damage, the article explained: “Labourers are refusing to return to work until government inspectors sign off on the integrity of the buildings, despite the fact that it might take months or years before they get around to every company.” The chemical factory is just one of a large number of firms in Sichuan where production has halted because of concerns among workers.

Bloomberg listed other cases. French-owned Lafarge SA, the world’s largest cement maker, may need a month to resume operation in its biggest plant in China—in Dujiangyang city, one of the severely-hit areas. Sichuan Changhong Electric Co., China’s second largest television manufacturer, has suspended production in Mianyang, another affected city. Dongfang Electric Co., China’s second largest power-equipment maker, claimed that the quake had damaged factories accounting for one fifth of its sales.

Japan is particularly concerned, because it imports 90 percent of metallic silicon, a material used to make semiconductors and solar cells. Most of the silicon used in the production comes from Aba in Sichuan which was hard hit. The price for the commodity has jumped from the pre-quake level of $US2,300 per tonne to $2,500. Sojitz Corp, a major Japanese trading firm, predicted the price could surge to $3,000 due to shortages.

The Chinese government has organised rapid repairs to vital facilities, such as water and power, primarily to demonstrate its reliability to foreign investors. The country’s largest state energy firm, PetroChina, announced that it had resumed gas production to pre-quake levels last Tuesday. Fuel distribution to the worst-hit areas resumed last week, although authorities had to dip into strategic oil reserves to ensure stable supply. The Electricity Regulatory Commission declared on May 19 that 85 percent of the damaged power facilities had been fixed and 80 percent of power supply in Sichuan restored—although many plants have only days of fuel reserves. Most telecommunication networks are reportedly back in operation.

The Canadian-based *Globe & Mail* enthused last week: “Within hours of the quake, China was able to mobilise its vast human resources and target them at a massive disaster in a remote and forbidding region.... It may have seemed chaotic at first, but a closer look revealed it as an impressive display of China’s economic prowess. China’s modern infrastructure—expressways, bridges, airports, bulldozers, excavators, cranes, trucks and vast fleets of private cars—allowed most of the quake victims to get help within days (even though many villages were bypassed in the early response).”

Edward Ratcliffe, an investment adviser, told Reuters: “Investors should probably come away from the events of the last few days with, the tragedy aside, relatively positive feelings about how the government has responded to the earthquake and how it has marshalled its resources.”

The Chinese government has been actively encouraging investment in the western provinces since 2000, in order to expand the country’s manufacturing base. In 2007, Sichuan attracted more than $2 billion in foreign direct investment (FDI), a small portion of last year’s national total of $74.8 billion non-financial FDI, but 33 percent up on 2006. Sichuan was just the ninth largest provincial contributor to China’s GDP, with an output of 864 billion yuan in 2006, but its growth rate in 2007 was 14 percent—much higher than the national average.

Some eyes are already on the profits to be made from reconstruction. A comment in the *Wall Street Journal* on May 19 declared that the quake could be an opportunity for “our ailing economy” because Beijing would spend billions to rebuild Sichuan. “US exports to China will no doubt increase as a result of the earthquake, but China buying American is nothing new. Indeed, China is our third-largest export market behind Canada and Mexico. Few politicians talk about it, but 406 out of 435 Congressional districts have seen triple-digit export growth to China from 2000-2007,” the newspaper noted.

Citigroup economist Tong Tsang told the *Australian* on May 20 that calls for “quality” buildings in Sichuan will lead to the dominance of large developers, including foreign firms, at the expense of smaller ones. The priority, however, will be commercial projects rather than the public services such as schools and hospitals. Kaven Tsang, a property analyst with Moody’s Investor Service in Hong Kong, bluntly explained: “There is no money in building schools.”

This discussion is taking place largely behind closed doors. But it does demonstrate that the real priorities of government and business are to boost production and profits, not to restore the shattered lives of the estimated 5 million people who have lost their homes, possessions and relatives.