Inflation worsens as China lifts petrol prices

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4 July 2008

In a major shift, the Chinese government raised retail fuel prices by 16-18 percent on June 19. The move will inevitably stoke further inflation and follows similar measures by other Asian countries in recent months. Most analysts were surprised by the move, as they had expected Beijing to lift the oil prices—a politically sensitive decision—only after the Olympic Games in August.

Rising petrol prices have fuelled a wave of protests and riots across the globe. Beijing also is well aware that inflation and deteriorating living standards were a significant factor in large numbers of workers joining protesting students in the demonstrations that were finally crushed by the military in Tiananmen Square in June 1989.

The National Development and Reform Commission (NDRC) announced the decision, declaring: "Due to the sharp spike in international oil prices, some refineries had to be shut down, with queues at petrol stations and rationing re-emerging in some regions. Appropriate increases in fuel prices will help raise supply and promote energy conservation."

Beijing lifted the retail price of petrol by 16.7 percent to 6,980 yuan ($US1,015) a tonne and diesel by 18.1 percent to 6,520 yuan a tonne. The retail price for electricity was raised by an average of 4.7 percent, except in areas hit by the May 12 earthquake and in the impoverished Central Asian province of Xinjiang.

Like most developing Asian countries, China maintains domestic caps on energy prices that are substantially lower than international benchmarks. As a result, the state-owned petroleum corporations and refiners such as PetroChina and Sinopec have incurred huge financial losses, forcing them to scale back or even halt production and imports. Some smaller refiners have gone bankrupt. China had to increase fuel prices by 9-10 percent in November for the same reason.

Jun Ma, a Deutsche Bank economist, commented that "energy shortages had become a bigger threat to stability ahead of the Olympics" than inflation. Shortages of fuel have caused long queues at petrol stations in many cities throughout China in recent weeks, causing concern that the transport sector would be badly disrupted, affecting the whole economy.

The state-controlled petrol price in China is about $0.85 a litre—still well below $1.08 in the US and $2.33 in the UK. Low prices have been an important stimulant for the rapidly expanding auto industry. China is now the world's second largest market of automobiles after the US.

Beijing has come under growing international pressure, especially from Washington, to raise fuel prices. American politicians have blamed the Chinese demand for oil for causing price rises. Last week, 16 Democratic senators, including former presidential candidate Hillary Clinton, sent a letter to the Bush administration demanding action to force Beijing to end its controls on fuel prices. "What Americans see happening at the pump is driven, in part, by what is happening in China," they wrote.

The *Wall Street Journal* warned: "With inflation a growing worry world-wide, the political furore over China's price controls has threatened to supplant the long-standing tussle over its exchange-rate policies as the nation's most contentious international economic issue."

The crude oil futures in New York did fall by 2 percent following China's announced fuel rises. In the long term, however, China's demand for oil is unlikely to slow amid a rapid growth of privately-owned vehicles. China is already the world's second largest consumer and the International Energy Agency estimates it will account one third of the global oil demand growth from 2007 to 2030.

Analysts warn that the increased energy prices will only worsen inflation, which eased to 7.7 percent in May—a slight fall from 8.5 percent in April and a 12-year-high of 8.7 percent in February.

Immediately after the fuel price hikes, the finance ministry announced subsidies of 19.8 billion yuan or $2.9 billion for farmers, taxi drivers and low-income families. Although car ownership is still relatively low, the numbers are growing. Liu Honghui, one driver who had queued in Beijing to fill up petrol, told the *Financial Times* on June 20: "The price increase is high. It doesn't matter for official cars and the rich, but for ordinary people the burden will be much heavier."

Kong Fanshan, a taxi driver in Beijing, told Agence France

Press (AFP) that he could not stop driving, even though the hikes would cut a quarter of his monthly income of 2,000 yuan ($290). He would lose a deposit of 20,000 yuan if he terminated his contract with the taxi company. “Besides, I only know driving. People my age can’t get another job. That’s the case for most taxi drivers,” he said.

Simon Yang, a cosmetic shop owner, said his small business would be affected as he made deliveries to clients. “It’s certainly not reasonable, especially when other prices are so high. Everything will rise following the gas price hike,” he said.

For the majority of the population, the increased petrol prices will translate into higher public transport fares. Credit Suisse First Boston (CSFB) estimated that an increase of 8 percent in public transport costs would add 2.3 percent to the inflation rate in China.

The World Bank sharply revised its inflation forecast for China in 2008 from 4.8 to 7 percent in a recent quarterly assessment. While the “worst of the food price hikes” was over, it stated, China was facing a second wave of inflationary pressures from rising prices for industrial commodities. On June 23, for instance, Anglo-Australian mining giants BHP-Billiton and Rio Tinto forced Chinese steel companies to pay up to 100 percent more for iron ore—a new record high.

The World Bank report rather optimistically predicted a growth rate of 9.8 percent this year, despite the economic slow down in the US and Europe and the closure of many low-end factories in China. It urged the government to increase interest rates and speed up the appreciation of yuan to combat inflation. Although China’s foreign currency reserves have reached $1.76 trillion, the bank dismissed fears that inflation was being fuelled by an oversupply of liquidity.

The Chinese government’s analysis differs. Under the pressure from the Bush administration and the US Congress to reduce China’s huge trade deficit ($256 billion in 2007), Beijing ended the yuan’s peg to the US dollar in 2005 and linked it to a basket of currencies instead. The yuan has gradually appreciated by less than 10 percent against the greenback. Speculative capital has flooded into China in the expectation that the yuan will be further revalued and that interest rates will rise.

In April, Zhu Baoling, the deputy chief of the State Information Centre’s economic forecasting department, estimated that the amount of speculative capital reached $80 billion in the first quarter—compared to $120 billion for the whole of 2007. A new estimate by Zhang Ming, a researcher at the Chinese Academy of Social Sciences, put the cumulative total of “hot money” at a staggering $1.75 trillion for the period from 2003 to March this year—far higher than the previous estimate of $500-$600 billion.

Zhang warned of the dangers of a sudden withdrawal by speculators. “The possibility of a large-scale evacuation like in the Asian financial crisis [in 1997-98] is not very big. But if they think the economic fundamentals will change significantly, the outflow can be huge,” he stated.

The *South China Morning Post* commented on June 16 that it was not just foreign investors who were speculating but state firms and private companies, which “falsify export receipts to move hard currency into the mainland and take advantage of the rising yuan”. At the same time, the rising yuan has hurt export processing industries in the Pearl River and Yangtze River deltas that play a central role in creating the 10-20 million new jobs needed each year.

Tensions between the US and China are rising. During the US-China “Strategic Economic Dialogue” last month, US Treasury Secretary Henry Paulson urged Beijing to abandon its oil price control and further revalue the yuan. Chinese officials fired back that Washington was in no position to demand that China act because of the subprime mortgage mess in the US.

China’s central bank chief Zhou Xiaochuang pointedly told reporters: “China is of course interested in learning from the experience of the United States in macroeconomic regulation and using a market economy, and now we also want to see what lessons we can draw from the experience of the US after the turbulence [of the subprime crisis].” The *New York Times* commented: “Chinese officials seem to be galled by the apparent hypocrisy of Americans telling them what to do while the American economy is at best stagnant.”

While they have been blaming the falling US dollar and subprime crisis for rising commodity prices and other global economic problems, Chinese officials are deeply concerned that economic troubles in the US and Europe—their largest export markets—can quickly impact on the Chinese economy and lead to social and political unrest.