

# **China's Economic Transformation II**

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**International eChem/ICIS**

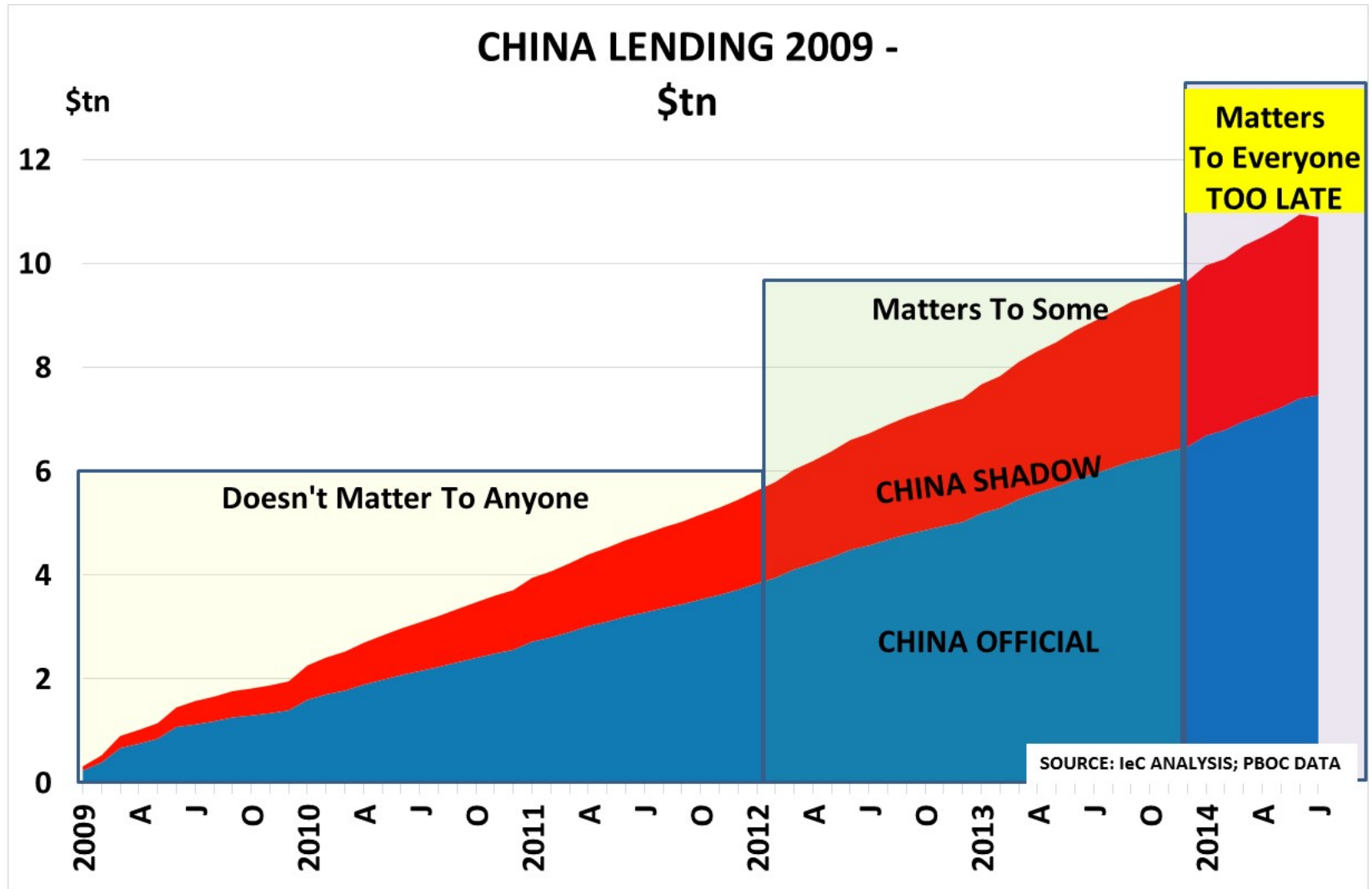
**September 2014**

# Where do we go from here?

- The likely impact on global markets of the unwinding of China's vast stocks of metals, polyethylene and other commodities
- Problems faced by the PTA and polyester industry: Severe oversupply and a collapse of global cotton prices
- The new Chinese leadership's reform drive and what it means for petrochemicals growth
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# China's lending problems have begun to worry the world – too late



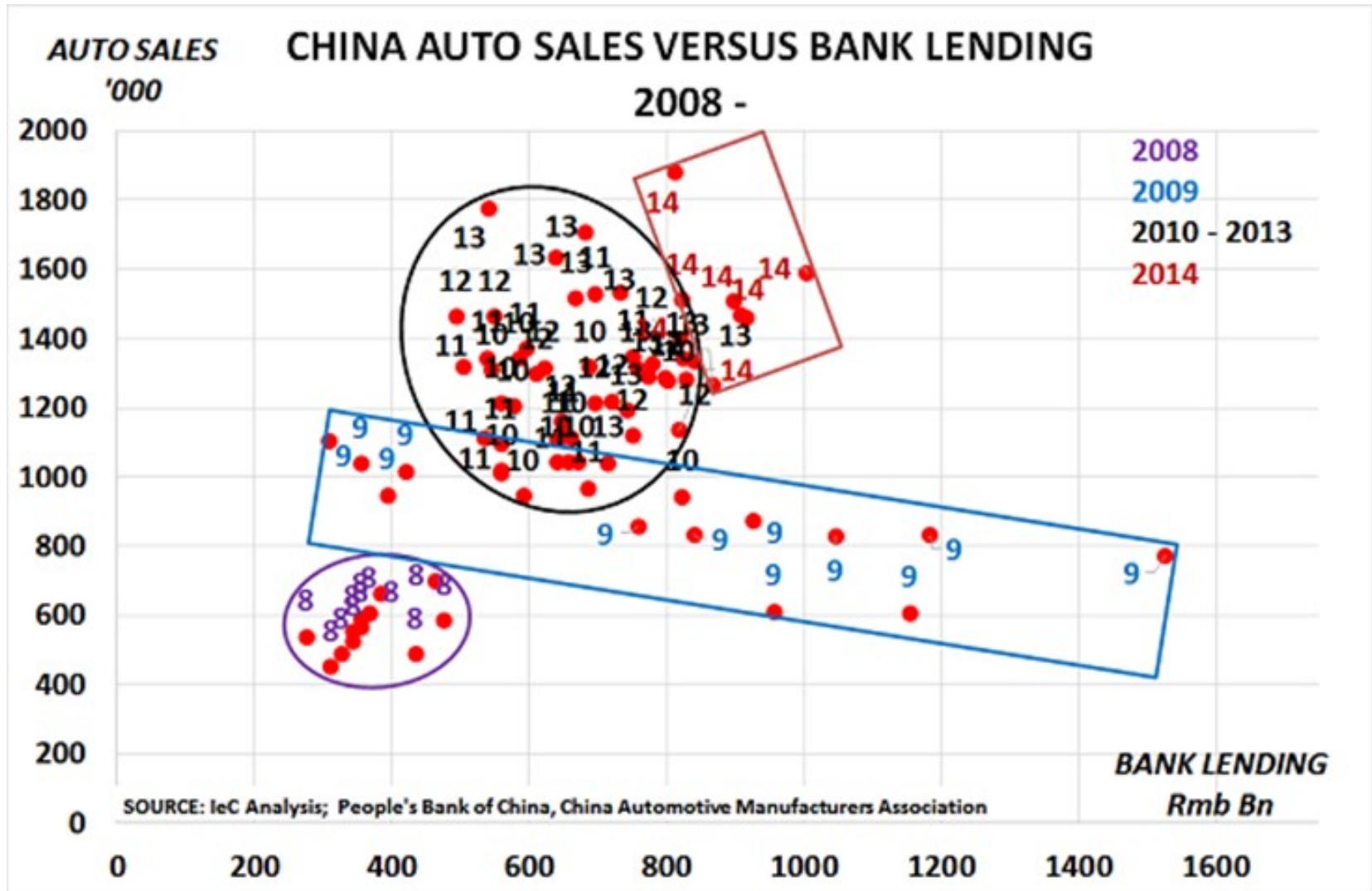
# China's housing bubble has driven GDP growth since stimulus began in 2009

- China's property market is 20% of GDP, and 40% of local government revenue
- The National Reform and Development Commission warned last year that “reckless expansion of cities in China has left many of them empty”
- Much of the funding for developers has come from the shadow banking system and from foreign lenders
- Li Ka-Shing, Asia's richest man, began selling all his Chinese properties last year in anticipation of a major downturn. He now has no investments in the sector

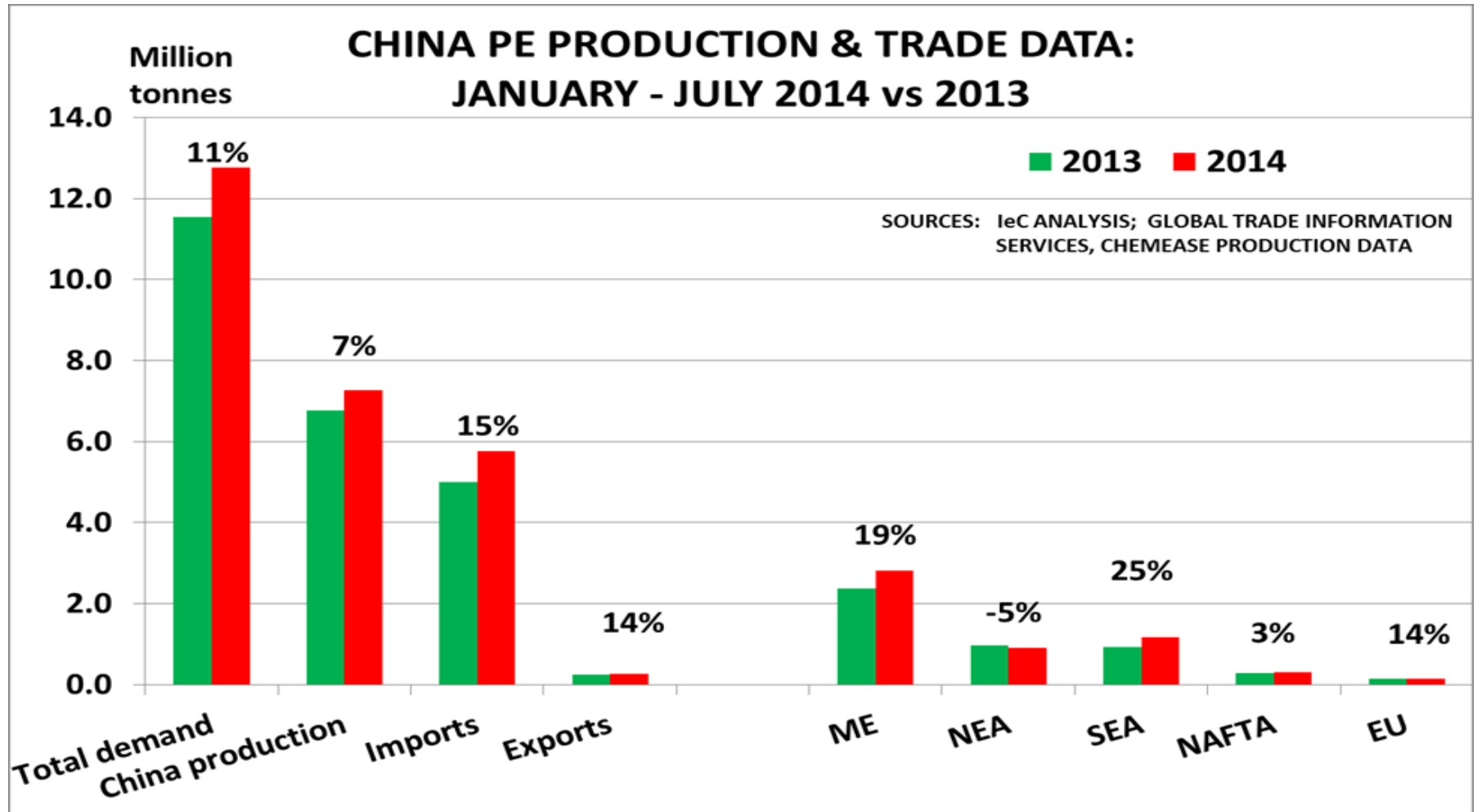


SOURCE: WALL STREET JOURNAL

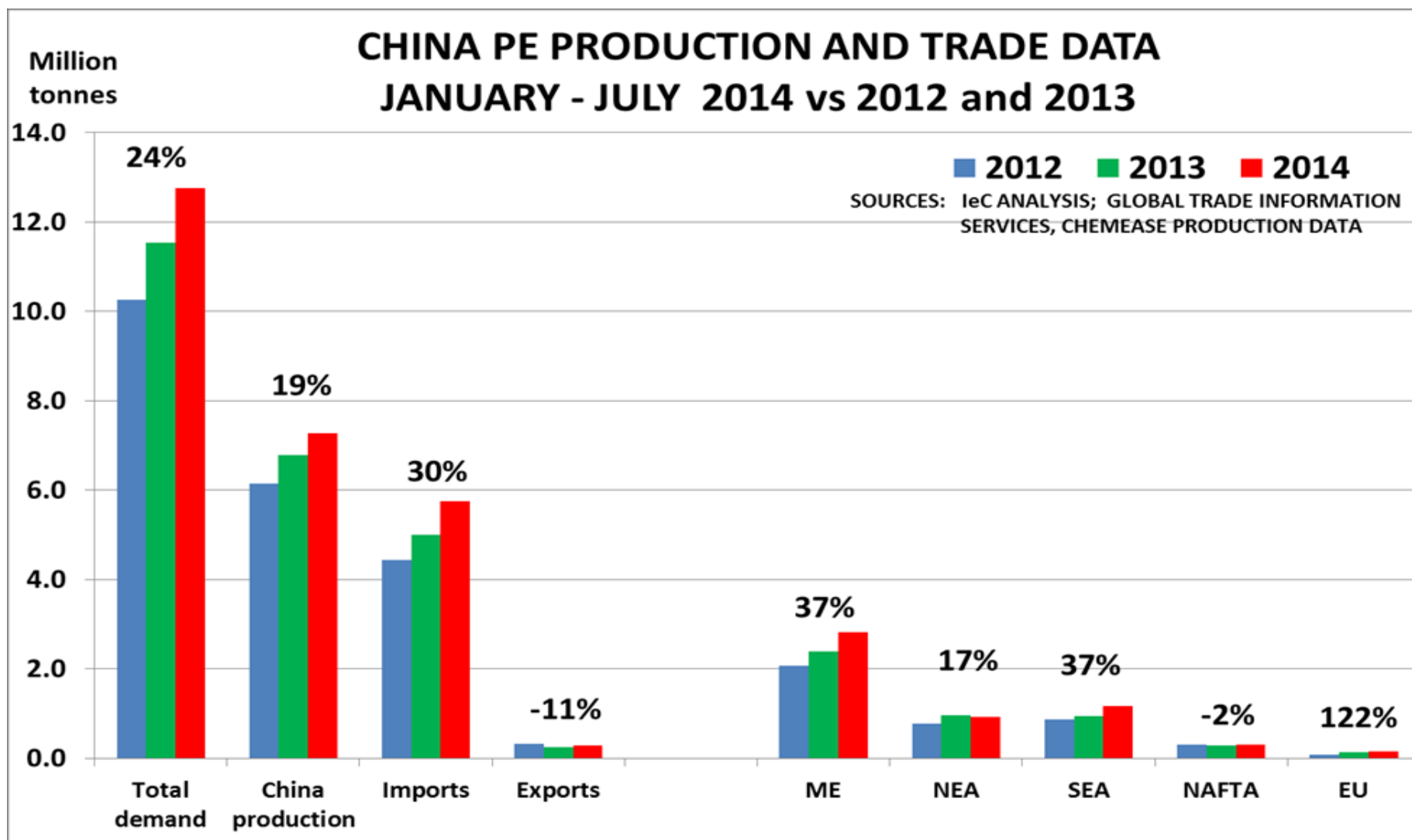
# Auto sales have been driven by the property 'wealth effect', not incomes



# Polyethylene markets tell us something alarming

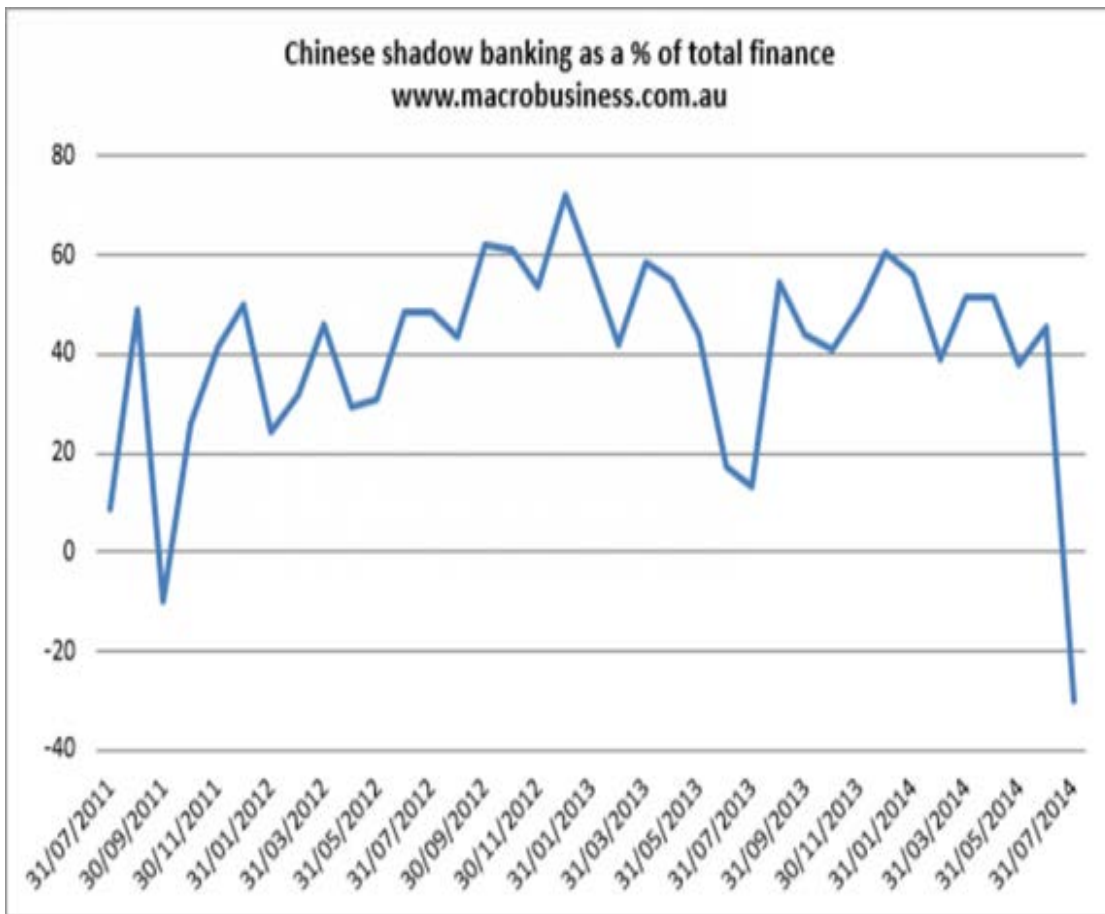


# And compared with 2012!





# The government is clamping down on shadow bank lending

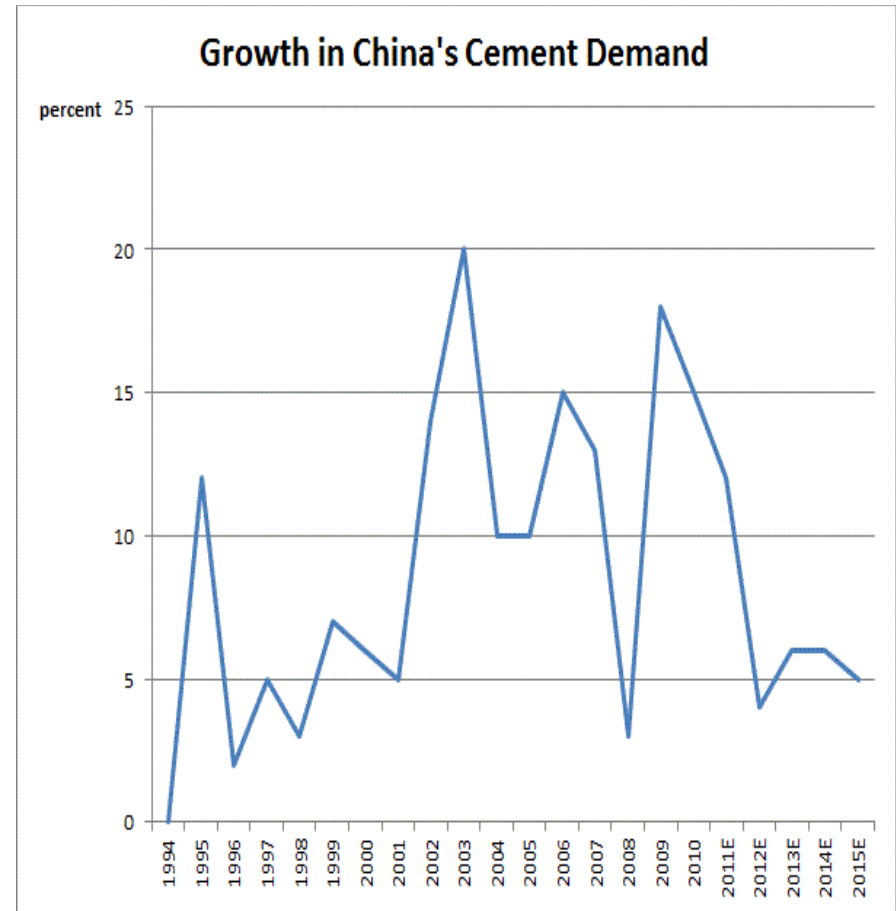


- PE will actually grow by no more than 6% this year compared with year-on-year apparent demand growth of 11% and the 24% increase versus 2012
- This is more evidence of the “end game” as property developers get desperate for shadow financing



# This is definitely the end game because....

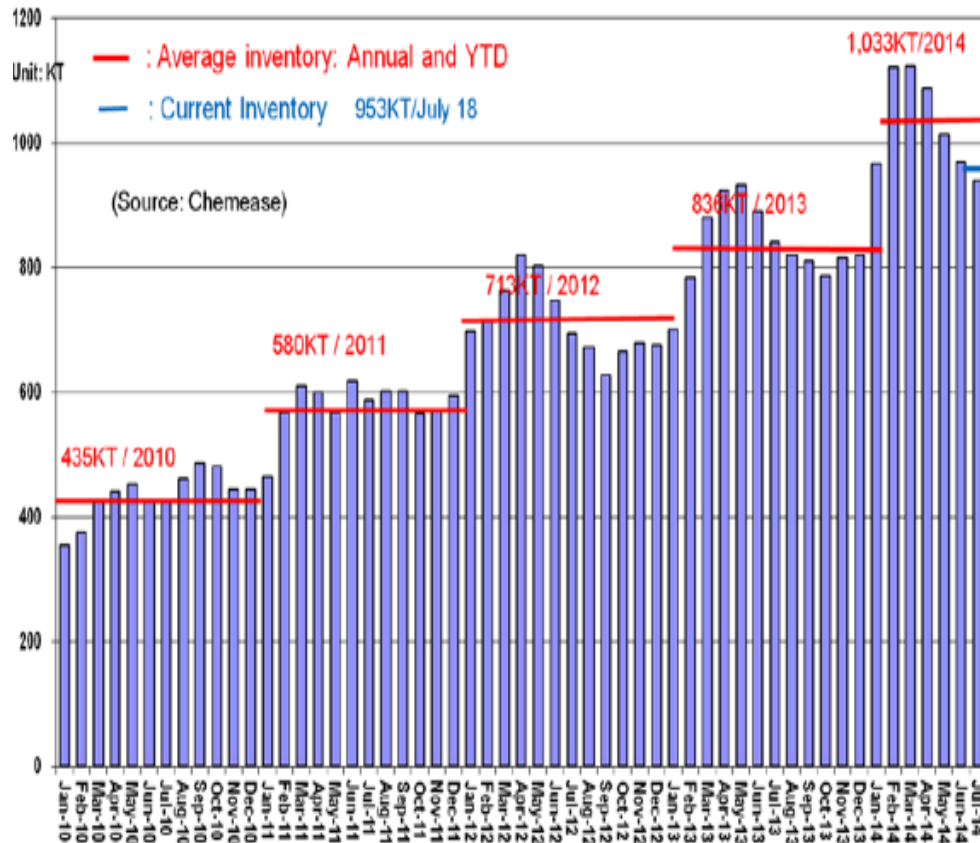
- ...China produced more cement in 2011-2012 than the US did in the whole of the 20<sup>th</sup> century
- ... S&P say China's corporate debt hit **\$14.2tn** in 2013, versus \$13.1tn in the US – with 30% owed to shadow banking sector
- The government estimates:  
2007, \$1 of credit added 83 cents to GDP  
2013, \$1 was only adding 17 cents  
2014, \$1 will add just 10 cents
- Short-term credit for SMEs was cut by Rmb 236bn in July (\$38bn)



# Commodity inventories will begin to unwind

- In polyethylene, MEG and quite possibly in other chemicals and polymers
- China has been buying two-thirds of the world's supply of iron ore, and has been responsible for 40% of global copper market demand.
- Reuters suggests 100 million tonnes of iron ore are currently "off-market" by being tied up in 'collateral trade'. Enough to build 1,200 Empire State buildings

## China coastal MEG Inventories



# Here is how it has worked...

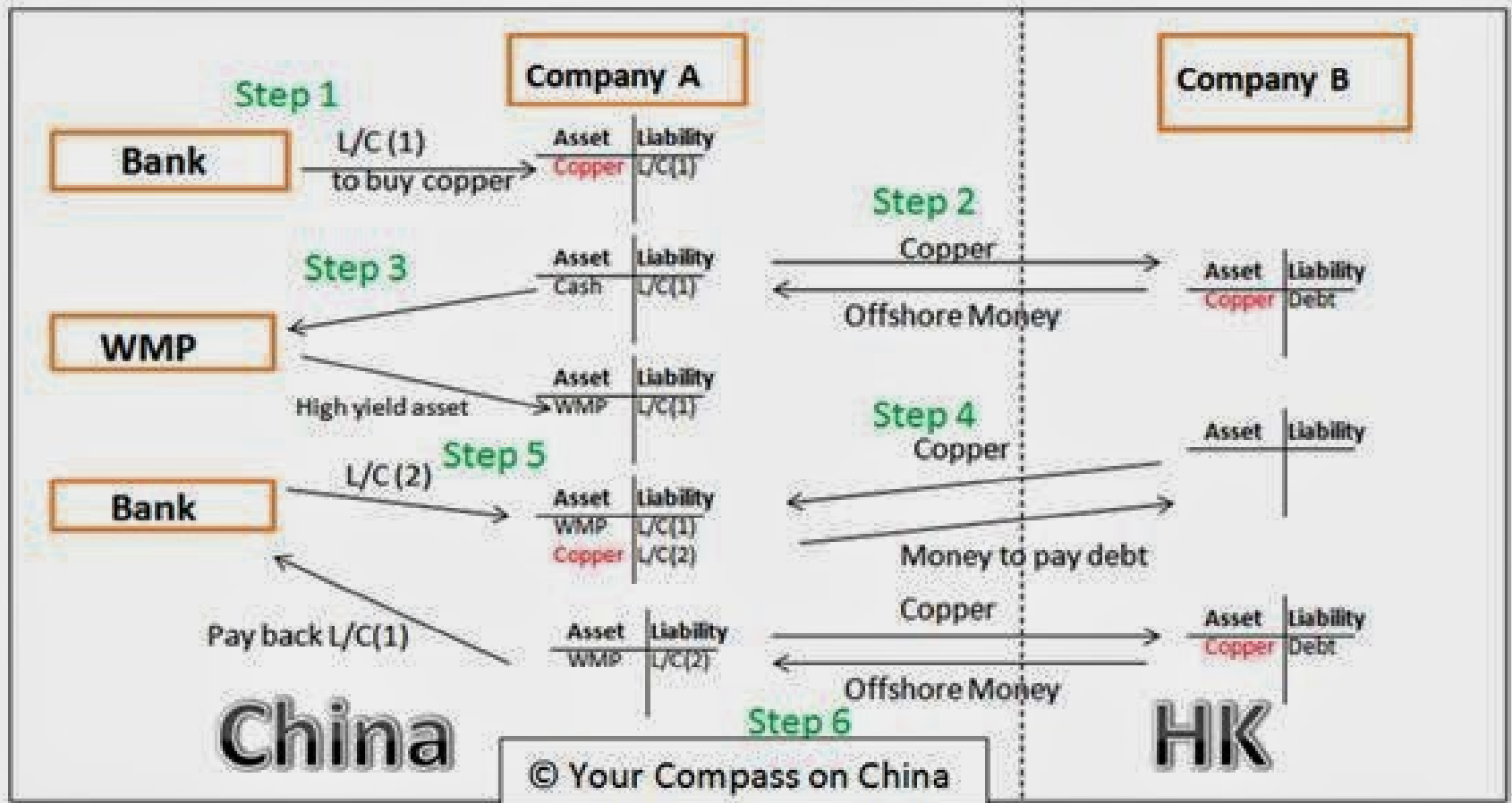
## Scheme A

- A local trader buys an overseas PE cargo using a letter of credit raised with a foreign bank
- He then immediately sells the cargo on the Dalian Commodity Exchange's LLDPE futures contract
- He then uses the cash from his Dalian sale to invest in the shadow banking system. The money ends up in the hands of real-estate companies desperate for funding

## Scheme B

- Imports of LLDPE and LPDE film grades are sold by local distributors straight into the domestic physical market to converters at slightly discounted prices
- The money is invested by distributors in the shadow banking system in the hope that their returns will more than cover the interest cost of a foreign LC and any loss they make on the physical cargo

# A complicated web of transactions, often using the same commodities cargo over and over again



# How this could play out



- Many banks have frozen their finance for metals trading. Most others have increased their LC deposit levels to 50%
- Potential for a 'cascade effect' as many collateral traders cannot afford 50%
- Copper, iron ore etc. will return to original owners
- As demand continues to fall these cargoes will have to be sold, **as will petrochemicals cargoes**

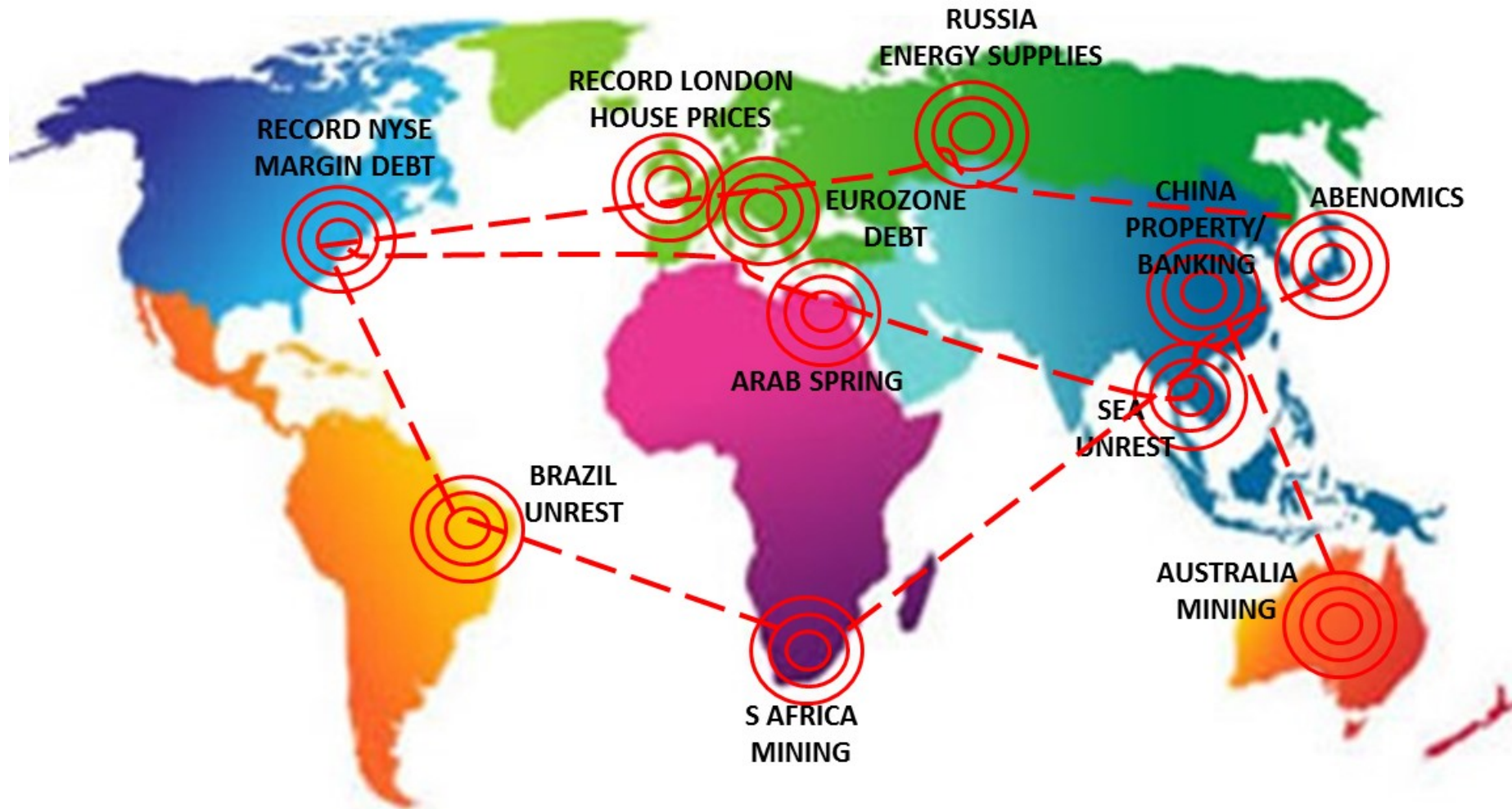
The 'whack-a-mole' game intensifies

# Financial markets have higher levels of margin debt than in 2007 and 2000





# Central banks have created a debt-fuelled 'ring of fire'





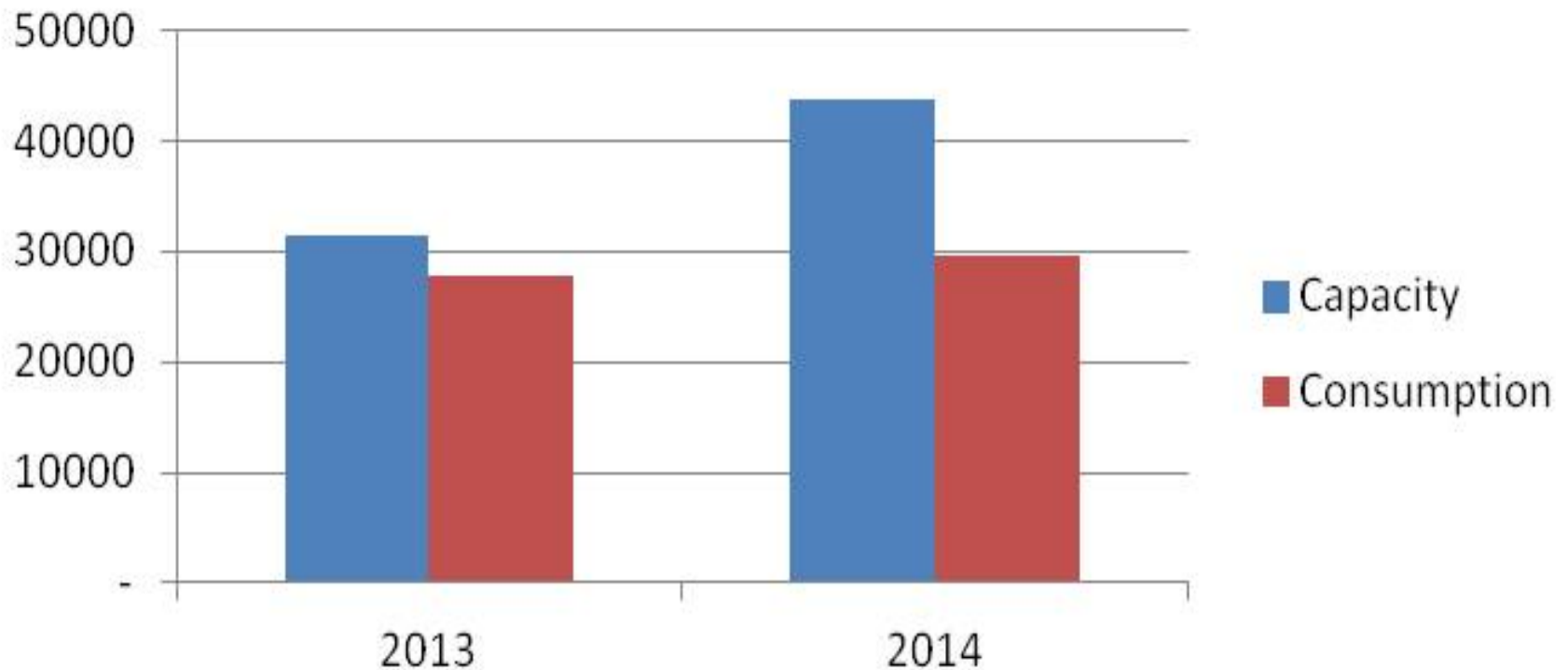
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# China's over-expansion has created a crisis for PTA

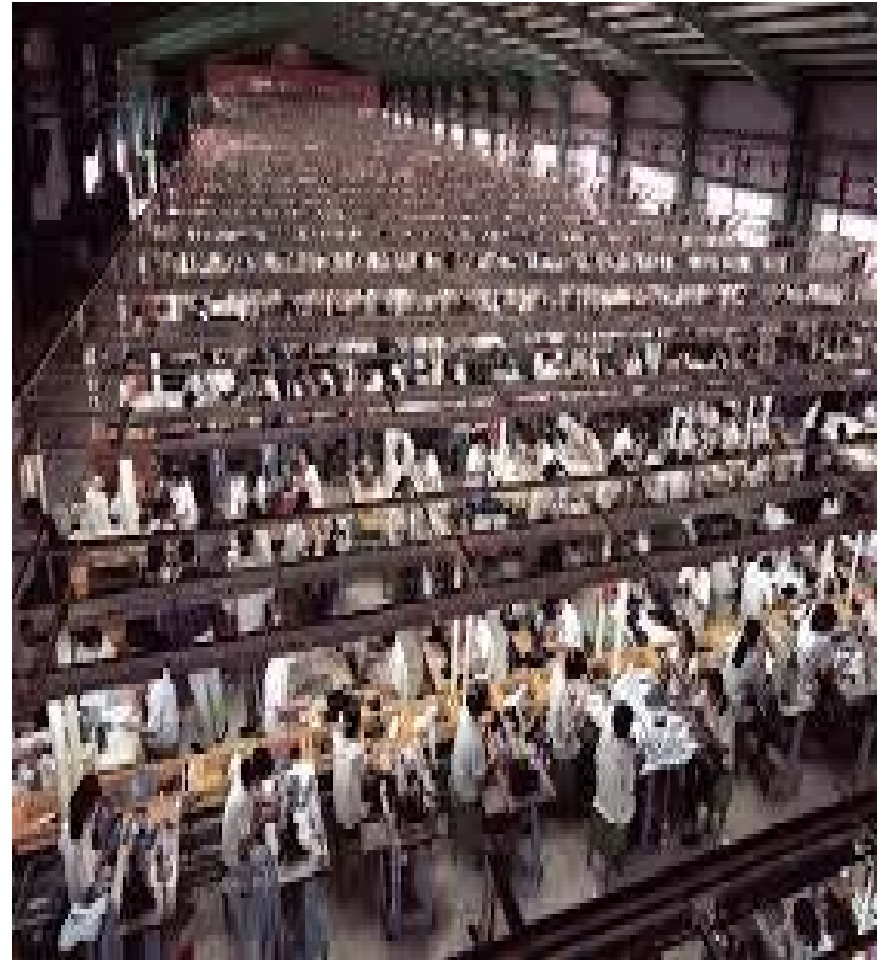
## China PTA in '000 tonnes



ICIS Consulting

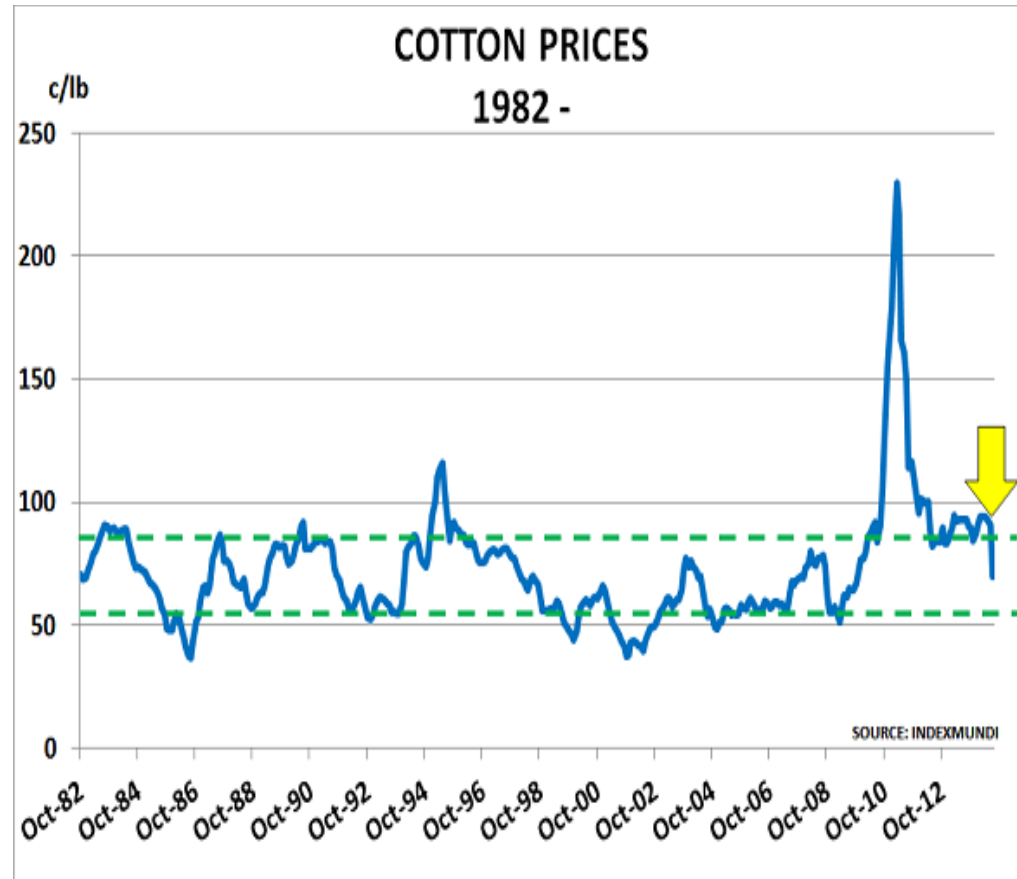
# Why this happened

- Local governments supported PTA and polyester fibre projects, without too many questions being asked about their viability
- Their focus was on meeting their local GDP growth targets
- Tax income from land sales supported their income
- It also seems likely that corruption played a role in 'oiling the wheels'



# Enough cotton to make 3 pairs of jeans for everyone.....

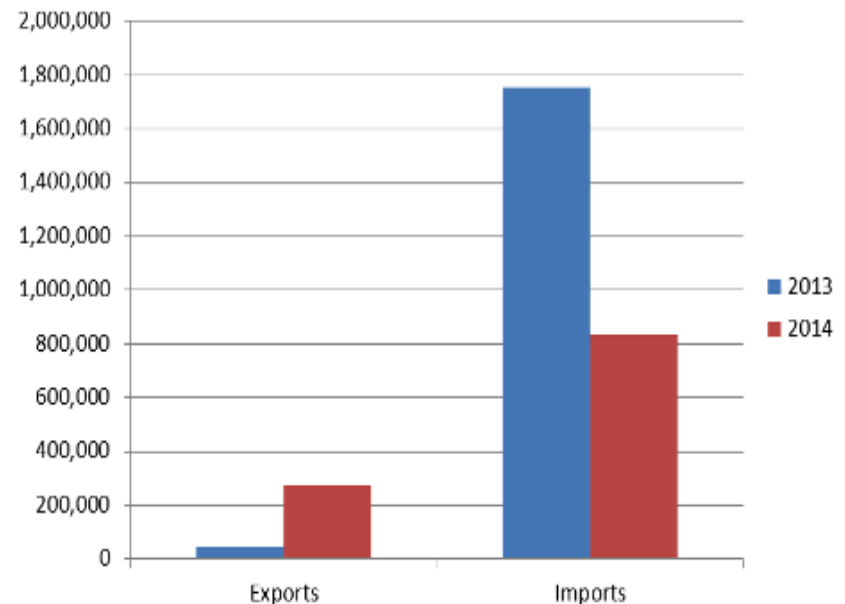
- Polyester sales are also being hit by the collapse of cotton prices
- The previous Chinese government had built record levels of cotton storage to support farm incomes
- The world now has enough cotton in storage to make three pairs of jeans for every person on the planet....and the new US and Indian crops are likely to be good after 2 years of drought



# PTA faces major over-capacity as China starts to become an exporter

- China used to be the world's biggest PTA importer – buying 6.5 million tonnes in 2010 and 2011
- Last year its imports more than halved to 2.75 million tonnes as new capacity began to come online
- In H1 this year, it bought just 750KT
- And it **became an exporter for the first time in history**, exporting 225KT
- India is also about to bring major new capacity online

China PTA - January-July 2014 versus January-July 2013



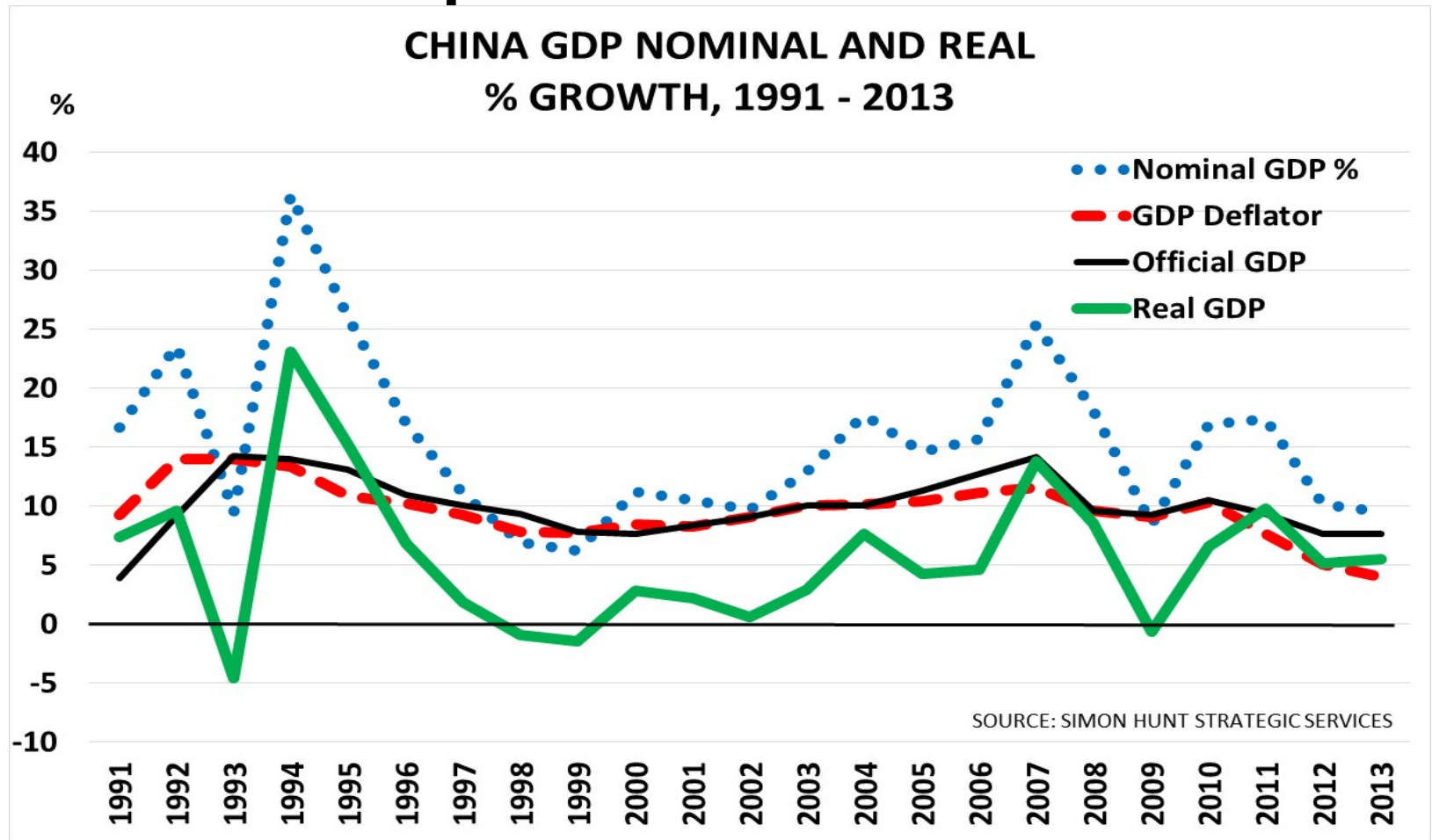
Source: China Customs

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# China's growth has been much lower than reported



**Premier Li has said published GDP data is  
“man-made and therefore unreliable”**



# Most parts of China are now seeing “a serious economic cooling-off”

## PROVINCIAL ECONOMIC WELL-BEING INDEX IN Q1



Source: An economy research institute under the 21st Century Business Herald

CHINA DAILY

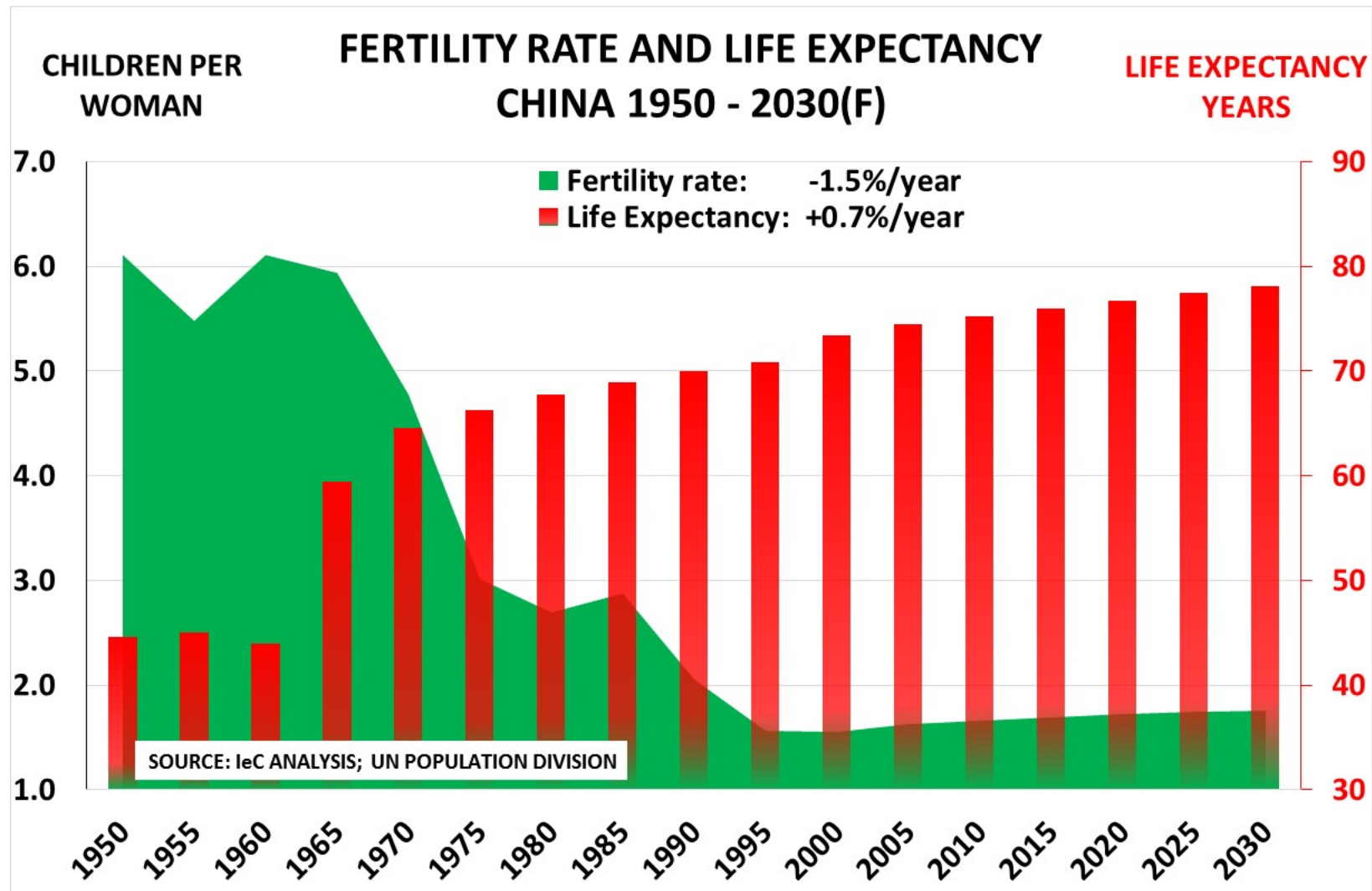
**China's 'one child policy' since 1978 means its wealth creator 25-54 age group is declining**



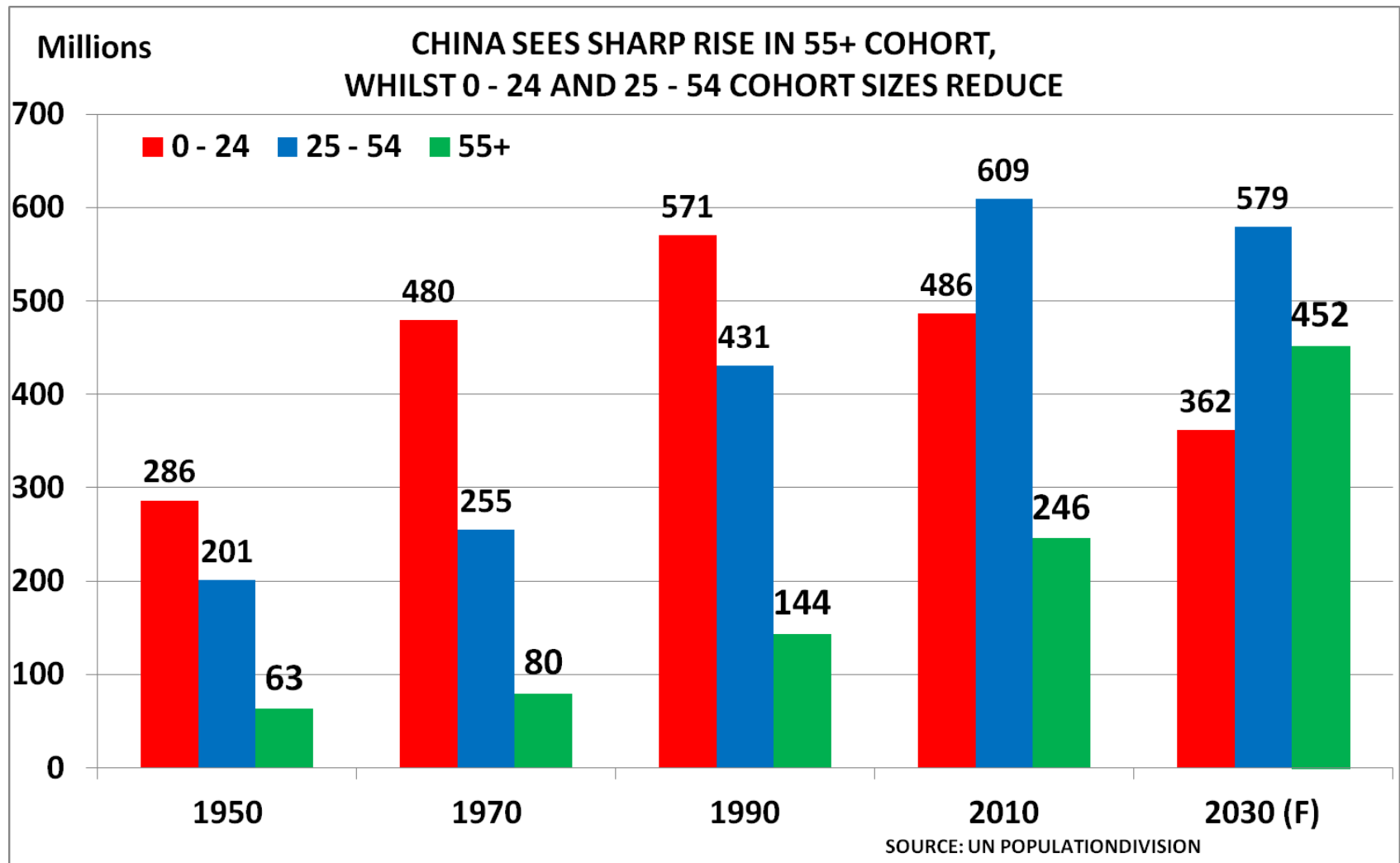
chineseposters.net

International Chem

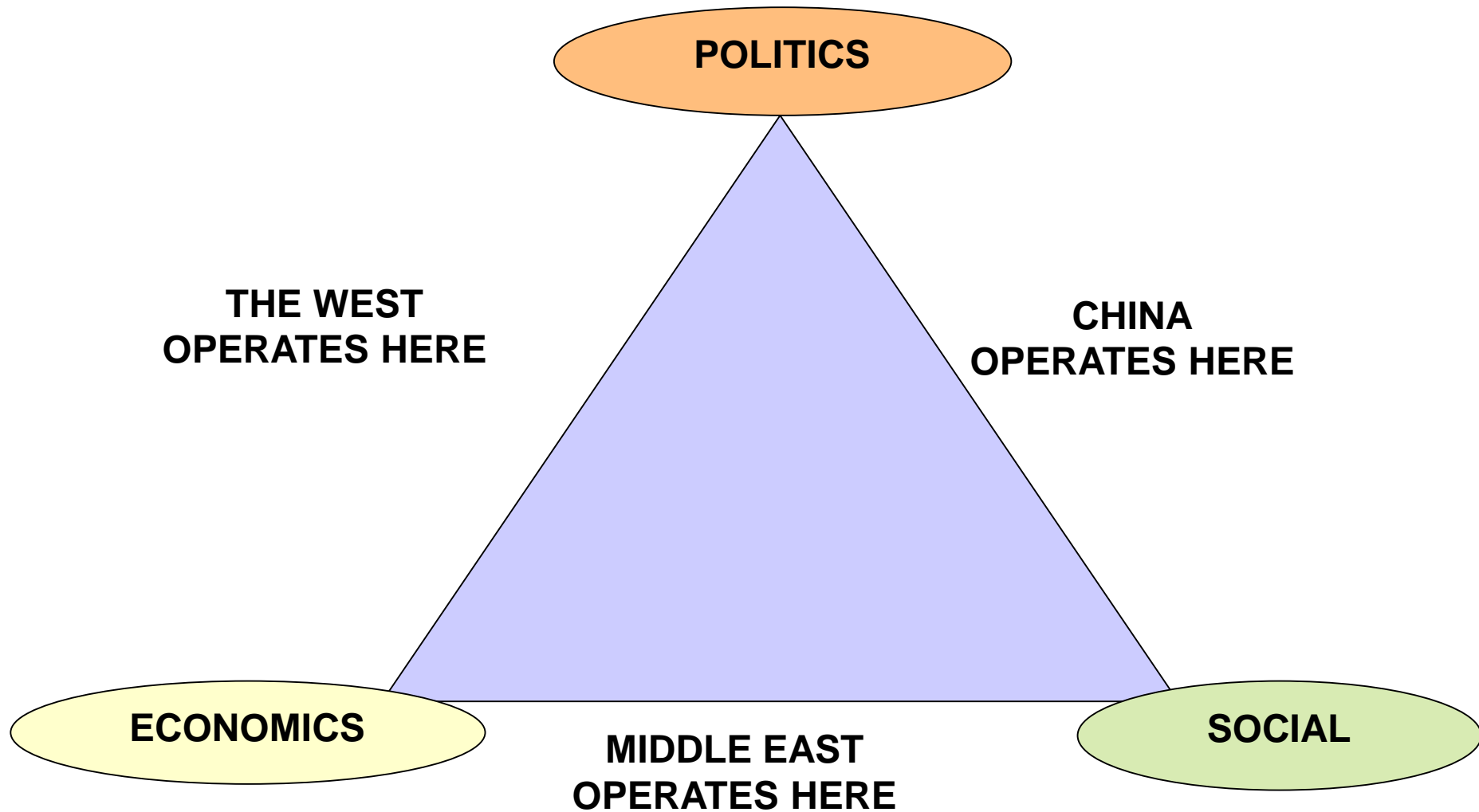
# China's life expectancy has risen 71% since 1950 as fertility rates have fallen 75%



# China's population is ageing, as in the West

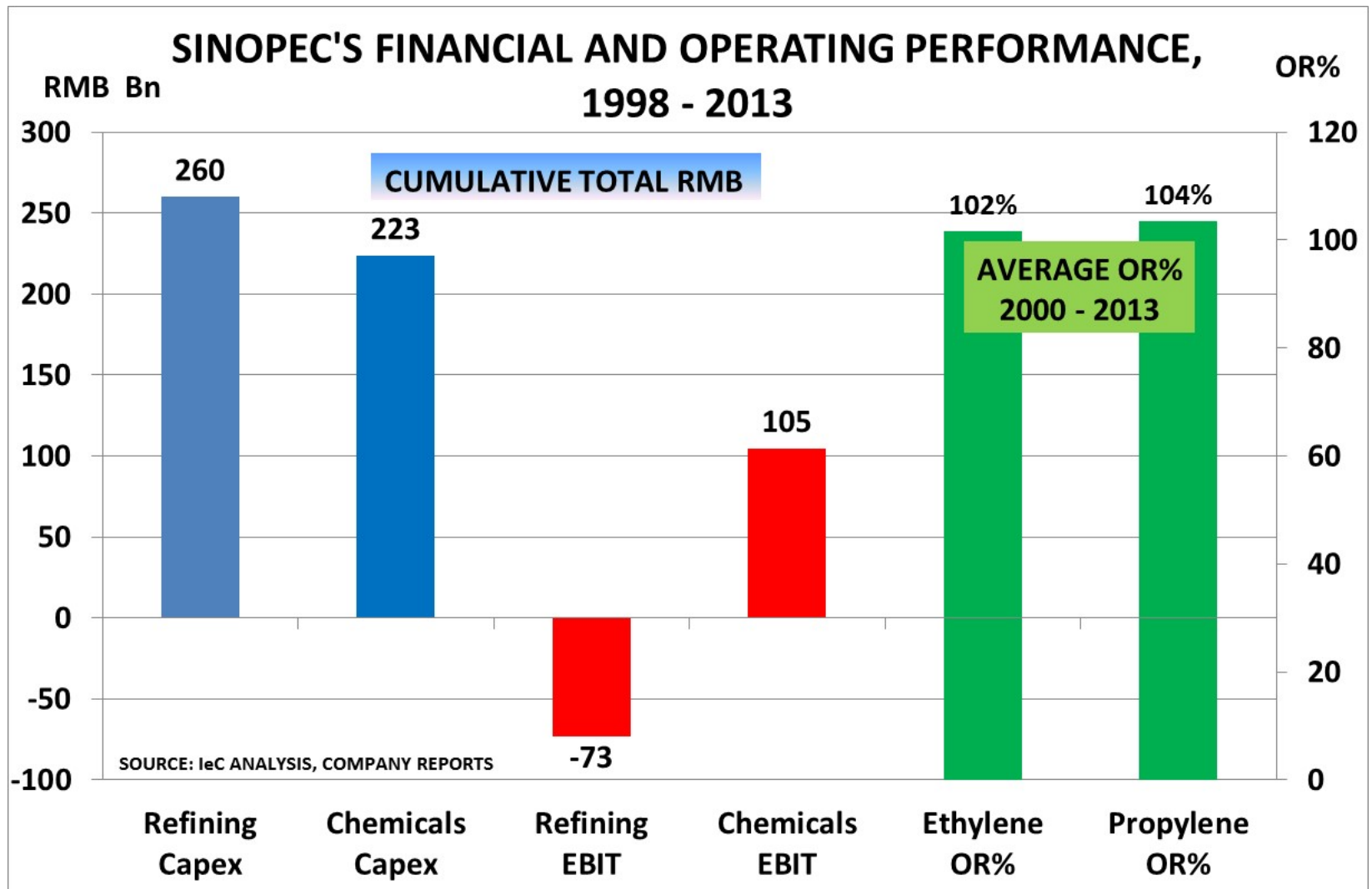


# China operates to Deng's 1992 Southern Tour model- living standards must rise to keep the party in power





# Sinopec operates as a utility with a social agenda, maximising employment – not profit



# China's GDP has been based on targets, not output

- ❖ China's local governments have focused on meeting GDP targets via a 'make and break' construction policy.
- ❖ Shenyang blew-up a 9 year-old indoor sports stadium in June 2012, which cost \$126m and was the largest in Asia when it was built.
- ❖ China Daily reported at the time

*"I don't know how much of our GDP comes from this make-and-break game played by some local officials. But I do know it not only wastes resources and causes irreversible environmental damage, it also inevitably provides a hotbed for rampant corruption."*

*"But it is a game some officials like to play because it boosts local GDP, which has long been a key criteria for promotion, despite Beijing's repeated calls for green growth."*





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# China's luxury market is disappearing as the anti-graft campaign reaches the "tigers"



- Thousands of officials have lost their jobs or been disciplined since the corruption campaign began in 2013
- 5 star hotels have downgraded themselves to 4 star; airlines have dropped 1<sup>st</sup> class
- Major investigation is now underway in Shanghai



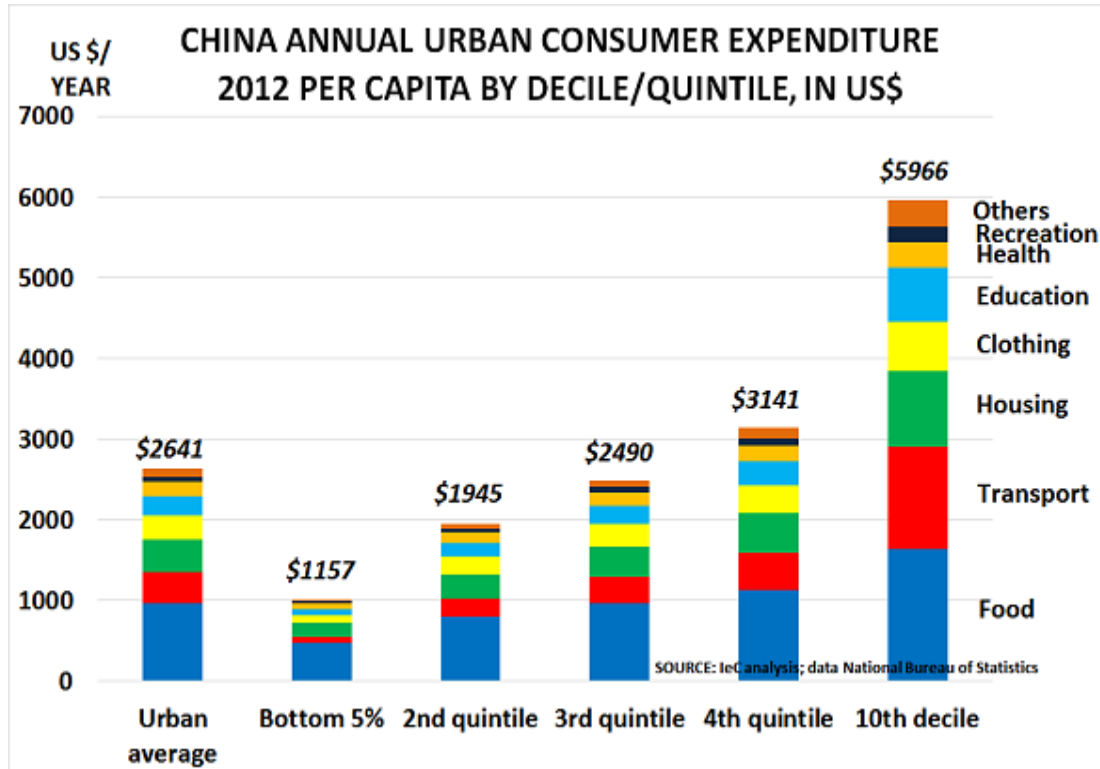
A gift of silver 'moon cakes' for yesterday's Mid-Autumn Festival was a reportable offence

# And the importance of the environment



- Investment-led growth blamed for problems such as chronic air pollution
- “One-sixth of China’s arable land — nearly 50 million acres — suffers from soil pollution. More than 13 million tonnes of crops harvested each year are contaminated with heavy metals” – Ministry of Environmental Protection
- 2013 saw the issue become critical for the maintenance of social order

# China is not “middle class” by western standards



- Average per capita urban incomes in 2013 were Rmb 29547 (\$4769)
- Average per capita rural incomes were \$1276

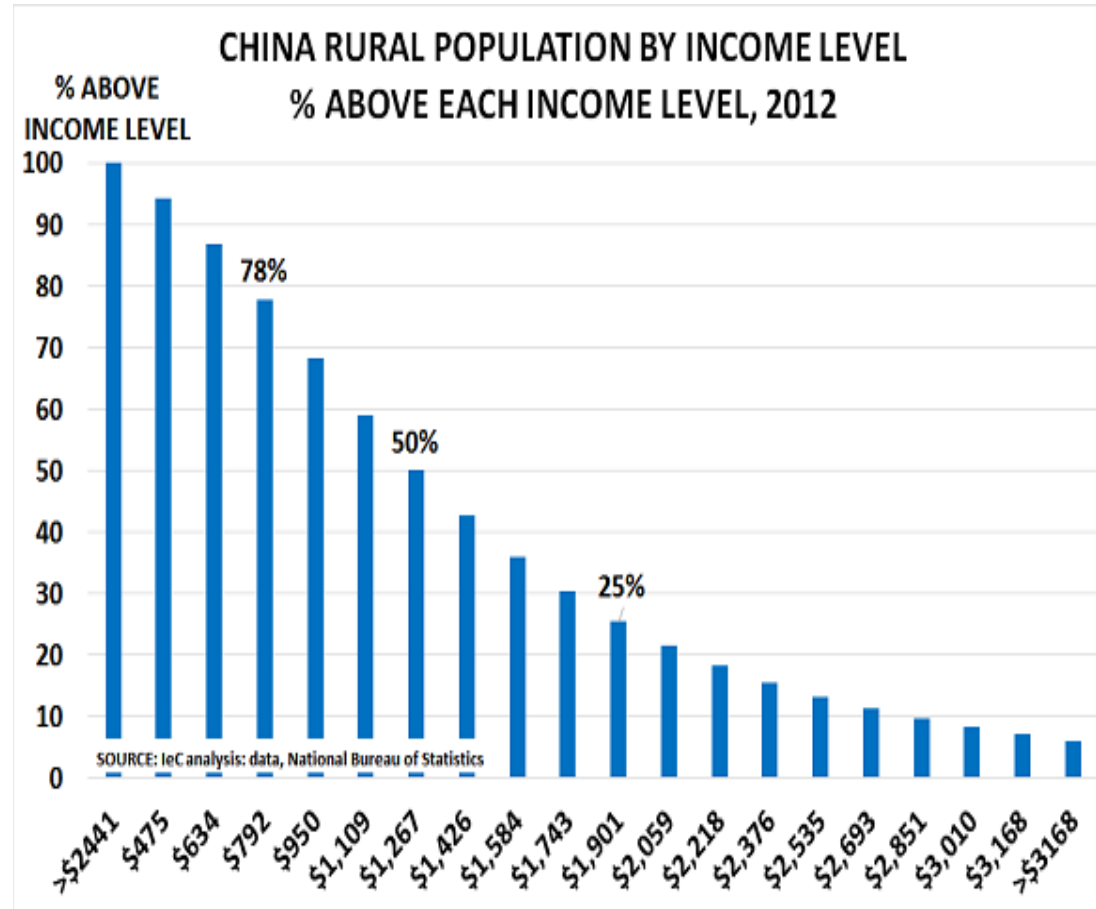
# Affordability based on income, not the property wealth effect, will be key to future growth

- **In rural areas:**

- *Every household has a mobile phone and a colour television*
- *2 out of 3 households now own a washing machine and refrigerator*
- *2 out of 3 households now own a motorbike, whilst bicycle ownership has halved since 1995*
- *But only 1 in 5 own a computer*

- **By comparison, in urban areas:**

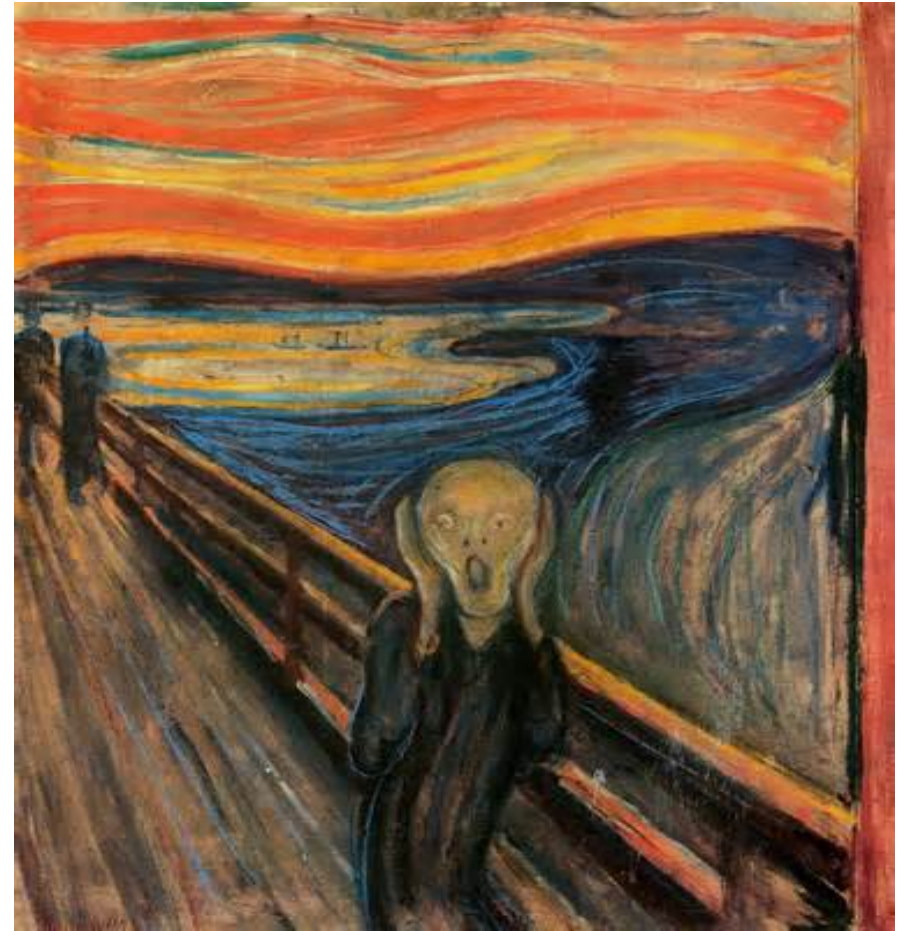
- *Every household owns a mobile phone, colour TV and air conditioner*
- *Everyone owns a washing machine and refrigerator*
- *1 in 5 households own a motor bike and the same proportion own a car*
- *Almost every household owns a computer and water heater*





# From denial to acceptance

- People start to notice demand is down but attribute it to a modest slowdown
- They see a longer slowdown - and assume new stimulus
- Then, as the slowdown carries on, they assume production cutbacks
- Then they think it is all cyclical
- Then they realise supply is increasing back in the West due to disorderly arrivals of raw materials from China



**Edvard Munch: Scream**

# The long road to acceptance



- Then they start to recognise that all this is connected and has the same cause - the withdrawal of credit in China
- They will still prefer not to put 2 and 2 together and to link the perceived demand to the collateral trade
- Only at the very end will they very reluctantly recognise that they invested in new capacities on the basis of totally false assumptions about the pace of growth and real demand



# What does this mean for chemicals?

## The transition to the New Normal creates winners & losers

Potential losers in the New Normal believe:

- ❖ Stimulus programmes will return markets to the way they used to be.
- ❖ China's demand will be the saviour of the global industry
- ❖ The rise in oil prices means that end-user demand is robust.
- ❖ Companies now 'caught in the middle', neither low-cost or selling an effect, will somehow regain pricing power.



Potential winners in the New Normal believe:

- ❖ The future will be different from the past, with new challenges and opportunities.
- ❖ Companies need to refocus their offerings, and align them with key demographic drivers eg the ageing BabyBoomers and greater domestic consumption in emerging economies
- ❖ Such key 'Megatrends' include:
  - ❖ increasing food production
  - ❖ improving water availability
  - ❖ increasing life expectancy
  - ❖ reducing carbon footprint

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