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Welcome to Austeria

As policy-makers continue to make huge mistakes around the world, the chemical industry can look forward to a tough 2012 and beyond

PAUL HODGES INTERNATIONAL ECHEM

New Year is a time for looking forward, as well as back. It is now three years since the Great Recession began. I wrote then that "downturns are not much fun. There will be rallies along the way, of course. But it is unlikely that governments will find a "magic bullet" to quickly correct the causes of today's problems" (*ICB, January 5–11 2009*). Sadly, there seem few reasons to change that analysis today.

The key question, of course, is whether we can expect much improvement in 2012. Here, the signs are not promising. Policy-makers did a good job in averting global financial meltdown in September 2008. But since then they have struggled. Instead, we have had a »

» series of stimulus initiatives that appeared to provide short-term relief, but ended up creating ever-larger debt problems. Examples include:

- In the West, "cash for clunkers," quantitative easing versions 1 and 2 (QE1, QE2), bail-outs of the bank and housing markets, and the current Operation Twist.
- In emerging economies such as China, major increases in bank lending, plus subsidies for purchases of autos and household goods.

Policy-makers thought these measures would somehow restore confidence and provide the "escape velocity" needed to return us to steady growth. But the only result has been it is eurozone countries such as Greece and Spain that are now in trouble, instead of banks such as Lehman Brothers.

Companies cannot ignore the impact of policy-makers' actions. We all suffered last year as the US Federal Reserve's misguided QE2 program led to a 70% rise in oil prices, via the supply of $600bn of liquidity to the high-frequency traders who now dominate financial markets. Chemical companies were left to pick up the pieces, as perceived demand first soared and then collapsed:

- Buyers were forced to buy forward in the first quarter to protect their margins.
- They then spent the summer trying to reduce their inventories to more "normal" levels, as oil prices stabilized.
- Finally, in the fourth quarter, these sustained high oil prices led consumers further to cut back discretionary spending on the products that drive chemical industry demand.

As the great investor Warren Buffett once observed after a period of poor performance, it would have been better if US Federal Reserve governors "had regularly snuck off to the movies" instead of turning up to the office.

Scenario planning will therefore continue to be critical in 2012, but not the scenario planning of the supercycle years, when executives could usefully spend time debating whether ethylene growth rates might be 4.2%, or perhaps 4.5%, or maybe only 4%. The history of the past three years teaches us that the margin of uncertainty has greatly increased.

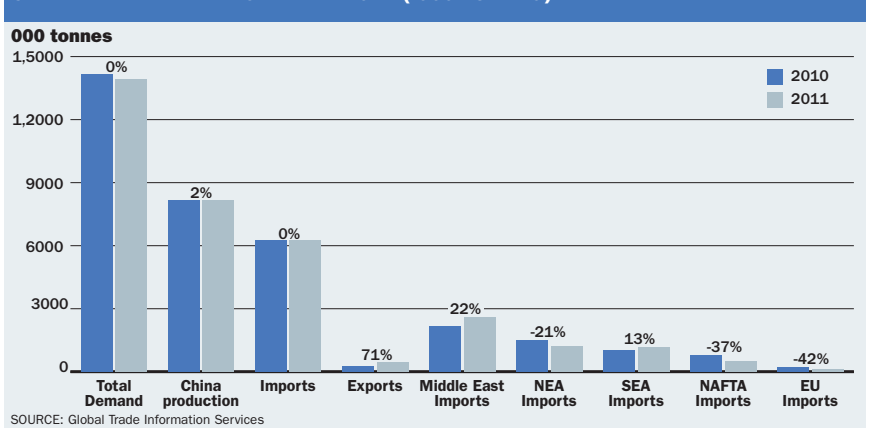
More and more Western governments are now replacing stimulus programs with austerity. Taxes are rising and spending is being cut, while high levels of unemployment create a further drag on the economy. So companies need to consider a downside scenario in which growth remains below previous levels for some years to come. Equally, they need to worry about what may happen in China.

It gave powerful support to chemical demand in 2009–2010, as the government doubled bank lending and focused on supporting housing and auto markets. These are core demand sectors for chemicals. Polyethylene (PE) demand in China thus jumped by 53% in 2008–2010, from 11.7m tonnes to 17.9m tonnes. China's lending surge naturally led to a rapid rise in inflation. By July 2011, food price inflation reached 13% and the price of pork had risen by 57%. China is a relatively poor country – 96% of the population earns less than $20/day – according to the Asian Development Bank. So the government had no choice but to reverse course:

- Bank lending in January–October was down by 29% versus the same period in 2009.
- Prices for new suburban apartments in major cities such as Beijing and Shanghai fell by 30–50% in the third quarter, as lack of credit led to forced sales by developers.
- PE demand stagnated, with volumes during January–October 2011 at 2010 levels

There has also been a significant switch in the pattern of China's PE demand during the past three years. Domestic production continues to rise, as Sinopec realizes its ambition to become the world's largest ethylene producer by 2014. But following 2008–2010's growth, import volumes have fallen back to 2009 levels. The pattern of imports is also changing. No longer does China's "rising tide float all boats". Instead, as the chart based on Global Trade Information Services data shows, China is preferentially sourcing from the Middle East (net imports up by 22% versus 2010) and Southeast Asia (up by 13%). China and the Middle East have a strategic corridor as China needs energy imports and the Middle East needs markets for its production. Southeast Asia benefits from its free-trade agreement with China. But net Northeast Asian imports are down by 21%, those from NAFTA down by 37%, and from Europe down by 42%.

CHINA PE DEMAND WAS FLAT IN 2011 ('000 TONNES)



SOURCE: Global Trade Information Services

PROTECTIONISM ON ITS WAY

This highlights major changes in global trade patterns. The Western baby boomers (born between 1946 and 1970) sparked a consumption boom as they entered the 25–54 age group. This led to an economic supercycle, and a massive expansion in world trade between 1980 and 2005. Now the boomers are entering the 55+ age group, when people typically spend less and save more.

Sadly, the failure of policy-makers to understand the impact of this changing demographic has led to growing Western disillusionment with the concept of free trade and outsourcing, and each failed stimulus program adds to the disillusion. This leads to a growing risk that populist politicians will aim to reverse direction. With unemployment uncomfortably high in most Western countries, they have plenty of potential support.

High and unpredictable oil prices also make outsourcing costs much higher than in the 1990s, when companies began to develop this strategy, while rising wages in emerging economies have further eroded cost advantages. Countries such as China must move from export-driven growth strategies, and focus on improving living standards.

We are seeing a generational shift in trade and demand patterns. The world will be very different in a few years, as described in the new *Boom, Gloom And The New Normal* eBook, co-authored with ICIS journalist John Richardson. Flexibility must be the name of the game in 2012. It could be a very tough, and unpredictable, year.

But it also offers unparalleled opportunities, for companies prepared to look forwards rather than backwards. 272m people in the West are now over 55 years old, and they constitute 29% of the population. Equally, millions of people in the emerging economies are now climbing out of poverty, and have a few dollars to spend for the first time in their lives. These major changes are creating the growth opportunities of the future, for those with the vision to grasp them. ■

Paul Hodges writes the ICIS Chemicals and the Economy blog and is co-author with ICIS director John Richardson of eBook *Boom, Gloom And The New Normal*, available for free monthly download at www.icis.com/NewNormalebook