Time is ripe to plan for uncertainty

With austerity measures kicking in globally, a slowing Chinese economy and permanent lower growth in Western countries, now is the time to budget for uncertainty

PAUL HODGES INTERNATIONAL ECHEM

The year 2010 was better than many had expected. It began with a boost from restocking, after inventories had been run down quite dramatically in the fourth quarter of 2009. It then received further support from the continuing government stimulus programs around the world, which were focused on key areas for chemical demand such as autos, housing and electrical appliances.

But as the graph opposite from the American Chemistry Council shows, global operating rates (OR%) have still not recovered to previous "normal" levels. They have certainly improved from the all-time low of 77% seen in December 2008, but are now only back to 2002–2003 levels, at 87%. This is well below the 92–94% range seen in the boom years between 2003 and 2007, and also below the levels seen during most of the period 1989–2003.

The good news is margins have generally been much stronger than normal at such low operating levels. This has been down to a variety of causes, such as lower refinery OR% and lower oil demand reducing feedstock availability, along with a relatively high level of forces majeures. But these are supply-driven constraints and are therefore inherently unstable.

The key question is what happens next? The chart shows three possible directions:

- A **Base Case**, where OR% maintain the improvement since 2008.
- An **Upside Case**, where they continue to improve and deliver a full recovery.
- A **Downside Case**, where they fall back again as demand growth stalls.

This is also the focus for my new White Paper: Budgeting for Uncertainty. It presents a completely fresh picture of the major changes now underway in consumer markets in both the emerging and Western economies. Its analysis provides compelling evidence that we are moving to a "New Normal" in terms of chemical demand patterns.

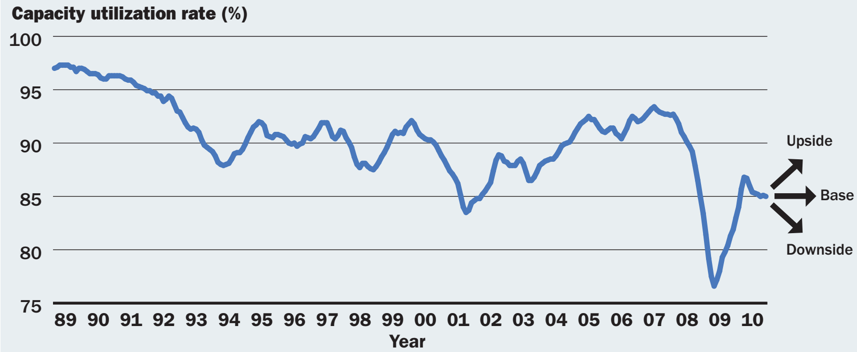
ECONOMIC DRIVERS

The driver for this move towards the New Normal is that Western societies have started to save more and spend less, under the impact of the economic crisis. And this trend is now set to accelerate as Western governments abandon stimulus measures. It is clear that their focus is instead on austerity measures such as spending cuts and tax rises.

In turn, this is forcing governments in emerging economies to abandon their current

Rex Features

CAPACITY UTILIZATION IN GLOBAL CHEMISTRY



SOURCE: American Chemistry Council

export-driven development model. Instead, they now have to focus on building domestic demand, if their GDP is to continue to grow.

Thus we are now in a major period of transition for both emerging and Western economies, and this has enormous implications for chemical demand. If companies understand the transition now underway and they are quick to adapt to it, OR% could maintain current levels, or even improve. But if they simply assume that we are returning to the consumption patterns of the 2003–2007 boom years, then we are likely to be disappointed.

Over the past two years, China has been the prime engine for the recovery in global chemical demand. And the changes underway highlight the enormity of the transition. They are secular in nature, not just cyclical. This is why I have subtitled the White Paper: the Difficult Transition Ahead, as we Enter the New Normal

For a start, it is clear that the government is now rolling back its emergency programs, introduced after the crisis began in the second half (H2) of 2008. It doubled bank lending to \$1.4 trillion (€1 trillion) in 2009, equal to one-third of GDP. And it introduced a \$580bn stimulus package, worth another 13% of GDP. This did the job, on a temporary basis, in keeping China's vast population employed.

But, in turn, it led to rampant speculation. Property prices in Hong Kong, for example, have risen by 50% since the end of 2008, owing to flows of hot money from the mainland. Inflation has also risen sharply, to 5.1% in November. So now the government has begun to slow the economy. Interest rates have already begun to rise, while property loans were cut back for November and December.

Even more importantly, the government clearly understands that its export-driven economic model needs to change. Instead of catering to the demands of wealthy Western consumers, it is starting to redirect the economy towards the domestic market. So the 2011–2013 period is likely to see slower GDP growth in China and a major shift in demand patterns.

This new strategy was highlighted in July by Yi Gang, deputy governor of the central bank. "China's future economic growth will definitely gradually slow down," he warned. "The issue … is the quality of growth, which is why we now have to carry out structural adjustment and transform our development model."

The driver for this move… is that Western societies have started to save more and spend less

China's planned transition is not unique. Similar changes are underway in many other emerging economies. In India, for example, the auto company Tata has introduced its new Nano range, which retails for only \$2,250 and aims to create a new market by encouraging customers to "trade up" from motorbikes. And its high fuel economy of 73 miles per gallon means it uses much higher levels of polymer than many larger Western autos. Equally, Hindustan Lever (part of the global Unilever group), has highlighted the potential scale of the opportunities in detergent and other markets that are starting to develop.

ENTERING THE NEW NORMAL

But most chemical demand is focused on Western markets. My first White Paper, Budgeting for a New Normal, argued that these were seeing major changes in demand patterns. And a year later, it is clear that some important chemical industry markets, such as US housing, have indeed now entered the New Normal.

US housing, for example, used to be a \$35bn market for chemicals, with up to 2.2m housing starts a year, each worth \$16,000 in sales. Now it is worth just \$10bn, with recent starts only around 600,000. Plus, there is increasing evidence that families are starting to share homes again, as children find it too expensive to live on their own and grandparents worry about the costs of residential care.

This is quite a shift from the boom years, when consumers often defined themselves by the price of the car they drove or the size of the house they owned. Instead, as global research firm Datamonitor explains, people are becoming more focused on family and friends. And their values are shifting toward more long-term concepts such as sustainability and carbon footprint, rather than short-term consumerism. Trustworthiness and performance are also becoming increasingly important.

My research for the new White Paper has highlighted the potential scale of the changes now underway in Western and emerging markets. The New Normal represents a major challenge to existing chemical and polymer demand patterns. But the industry has faced similar challenges in the past and adapted its offerings successfully. I am also convinced that the New Normal offers significant opportunities for far-sighted companies to achieve major gains in terms of both profit and market share.

Budgeting for a New Normal aroused enormous interest around the world, and I hope Budgeting for Uncertainty will help you to understand the potential impact of these changes for you and your business. ■

Paul Hodges is chairman of UK consultancy International eChem, www.iec.eu.com. His new White Paper: Budgeting for Uncertainty – the Difficult Transition Ahead, as we Enter the New Normal is available free at **icis.com/newnormal**