INSIGHT: The China question

26 August 2009 15:15 **[Source: ICIS news]**

By Paul Hodges

LONDON (ICIS news)--The more I read about China's economy, the more I worry.

The reason for this concern is that China has become a major player in the global chemicals industry in recent years. If it hits problems, then we will all feel the impact.

Why should China hit problems? China is vulnerable because its economy, and hence much of its chemical demand, has been export-driven over the past decade. In 2001, China's exports were around 20% of GDP. By 2007, this percentage had nearly doubled to 37%. And the growth rate for exports was running at 26% per annum.

These exports were due to China's success in becoming the manufacturing capital of the world. It took full advantage of the trend in many developed economies to outsource industrial employment in favour of a focus on services, particularly in the financial sector.

But China's exports have now fallen for the past nine months. In July, they were down 23% versus 2008 levels. And many of its end-user markets in the west seem unlikely to recover quickly, if at all, to their previous heights.

Reckless lending by the western financial sector during the 2003-2007 period encouraged many people to borrow money they could never afford to repay. And many of their purchases were in key demand areas for chemicals, such as housing, autos and electronics. In turn, China's exports naturally contained a high proportion of chemicals.

Now, the party seems to be over. Western lenders have returned to more prudent standards for assessing loan eligibility, while there are increasing signs that the western population is starting to save more and consume less. Both these trends are likely to grow in importance as unemployment continues to rise.

So can we really be confident that China can lead the world, and the chemical industry, out of recession, as many financial analysts now argue? Not according to China's premier, Wen Jiabao, who warned this week: "There are still a lot of unstable and uncertain factors ahead and the economic situation ahead is still very grave, although both the world economy and the national economy are now making positive changes."

The facts bear out his concern. China's GDP is around $4,000bn, and it accounts for just 7% of the world's economy. Its GDP/capita is around $2,500 per person, versus an average of $38,000 in the developed economies. And so it seemingly has very little scope to expand domestic consumption in the areas that would impact chemical demand, as these are linked to high levels of GDP/capita.

Instead, the government has done the only thing it could, and focused on boosting domestic spending on infrastructure. After a disastrous fourth quarter in 2008, when GDP failed to grow at all, and the economy lost 23m jobs, the government extended loans worth $1,000bn in the first half of 2009, three times the amount lent in the same period in 2008.

No, that's not a misprint. The loans made by the government were equal to a quarter of the country's total annual economic output. In addition, it introduced a stimulus package worth some 14% of GDP. More recently, it has also reintroduced tax incentives to help boost exports.

What has happened to all this money? John Richardson's Asian Chemical Connections blog recently reported that downstream inventories, not captured by the usual surveys, are now at relatively high levels for products such as polyethylene. And he also highlighted its impact in helping factories to temporarily sustain production of white goods such as refrigerators and washing machines.

Even more worrying is the assessment by Royal Bank of Scotland that at least half of the recent lending may have gone into speculative activity. They estimate 20% has helped to fuel the recent boom in the equity market, and another 30% into property and other speculative activities.

Certainly China's chemical futures markets, such as Dalian, have recently seen unprecedented levels of activity. In April alone, it traded 80m tonnes of linear low density polyethylene (LLDPE), around four times total annual world production. Other major chemical products, such as purified terephthalic acid (PTA) and polyvinyl chloride (PVC), have since seen similar excitement develop.

This is why I now worry about what will happen next to China's economy. The answer is extremely important to the near-term outlook for the global chemical industry.

If recent levels of Chinese demand have been "real", then there is nothing to fear. But if it has been "apparent" demand, stoked by easy money and the thought of quick trading profits, then there could be trouble ahead.

A worst case would see a fall in crude oil prices, caused by a loss of belief in the sustainability of China's economic recovery, followed by liquidation of speculative positions in oil-related chemical products. At a time of weak demand levels outside China, the impact of this downside scenario on chemical industry margins could be quite severe.

*Paul Hodges is chairman of **International eChem** and writes the **ICIS Chemicals and the Economy** blog*
To discuss issues facing the chemical industry go to **ICIS connect**

By **Paul Hodges**