China Trip 2017

Healthy growth leaves room to tackle overcapacity
Our travel notes: we left China more positive than we arrived
Party congress will consolidate President Xi’s power
Cutbacks in China finally rebalance commodity markets
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China Trip notes

Room for tackling credit, overcapacity and pollution

Our overall impression from our recent trip to China was that the economy is doing very well and that growth will slow only gradually. In general, the experts we met seemed fairly optimistic. They highlighted the progress made in matters such as dampening property price increases and high credit growth (including shadow banking activities), cutting capacity in heavy industries and, not least, lowering air pollution. The nineteenth National Congress of the Communist Party, which will begin on October 18, was also on everyone’s lips.

We have just landed from a fact-finding trip to Beijing, Shanghai and Hong Kong, where we met economists from international investments banks, rating bureaus, international organisations, independent researchers and Nordic companies in China. We left China more optimistic than when we arrived. We were surprised by the positive mood that prevailed. Economic growth has rebounded. The authorities have managed to crack down on shadow financing, act against pollution and “reform” heavy industries. All are positive seen in isolation, but it was seen as even more positive that they have happen simultaneously (i.e. that the sound but activity-dampening initiatives do not seem to have had a negative impact on overall growth).

Even when asked about possible negative risks, most we met struggled to mention any short-term risks. It seems as though risk, or at least the perception of risk, from the usual suspects (credit and property bubbles) has faded. Of course, the longer-term and structural challenges, such as demographics and debt, kept popping up. Some pointed to policy mishaps by the authorities, such as tightening monetary/fiscal policy by too much or liberalising financial markets/capital controls too fast, as the biggest short-term risk.

Growth rebounded in 2017

The general impression was that growth rebounded in the first half of 2017 and has been stronger than expected by most. Three explanations were given for the rebound: 1) Stronger external demand for Chinese exports following a pick-up in growth globally, but especially in Europe and the US, and the lagged effect of the weakening of the CNY in 2016; 2) The higher profitability of companies in general, but especially commodity producers, following widespread capacity cuts and subsequent price increases. Higher profit supports higher wages and income, thus it buoys household consumption; 3) The housing and property market boom has continued, contrary to what many had expected.

Growth beyond the peak

However, most also agreed that economic growth is beyond its peak and that it looks set to slow gradually over the rest of this year and in 2018 particularly. The main reason was tighter monetary policy in general and the recent crackdown on shadow financing specifically, which should dampen overall growth and especially fixed investments. The property market and thus construction activity should also dampen ahead due to higher mortgage rates and the many measures taken to dampen house price increases. Leading indicators such as house sales already indicate slowing activity (see chart).

Combating air pollution finally a priority

While China still thinks it is up to more developed countries to lower CO₂ emissions to prevent global warming, the country is increasingly focusing on its own environment, especially air pollution in its cities. That was visible in the streets and when speaking to companies. Separate lanes for electric cars/trucks and giving electric cars priority in auctions for new licence plates are among the new measures.

China’s new focus on green technologies and sustainable energy offers huge opportunities to Nordic companies with strong expertise in those fields. However, there is a flipside to closing polluting production plants: supply-chain problems. Most managers of the Nordic companies we met did not feel in danger of being closed down, as they use modern production facilities and have all approvals and certifi-
cates in place. However, they had seen many of their Chinese subcontractors being shut down or have capacity cut by the environmental authorities, often with a few days’ notice. That poses the threat of supply-chain problems in many industries, such as steel products, car manufacturing and building materials, which all depend on deliveries from polluting production.

Capacity cuts deemed a success
One of our contacts with good insight into government thinking mentioned that capacity cuts within steel and coal industries has been deemed a success by the authorities, as they have lowered overcapacity and supported the overall economy by boosting commodity prices, thus profit. The authorities have already come a long way, but they are likely to implement further coal and steel cuts.

Furthermore, the model is likely to be expanded to also cover glass and cement, for instance. Some plants and companies will be closed, while others will be merged to form huge ‘national champions’ that are able to compete internationally and support China’s quest to expand direct investment abroad. Other contacts doubted that capacity will be cut as much as planned. When prices were low, unprofitable companies had an incentive to cut capacity to minimise losses. Now that prices have recovered, it is more difficult to convince a company or plant manager to halt production.

The credit bubble is finally being dealt with
The fear of a disorderly bursting of the credit bubble seems to have faded. The main reason is likely that the authorities have shown a determination to act and have apparently had some success in the sense that overall credit growth and shadow financing in particular have slowed without creating havoc. Non-financial corporations’ debt as a percentage of GDP has in fact fallen in recent quarters, although admittedly only very modestly (see chart).

The deleveraging is due to several factors. Some defaults among bondholders have been tolerated, which has lowered moral hazard and repriced risk.

Furthermore, the authorities have improved supervision and regulation of shadow banking activities, not least so-called wealth management products. Such products are deposit-like products but usually offer higher yields than ordinary (regulated and secure) deposits. Wealth management products have grown tremendously in the past few years, but they have fallen recently as regulators cracked down and started treating them like ordinary deposits.

China used to have three different regulatory bodies for the various parts of the financial sector, but they have recently been told to work more closely together. A single entity in charge of all three has been created. As one contact formulated the improved regulatory situation: “Banks and financial institutions are more creative and innovative than ever, but regulators are now aware of that and are also more alert than ever”.

Money market rates pushed higher

| 7 days repo rate (interbank money market rate) |
| 7 day reverse repo bid rate |

The last major reason for deleveraging is that the authorities have tightened interbank liquidity. That has dampened shadow banking activities especially, but the move
has hurt smaller banks in particular that depend on interbank funding. In contrast, the major banks face no funding problems.

After the rebound in economic growth, the official growth target is now easily within reach. Of course, that is an important prerequisite for continued deleveraging. One of the rating agencies sceptical about deleveraging asked "will the authorities be as willing to improve financial stability once growth slows again and the growth target becomes questioned?"

**Party congress a matter of people reshuffling**

The nineteenth National Congress of the Communist Party will begin on October 18. The event will shape China’s political future, so it was naturally on everyone’s lips. The main thing to watch for is the outcome of the huge reshuffling within the party, and thus within the government, particularly the Politburo Standing Committee. All agree that Xi Jinping will consolidate his power, but we await how many of his loyal supporters he can promote into or keep in the Standing Committee. Li Keqiang is likely, although not certain, to be allowed to stay on as Premier, even though he is not a close ally of Xi. Watch out for Wang Qishan, perhaps Xi’s closest ally, who might remain in the Standing Committee despite being older than the (maybe flexible) age limit.

For now, only vague and rather generic formulations about the economic priorities in the coming years are likely to be forthcoming. Formulations such as ‘will keep growth stable’ and ‘continued reforms of state-owned enterprises’ should be expected. The latter probably means increased efficiency within current ownership structures and the creation of national champions rather than privatisations.

The new five-year plan, including economic targets and priorities, will probably be published at the Central Economic Work Conference in December or the National People’s Congress in March 2018.

**Renminbi stability with a weakening bias**

A consensus seems to have formed that the CNY will be kept fairly stable ahead to create two-way expectations and avoid one-sided speculation. The jury is still out on whether that means stable versus the USD or in effective terms.

Some FX analysts we met expressed the view that the CNY is likely to come under pressure to weaken over the longer term, especially if the process toward freer capital movements is resumed. China’s current account surplus has shrunk quite quickly, from around 9 percentage of GDP in 2008 to below 2 now, not least due to increased household spending on imported (luxury) goods, including cars, travel and overseas education. That is a consequence of the general rise of China’s (upper) middle class, which apart from general wage income gains have been given a boost from the wealth effect from higher house prices. The process is unlikely to reverse. If the exchange rate is not allowed to weaken accordingly, the current account surplus could easily turn into a deficit.

**Current account surplus not for granted**

We left China more optimistic than we arrived. We hope we will not be disappointed.

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Commodities

Cutbacks in China: supply is rebalancing the market

The commodity market has witnessed a remarkable price rebound. This time, supply is creating a recovery rather than the normal pattern, where demand creates a boom and supply the bust. Industrial metals are benefiting from supply cutbacks caused by the Chinese air-pollution-control plan. Expectations reflected in commodity prices might have run ahead of fundamentals before the National Congress of the Communist Party of China on October 18, but we think the supply reform is more of a long-term factor, supporting prices well into 2018. After all, there is one thing that the policymakers’ children and the rest of the population’s children have in common: the air that they breathe.

Cycle shift

Extractive industries are boom/bust industries and are by nature caught in a constant struggle between supply and demand dynamics. The most recent cycle started in the early 2000s, as China emerged as the single-largest commodity consumer ever. With few barriers to entry other than capital and time, resource industries responded by expanding. That phase of the cycle occurred from 2011 onwards and put severe pressure on prices. Oil was the laggard and that cycle broke down in 2014.

What has been seen recently is a broad pick up in prices. The demand side has not changed dramatically around the world though global growth has picked up somewhat recently. The price boost is coming from the supply reform in China. Over the last cycle, China grew from being a huge net importer to self-sufficiency or a net exporter of many commodities. As China cuts back to pursue better air quality, global commodity prices gain.

Stricter air pollution plan

In August, Beijing announced its plan to control air pollution during the autumn and winter period in Beijing, Tianjin, Hebei and the surrounding region. The new document has more detailed targets, wider coverage areas and stricter environmental measures. The latest plan calls for the PM2.5 Air Quality Index (shown below) to decline by 25%. We argue it is more feasible for China to deliver its cuts this time as they are presented as a plan including a target. As usual, a target in China is not something to strive for; it is something to deliver on.

Air quality often at ‘hazardous’ levels

Targeting the winter season

The main focus of the current plan is the heating season, from November 15 this year until February 2018. Winter is critical, as normal demand for coal-fired heating plants puts significant seasonal pressure on the environment. However, given that the production of raw materials is very costly and time consuming to shut down and restart, we argue that much of the production taken off line will probably stay off line, as it coincides with policymakers’ long-term target of scaling down unprofitable, environmentally-hazardous industries.
**China’s commodity balance**

China is both an outsize producer and consumer of commodities. The impact from the ongoing supply reform depends on the balance between Chinese consumption and production.

**China’s share of world consumption**

The Chinese commodity balance is easily divided into two clusters: those where China is self-sufficient from upstream assets and those where it is clearly not. Nickel, copper, iron ore and oil are commodities where China is highly dependent on imports for supplies.

At the extreme, China consumed 58% of all iron ore last year but produced only 10% of the world’s supply. At the other end of the spectrum, China produced more steel than it consumed, ending up exporting 10% of its production.

**China’s commodity self-sufficiency**

What has been possible to develop on Chinese soil, however, is downstream capacity. Process industries typically have shorter lead times to expand. In the transformation of China into a urbanised nation, central and regional authorities have used the needs for raw materials as a means to create employment opportunities. By expanding process industries, Chinese factories have captured a larger share of value chains in strategic commodities than what the captive minerals otherwise would suggest. Around the 100% the self-sufficiency mark lie aluminium, steel, stainless steel made from low-quality nickel ores, zinc and lead.

The massive buildouts of processing capacity have created a global surplus that has become a global problem. We estimate that global utilisation rates in copper and zinc smelting are around 80%, with steel processing at 75% and aluminium at 80% (e.g. around the lows of 2016). From that base, a Chinese cutback makes a major difference.

**Aluminium: the clear winner**

The sweeping wave of new supply in 2015 pushed prices lower and stalled expansion of new smelters. The current cutback reforms have taken their toll on net supply and growth is now at zero. Prices have gone through the roof and the only threat to falling back would be if China were to scale back on the campaign. Outside China, idled capacity is very rare. We argue swing production in commodities is a Chinese phenomenon after several years of low prices. In the developed world outside China, you are either in business or you are not. The exception here is shale oil production in the US.

**Steel: the bullseye**

While aluminium appears to be the winner among price gainers from lower supply, the steel reform situation has been different. Even though it would be imperative to scale back on steel in order to achieve Chinese air quality targets, very little has happened so far. Needless to say, steel is the most important commodity for some local governments in terms of keeping unemployment low. Steel production is also
spread over several provinces in China, making central governments’ influence on production less strong. There has been a flurry of cutbacks but just as many restarts, and production grew by 10% year-on-year in July and August.

**Chinese steel growth rate**

Many in the steel industry argue that the requirement to run steel plants at 50% capacity would create too much disruption, but that is the number required for China to reach its target of lowering air pollution by 25% during winter season. We think we will see increased efforts from central government to scale back this winter.

Chinese exports of steel have already been much lower, as domestic demand has gradually picked up during 2017. We argue there is room for a further drop of 50%, as there is little logic in exporting steel at low profit when pollution has been the bottleneck.

This does ease the structurally-gloomy outlook for steel globally, and steel could become more of a local-market commodity again, depending on local supply and demand.

**Iron ore: swing producers still alive**

Iron ore is the major steel-making ingredient; thus, it impacted both on the supply and demand side as a result of the current cutback campaign. Production was initially lower, but it has picked up recently because higher prices have offered an incentive to restart operations. This example suggests that the government’s policies to reduce production operate best when they work with, rather than against, market forces.

When prices were low, the production cutback policies added to the incentive to reduce production. Now that prices are higher, the policies have to work against that incentive to increase production.

In the end, we argue that iron ore trends will be dependent upon how effectively steel production is curbed. Lower steel production will inexorably take its toll on iron ore demand, so we argue that prices are set to fall further, as we are believers in a successful scaling back of steel production.
Coal: in fine-tuning mode
Cutback experiments in coal mining started already in 2016 and experiences have been mixed. Policymakers started too aggressively and prices skyrocketed. If there is one commodity affecting the average person in China, it is coal – everyone has an electricity bill to pay. Critics against the cuts forced policymakers to scale back a bit and increase the number of days that coal miners were allowed to produce.

Recently, production has trended lower again and prices are seeking a new equilibrium as Chinese production stabilises. Meanwhile, the market is using coal as an example: if cutbacks bite too hard, policymakers will retreat.

Copper and zinc
Zinc was the last metal where China came close to self-sufficiency. Mining zinc is not a critical environmental issue, but the refining business is highly energy intensive. Most recent data show that growth in refining zinc and copper is trending downward. If this persists, it would be very positive for western smelters, as refining charges have been low due to Chinese overcapacity.

Refining of net imported metals

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