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China's Lending Bubble and Its Impact on Chemicals Demand

John Richardson/Paul Hodges
ICIS/International eChem
April 2014

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- Team has an in-depth understanding of the issues, and of the 'real world' in which clients operate
 - Former senior managers from DuPont, ExxonMobil, ICI, INEOS, NOVA, Shell, TOTAL
 - Provide judgement supported by robust data analysis
- Co-author of 'Boom, Gloom and the New Normal'
- Write the 'ICIS Chemicals and the Economy' blog

About the speakers



John Richardson has deep knowledge of the companies and people who have transformed Asia into the world's major production and consumption region. His aim is to provide insightful, factually-based analysis of the key issues, and his views are highly valued by senior executives, who appreciate his balanced and independent approach.

John has lived and worked in Asia for over 15 years. Since 2006, he has been Director, ICIS Training Asia, having successfully launched the ICIS training business in Asia. John is a highly experienced business journalist who has been covering the Asian region for over 15 years. He was the editor of Asian Chemical News from 2000-2005, and deputy editor from 1997-2000. Prior to joining ICIS in 1997, he worked for the BBC and the UK national press.

You can contact John at jrichardson@icis.com



Paul Hodges is a trusted adviser to major companies and the investment community, and has a proven track record of accurately identifying key trends in global marketplaces. He has been widely recognised for correctly forewarning of the 2008 global financial crisis. His analysis of the key role of demographics in driving the global economy is now attracting increasing interest from senior policymakers and executives.

Paul is the Chairman of [International eChem \(IeC\)](http://International eChem (IeC)) and the non-executive Chairman of NiTech Solutions. Prior to launching IeC in 1995, Paul spent 17 years with Imperial Chemical Industries (ICI), both in England and the USA, where he held senior executive positions in petrochemicals and chloralkali, and was the Executive Director of a \$1 billion ICI business. Paul is a Freeman of the City of London and is a graduate of the University of York, and subsequently studied with the IMD business school in Switzerland.

You can contact Paul at phodges@iec.eu.com

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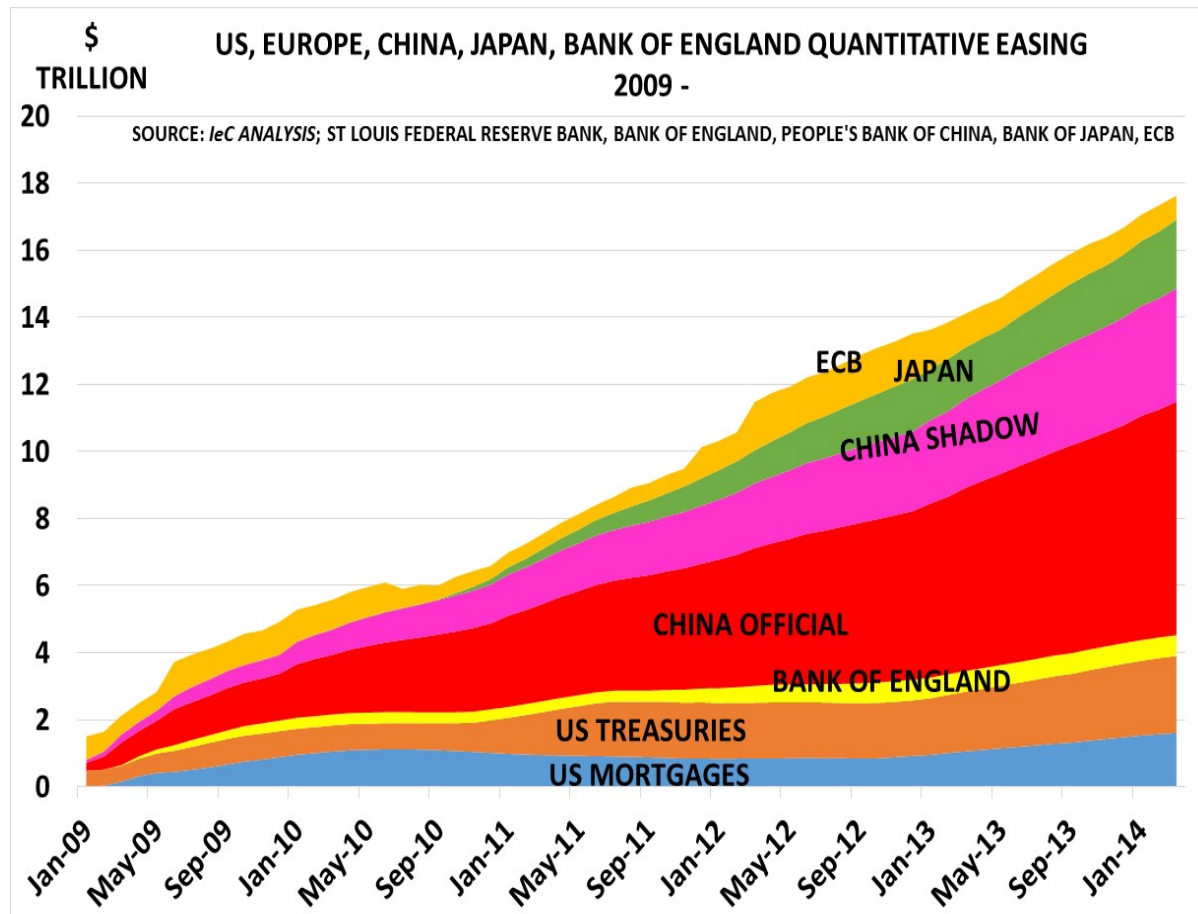
The “New China”

- China's lending bubble and its impact on chemical demand
- Today's problems of over-capacity and pollution
- The demographic drivers
- 7 key changes for the future



Never before in economic history...

- More than half of all central bank lending since 2009
- China's credit drawdown will be therefore be a much bigger deal than Fed tapering



The nature of bubbles....

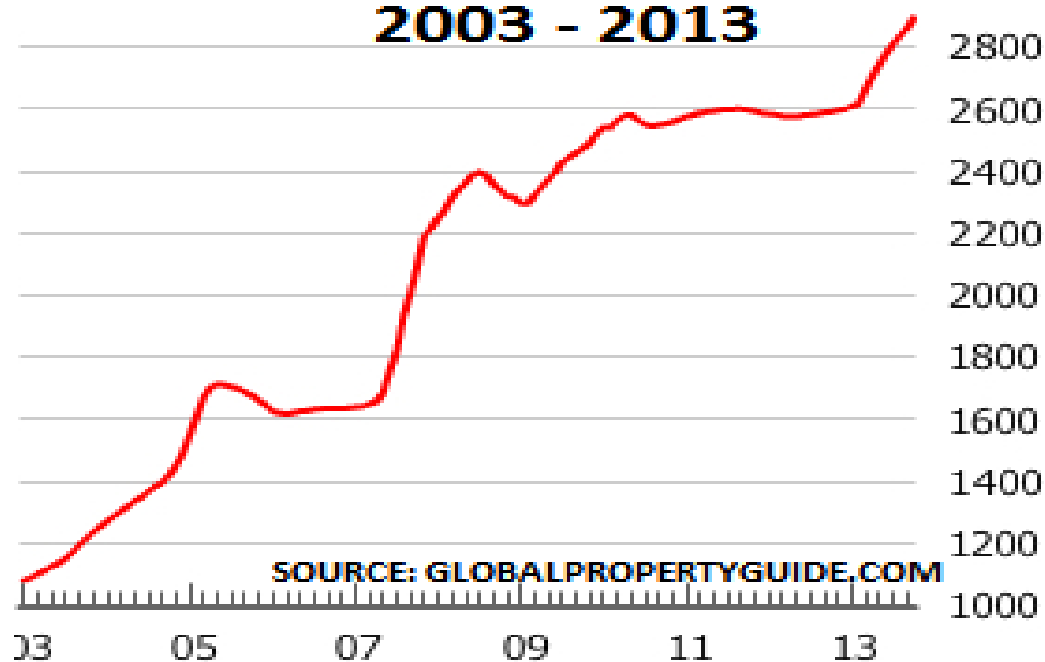
- In 2007, \$1 of credit added 83c to GDP
- By 2013, \$1 was only adding 17c
- 2014 estimates suggest \$1 will add 10c
- The PBOC would have to allow lending of more than Rmb 19tn (\$3.14tn) to create GDP growth of 7.5%
- “But that amount of total social financing would represent 12% year-on-year expansion, much faster than last year’s gain of 9%. An increase of that scale will cause massive macroeconomic risk” – the Chinese Academy of Sciences



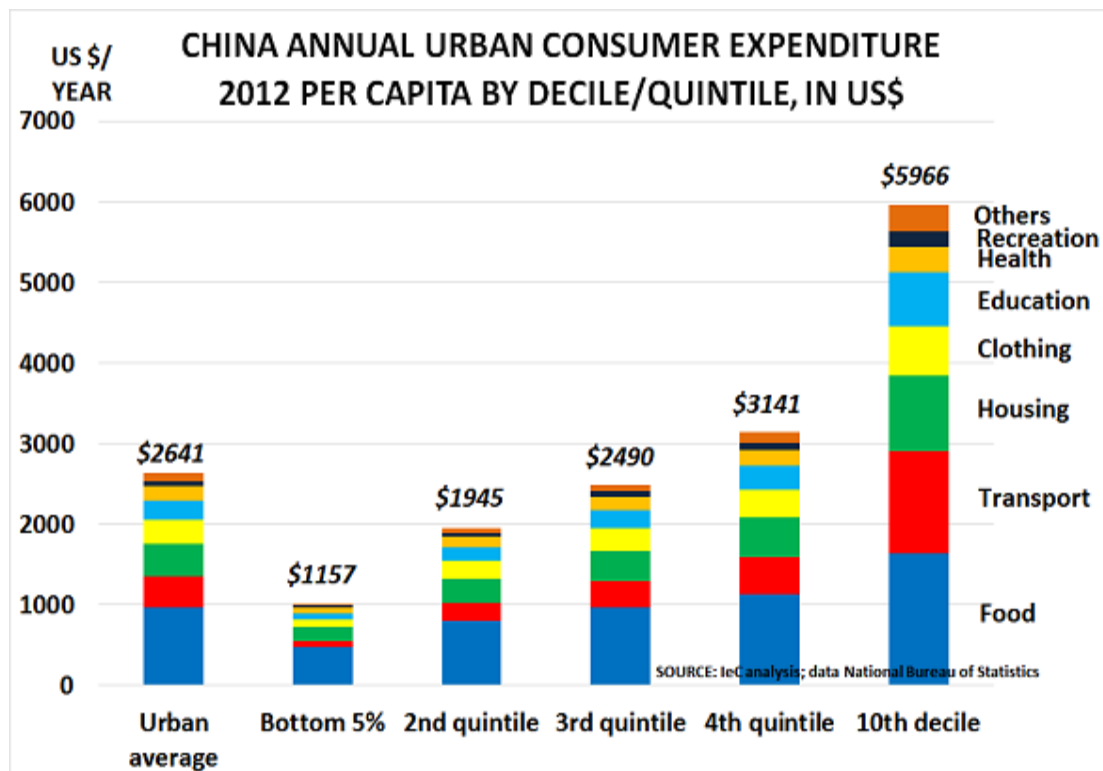
The property bubble created a 'wealth effect' which will now disappear

- Average prices several times the US sub-prime peak
- A great source of wealth, as well as consumption growth, as long as more money kept being added
- But it led to greater social inequality as the richest 1% of urban households own around 30% of all real estate assets

SHANGHAI HOUSE PRICE INDEX
2003 - 2013



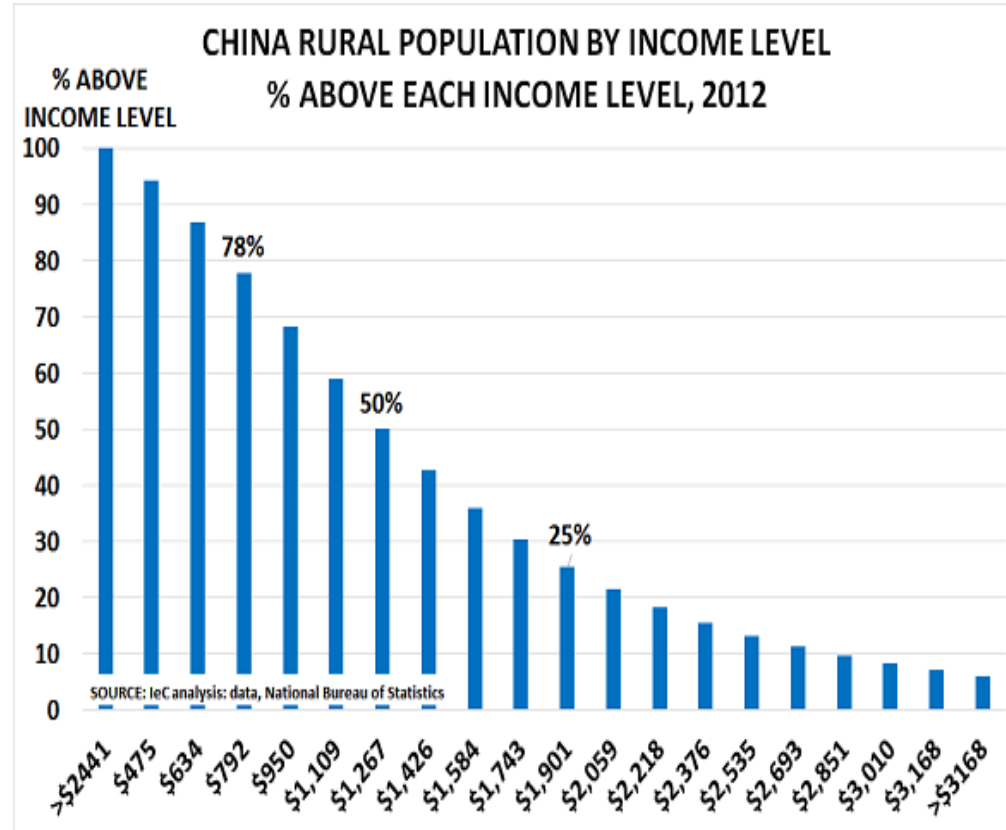
China is not “middle class” by western standards



- Average per capita urban incomes were Rmb 29547 (\$4769) in 2013 versus \$447 in 1993
- Average per capita rural incomes were \$1276 in 2013 compared to \$160 in 1993

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 of 5 households own a motor bike and the same proportion own a car
 - Almost every household owns a computer and water heater



They cannot 'blink'

Missing Money

A measure of China's money supply known as M2, change from a year earlier



Source: CEIC

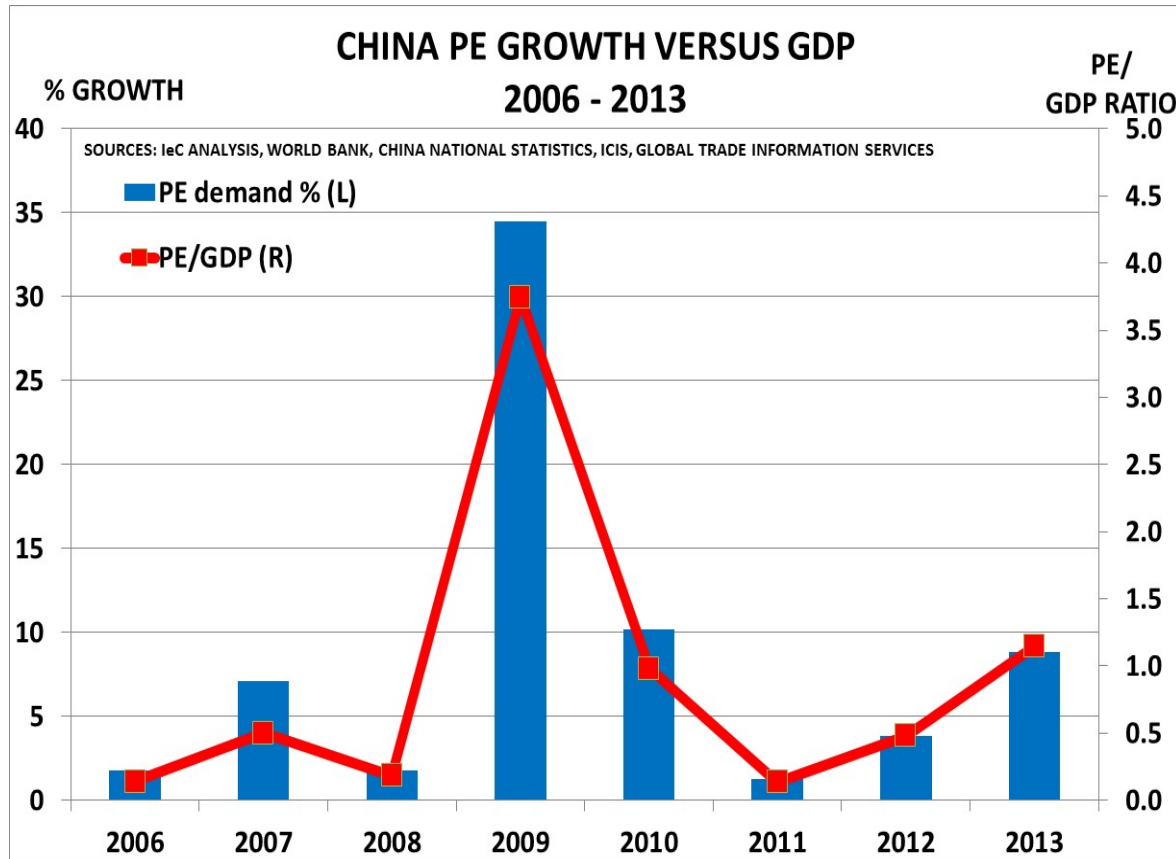
The Wall Street Journal

- China can no longer achieve growth because of cheap labour and rising exports
- Total social financing in March was down 19% versus 2013, and at lowest rate since 2005
- Money supply growth lowest since 2001
- Desperate measures are inevitable because the economy is so badly skewed

“Since the beginning of 2014, faced with complicated and severe economic environment at home and abroad, the Central Party Committee and the State Council have stood firm, launched their actions and made their efforts to take reforms and innovations, to transform and upgrade the economic development model, and to improve people’s well-being.”

Summary statement from the Q1 2014 GDP announcement

Credit flows have distorted polyethylene growth since 2008



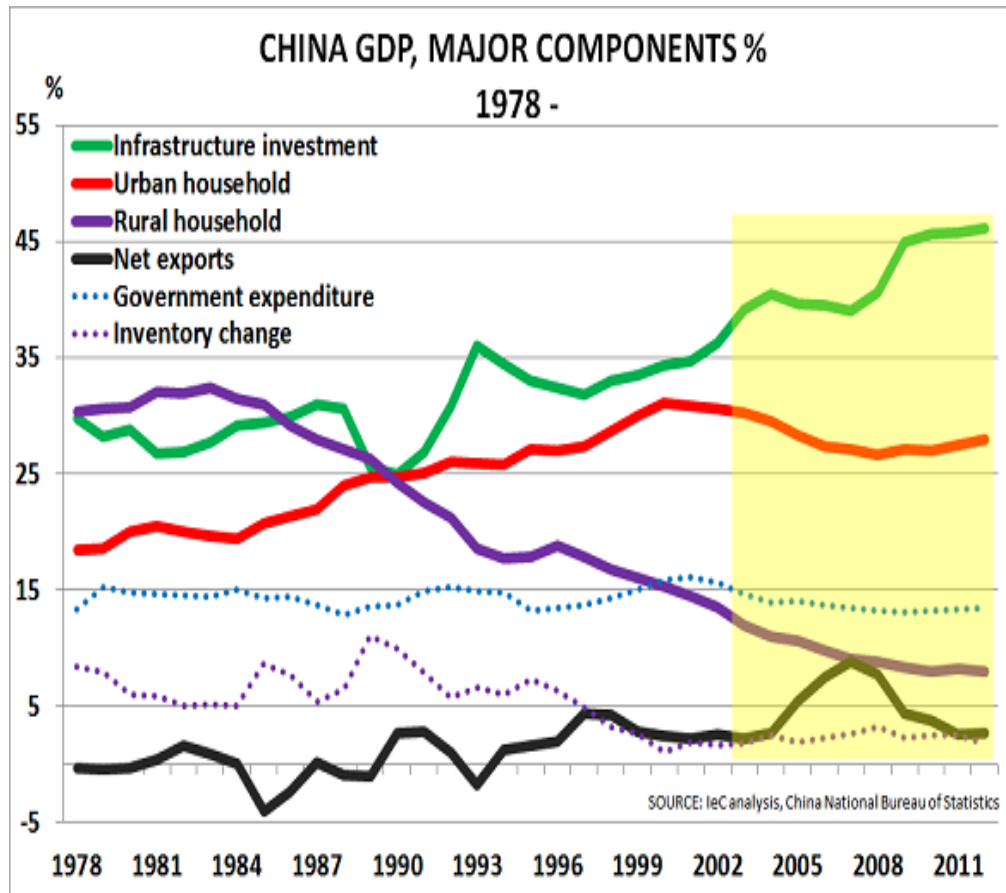
- 2009-2010 boom due to economic stimulus
- Tighter monetary conditions from April 2011 until late 2012. This exposed the scale of inventory distortions
- Last year saw “a last hurrah” as credit growth exploded again – e.g. Q1 surge in “shadow lending” and July mini-stimulus package

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Credit growth has become key to GDP. Here is why....



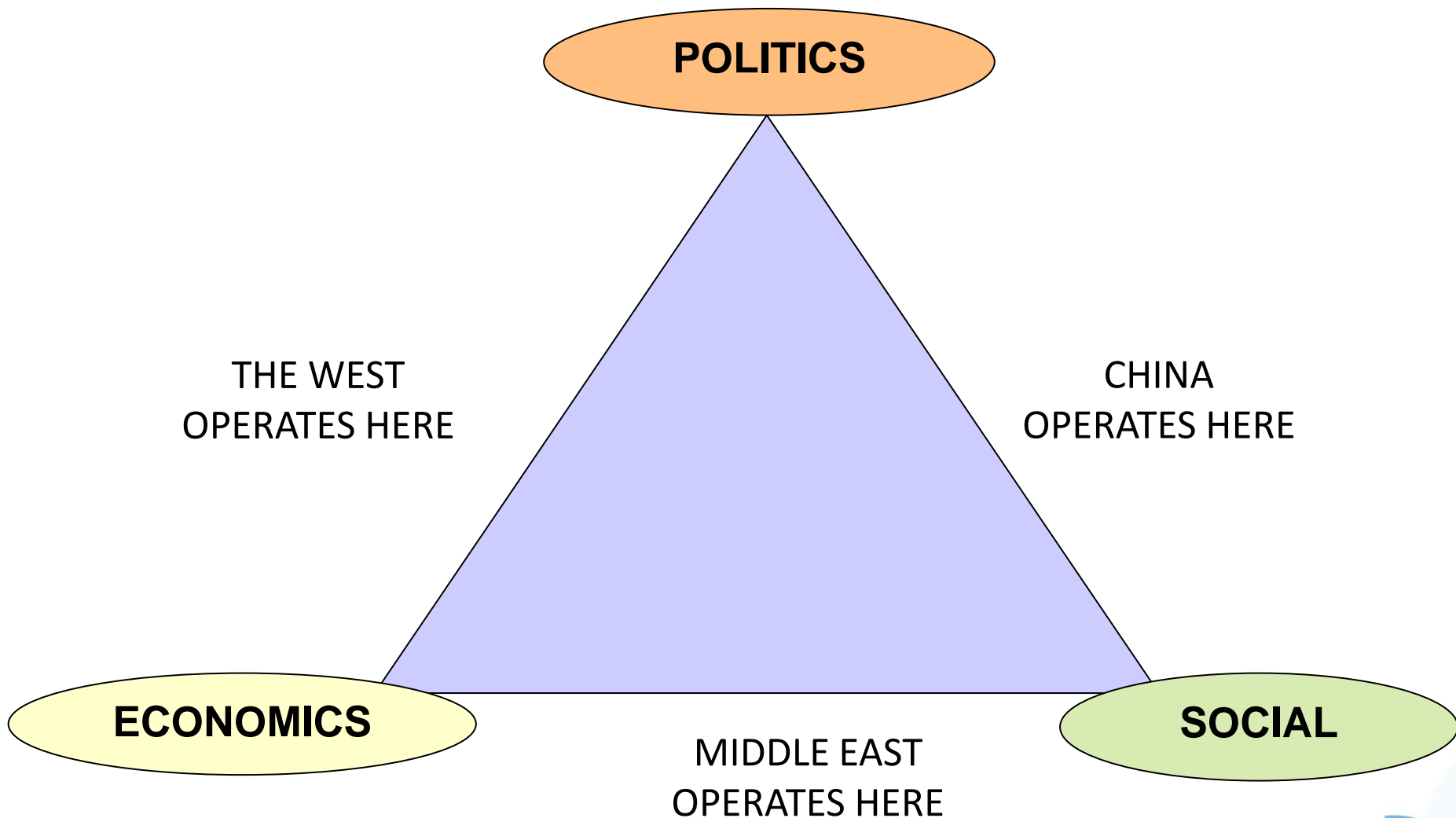
- Infrastructure spending now nearly half of GDP
- New property construction related expenditure is nearly a quarter of GDP
- Urban and rural spending has fallen
- *“Exports in 2012 made a negative contribution to GDP growth, and if you deduct speculative funds disguised as trade payments, you’ll find that exports were a drag on growth again in 2013” – China Daily, 11 Feb 2014*

And the importance of the environment

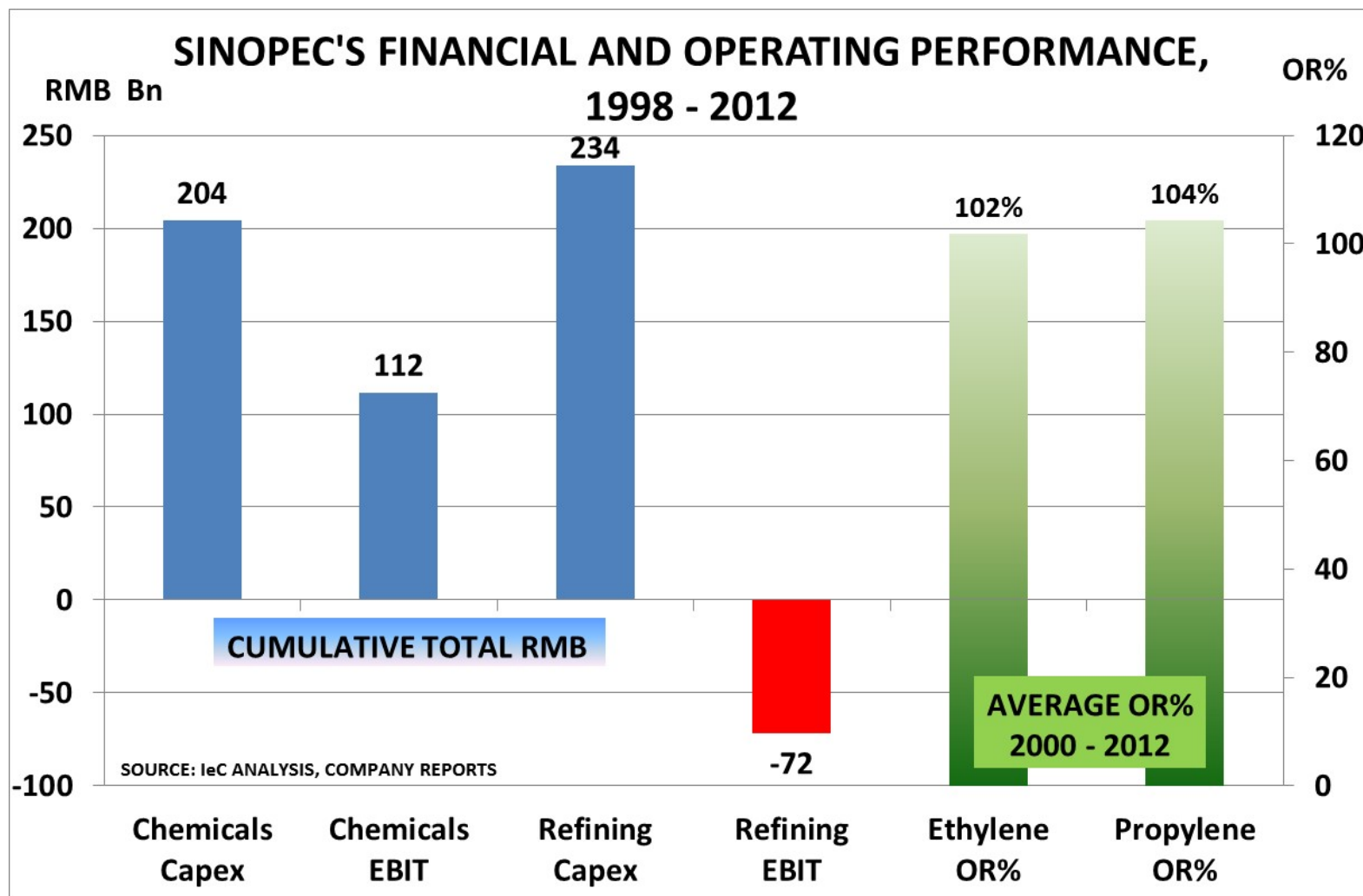


- Investment-led growth blamed for problems such as chronic air pollution
- “One-sixth of China’s arable land — nearly 50 million acres — suffers from soil pollution. More than 13 million tonnes of crops harvested each year are contaminated with heavy metals” – Ministry of Environmental Protection
-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

China does not operate on a profit-oriented basis

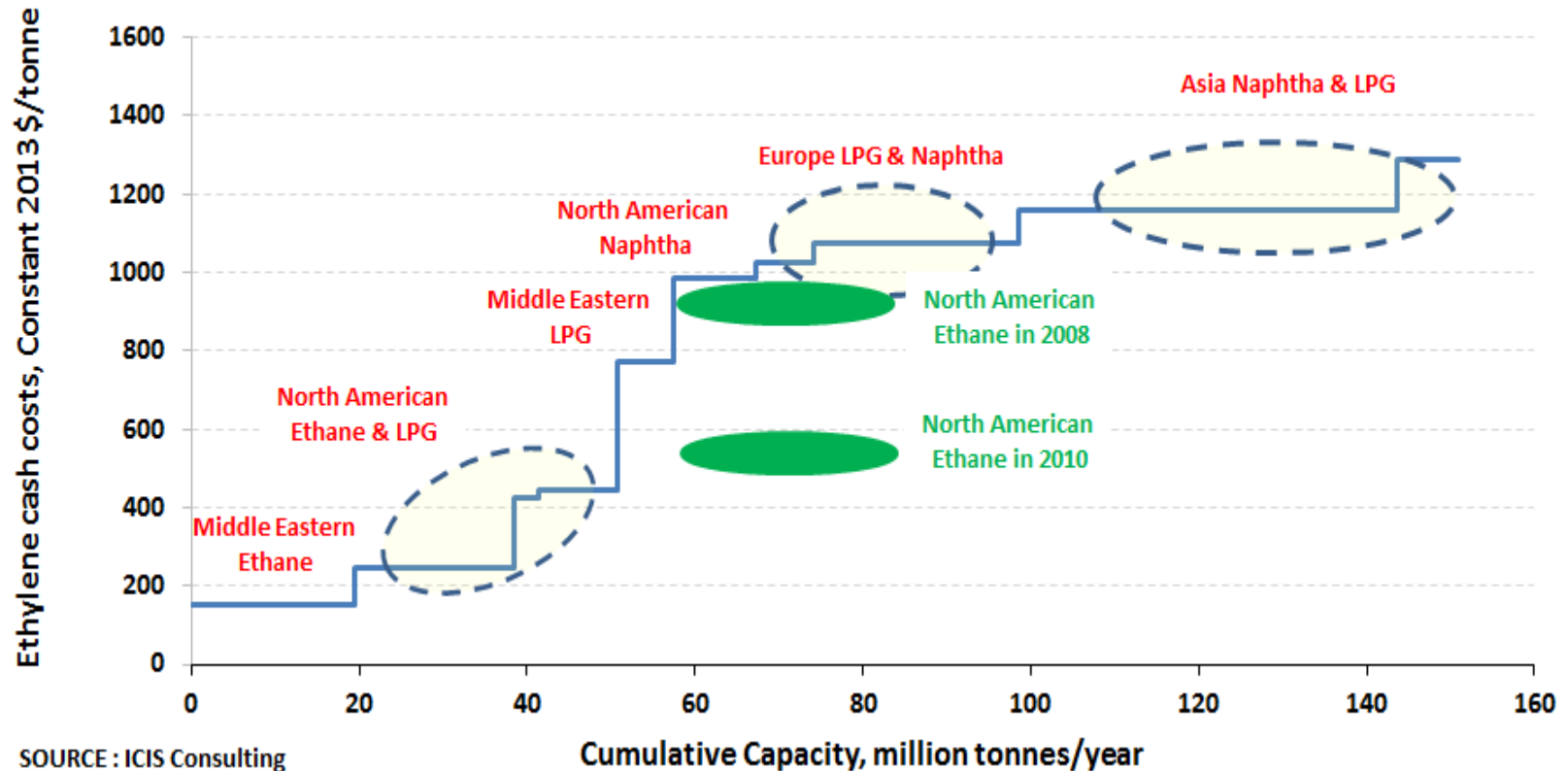


Sinopec operates as a utility with a social agenda, aiming to maximise employment - not profit



Cost curves don't matter when employment is the key driver

Ethylene Cash Costs of Regional Steam Crackers, 2013



The “New China”

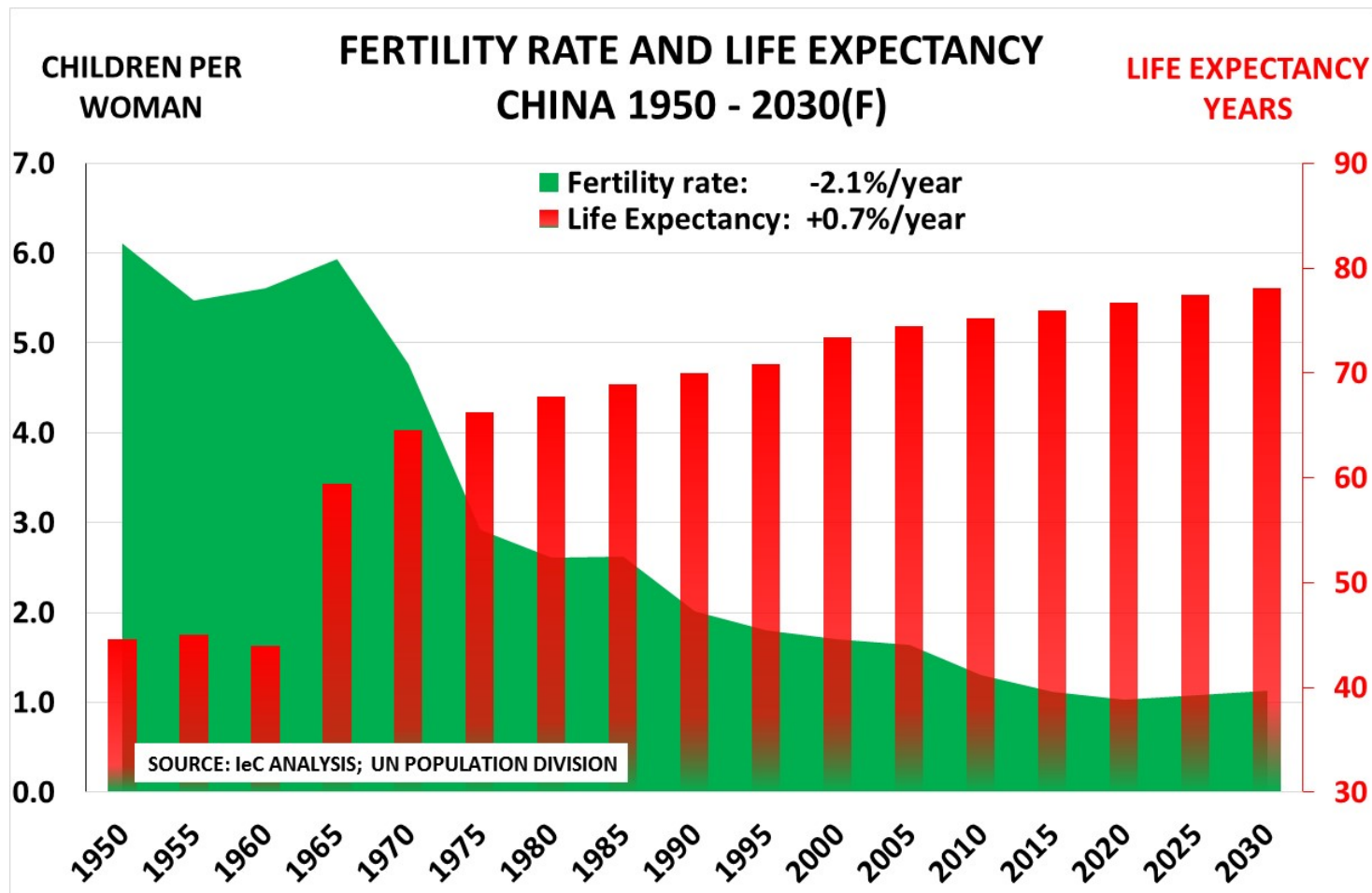
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China's 'one child policy' since 1978 means its wealth creator 25-54 age group is declining



China's life expectancy is now 75 years: Women have just 1.5 children

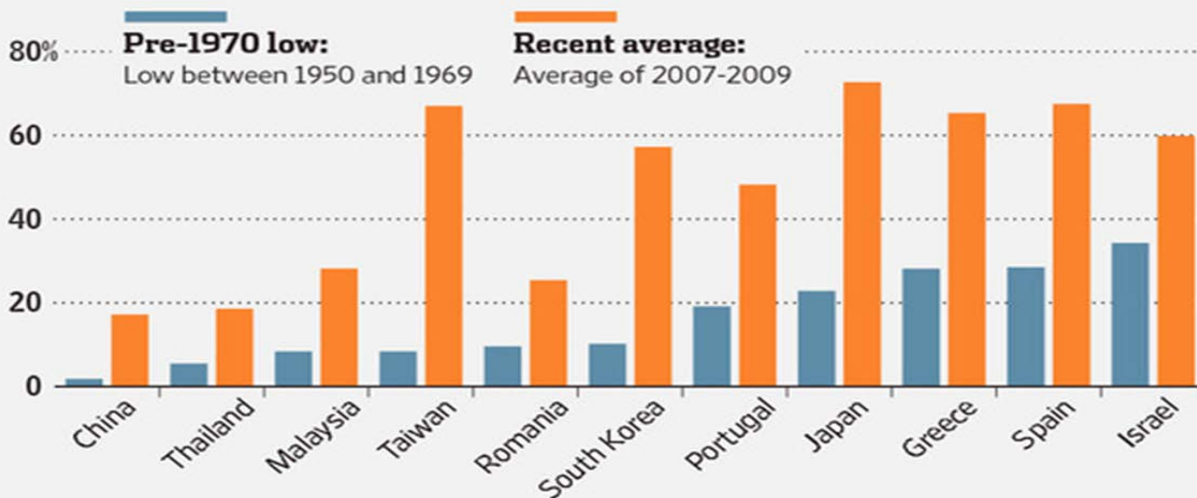


World Bank's 'China 2030 report' warned "growth is in danger of decelerating rapidly, without much warning"

Catch Up

A few once-poor nations have made progress in the past 40 years closing the gap with the world's richest nations.

GDP per capita adjusted for Purchasing Power Parity (PPP), as percentage of U.S.



Sources: Penn World Table, GK Dragonomics estimates

The Wall Street Journal

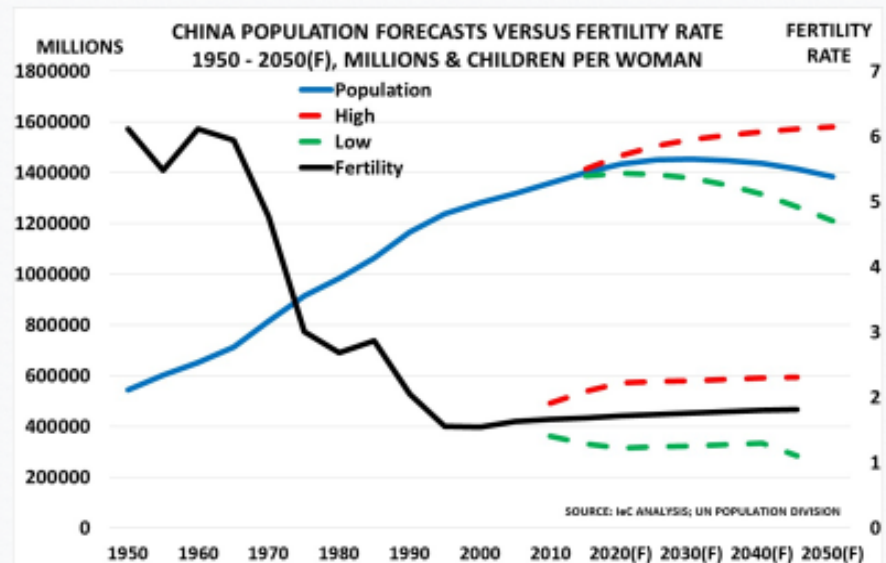
"A sharp slowdown could deepen problems in the Chinese banking sector and elsewhere, the report warns, and could prompt a crisis, according to those involved with the project."

Wall Street Journal, 23 February 2012

China's population is now likely to decline

- Tighter supply of blue collar workers
- Government still needs to find well-paying jobs for 7m new graduates every year
- Moving up the value chain essential in order for China to afford to provide essential services and pensions for its ageing population

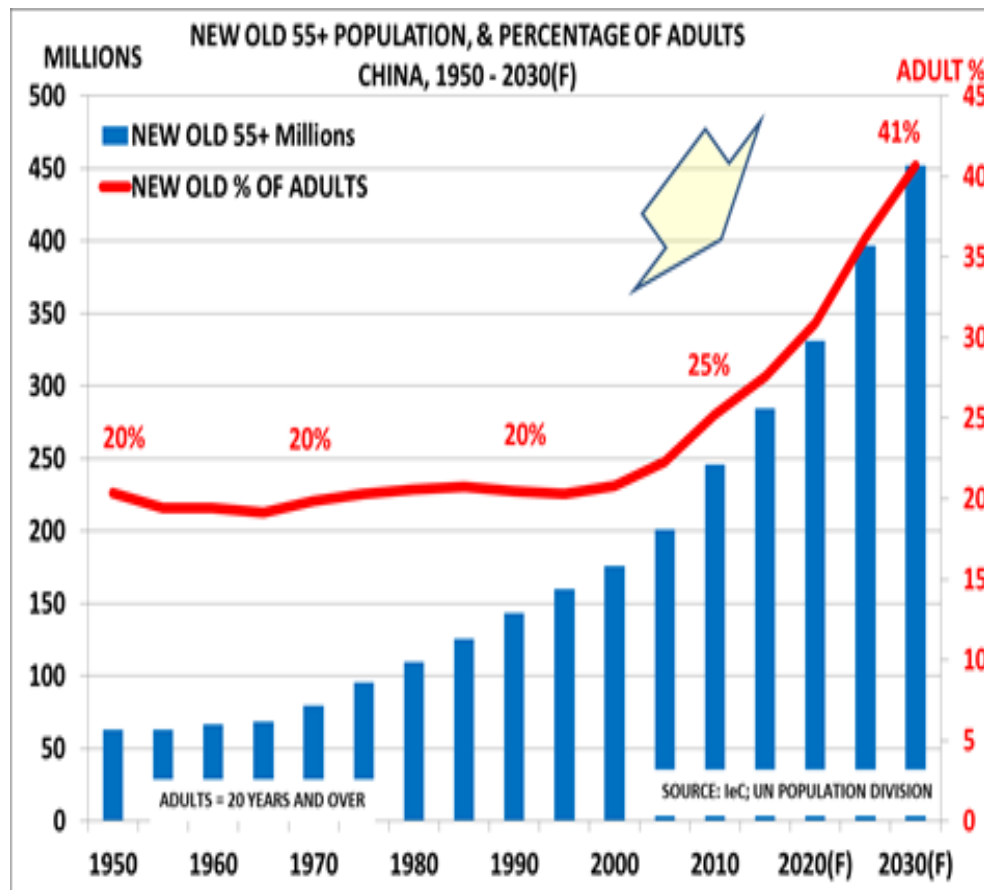
CHINA'S POPULATION NOW DECREASING UNLESS WOMEN SUDDENLY START TO HAVE >2.1 CHILDREN



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CREATIVE ENERGY FOR IMPORTANT ISSUES

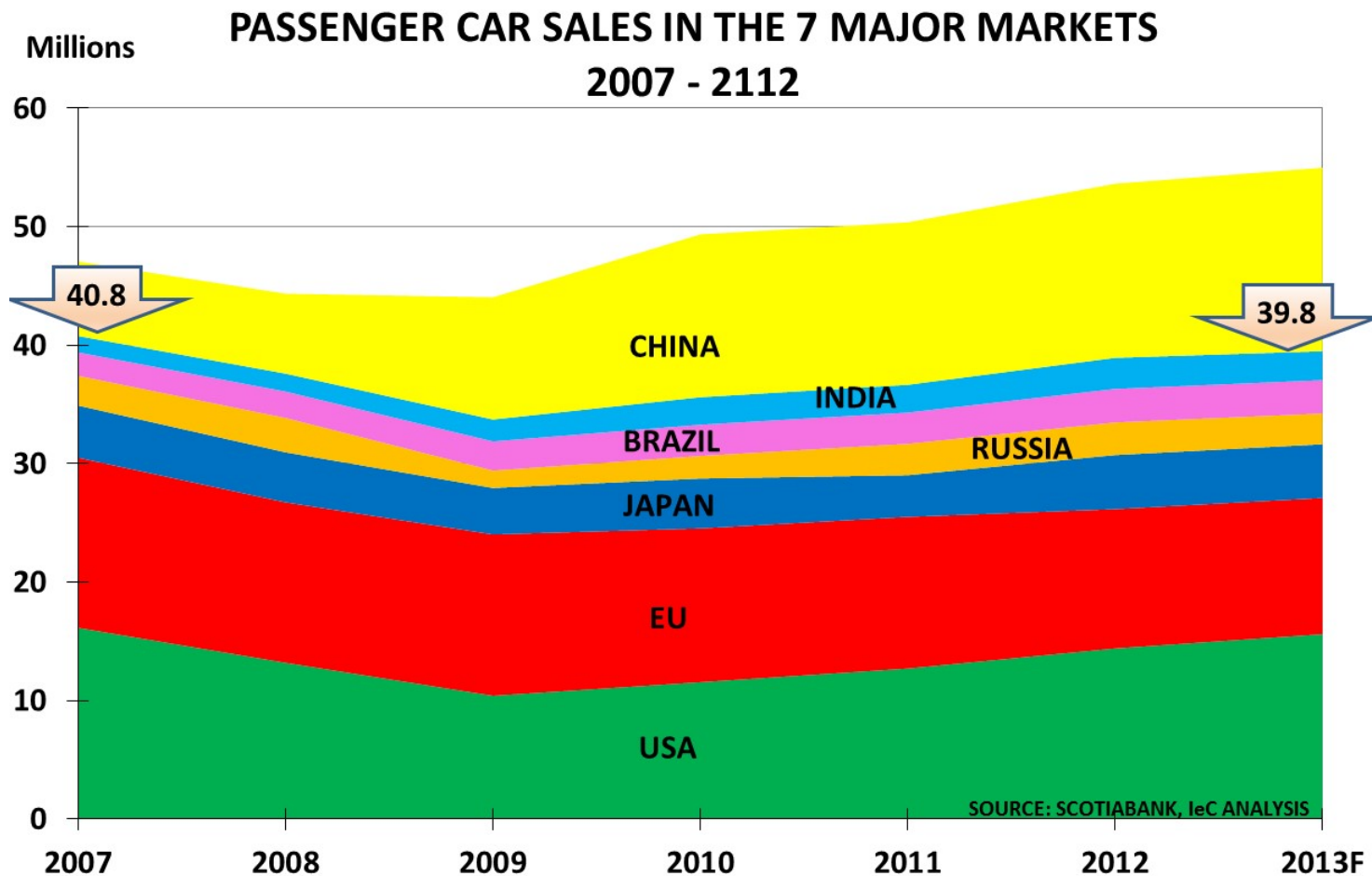
Ageing populations consume and spend less



- In 2000, one in five adults were in the New Old 55 generation
- The 'one child policy' means this ratio has now reached one in four adults
- It will reach one in 2.5 adults within ten years.
- Older people spend less and have lower incomes – particularly in China which has only very basic social security provision
- “Someone aged 50 can wait thirty to forty years to enter a state nursing home”, premier Li Keqiang, October 2013

China's 'wealth effect' has been critical for world auto growth since 2009

The 'top 7' are >80% of total world demand



The credit bubble

- China felt it had no choice post-2008
- This delivered great benefits to chemicals – e.g. 138% increase in auto sales
- So, where is chemicals demand heading as a result of
 - Lower credit growth?
 - Environmental restrictions?



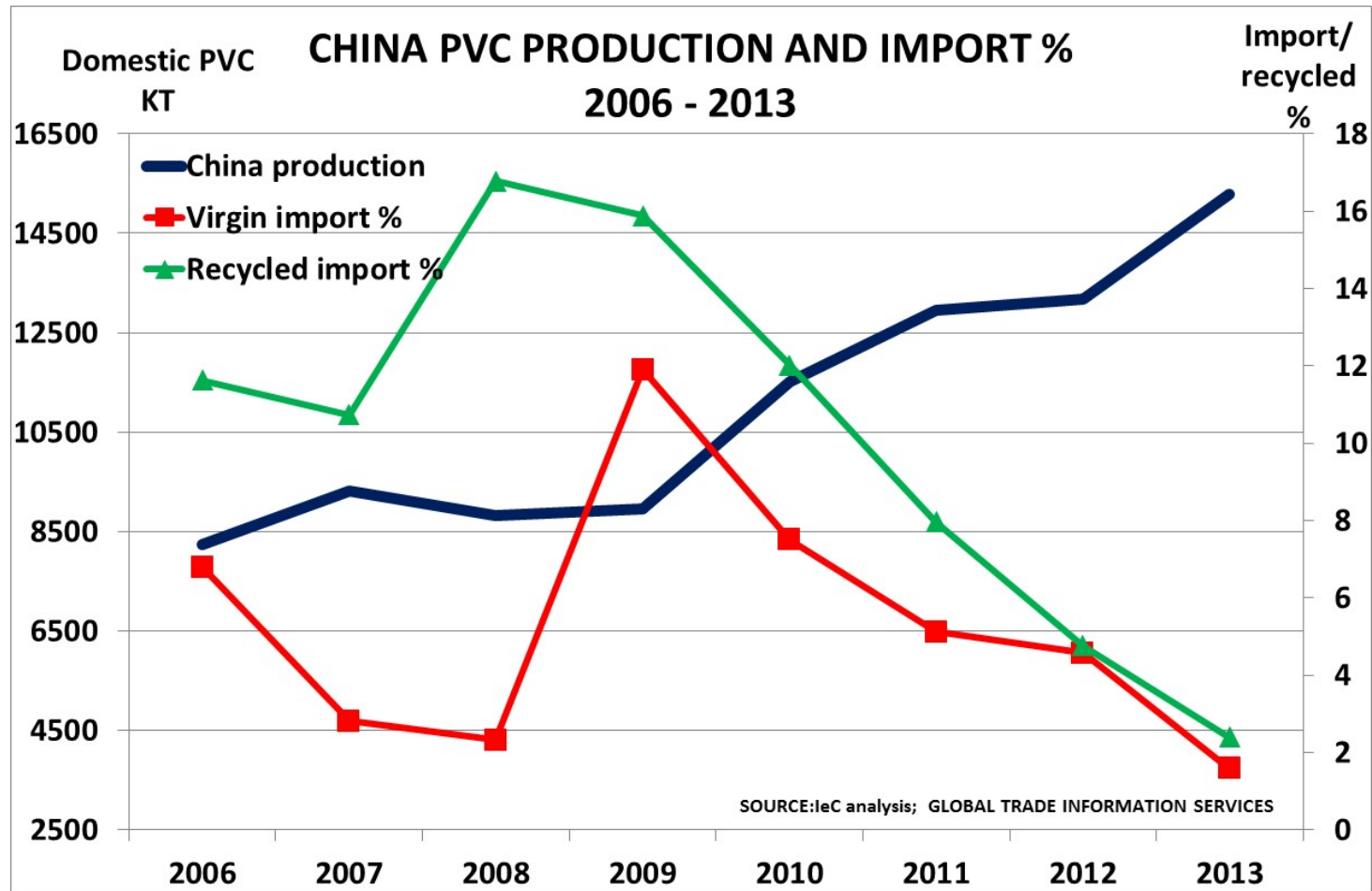


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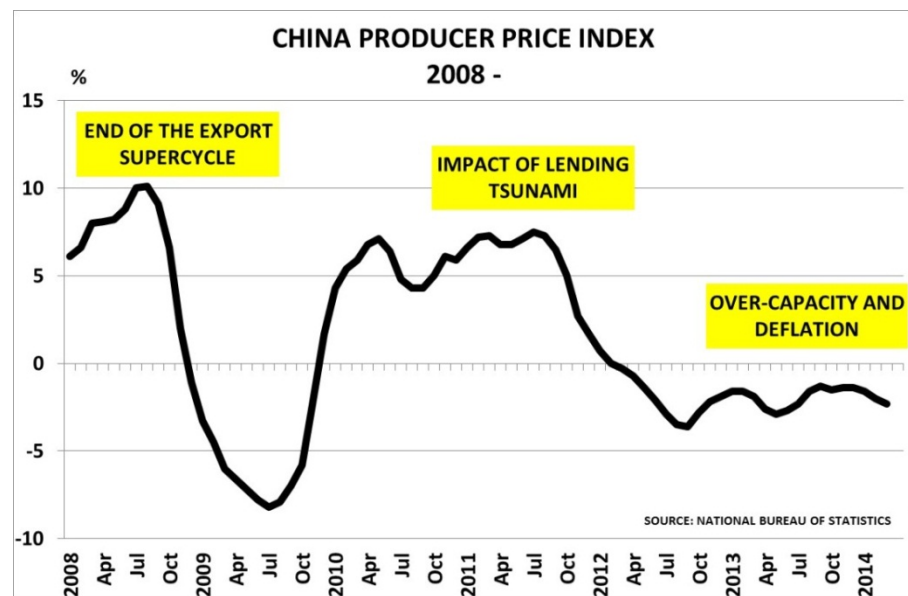


PVC illustrates how China is now raising its own production, and exporting rather than importing



The seven immediate implications, part 1

- **Domino effect.** Emerging economies hit in a wide arc from Argentina through to India and Indonesia to Turkey
- **Zero GDP growth possible temporarily.** Polluting factories being bulldozed; major resource needed to clean up eg the one-sixth of China's farmland currently contaminated with toxic waste
- **Deflation.** Employment is the key priority. China's producer price index has already been negative for 2 years: exports will be a key focus for policy during the transition. This will export deflation – volume rather than profit will be the priority



Part 2

- **Export demand.** China's main export focus will no longer be the cheap textiles and plastic products of the past. Instead it will create jobs via an aggressive drive to sell affordable cars, smartphones and relatively high-value chemicals into emerging and Western markets, based on the major new capacity installed in recent years
- **Dollar strength.** China's economic crisis will come as a shock to most of the financial community. We can therefore expect China's currency to begin to fall in value, and the US\$ to rise, all other things being equal. This, of course, will also help to boost China's exports



And part 3

- **Domestic demand.** China's domestic demand will change. Sales of high-end western luxury goods will continue to decline as the anti-corruption campaigns continue. Instead, the focus will be on affordable necessities such as \$50 refrigerators for the 90% of the population who earn less than \$20/day
- **Debt.** China's record \$1.3tn holding of US debt was built up as a form of vendor finance, to support US purchases of China's products. But this strategy is no longer relevant, so we may well see China slowly reduce its holdings for use at home – potentially putting upward pressure on Western interest rates

Reverse innovation



Reverse innovation isn't optional; it's oxygen.

~ Jeffrey Immelt, CEO of General Electric

More than 90% of China's population still relies on poorly funded, low-tech hospitals or basic clinics in rural villages.



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