

Minjing Journal

COVER STORY

CHINA

A soft or hard landing

Will China's growth survive its economic transition?

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Twelve five-year plans down and China still has the capacity to bewilder economists and politicians the world over.

Whether it is curbs on environmental pollution, working days at coal mines, the number of children families can have, or limits on trading stocks, the Chinese government's interventionist policies have the ability to substantially swing markets and sentiment.

With the economy having reached the heady heights of second largest in the world, its will to change direction has a massive impact on the demand for – and price of – commodities.

In 2014 and 2015, its efforts to cool the booming housing market saw commodity prices drop to their lowest level since the global financial crisis, while the 2016 infrastructure stimulus, in tandem with domestic coal mining restrictions, saw iron ore and coking coal prices more than double from their previous-year lows.

The question that has remained unanswered for many years, but is asked even more of late as commodity prices continue to be supported by Beijing's stimulus packages, is: how much longer will China continue with such tactics?

With landings of all varieties – bar an emergency variety on the Hudson River – being considered for China's economy in the near and medium term, the answer is: not much longer.

Finning down just when these measures might recede, however, is tricky. Not only does one have to take a view on the structure of China's future growth and how that impacts commodities, one also has to evaluate what the country's 'real' growth actually is.

Analysts and market commentators have picked holes in China's GDP figure for years,



using alternatives to try to paint a more accurate picture of growth.

As Paul Gait, of Bernstein Research, told *Minjing Journal*: "To think that the Chinese GDP figures is, qualitatively, the same kind of object as the US growth equivalent is to be mistaken about the nature of the object."

Ingo Hofmaier, of Hannam & Partners, said the metric is used to "project stability and linear trends, in particular, internally", while Caroline Bain, of Capital Economics, said it used its own in-house proxy for Chinese GDP in an "attempt to get away from this problem".

The alternative growth figures differ substantially from what comes out of Beijing.

For example, China's 'official' GDP figure is expected to come in at 6.5% in 2017, down from 6.7% in 2016, but Capital Economics' in-house metric, which takes into account low-level indicators such as cement production and electricity output, is pegged for 5% growth. Capital Economics puts China's 'official' GDP number at 6.5% next year, with its own growth calculation 2% lower at 4.5%.

The Economist Intelligence Unit (EIU), meanwhile, estimates 6.4% Chinese GDP growth in 2017, just 0.1% shy of the official figure, and 4.2% in 2018 using its own formula.

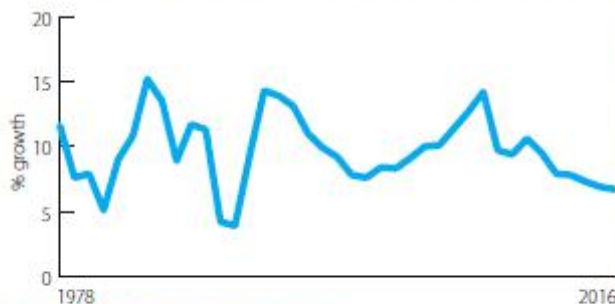
Looking beyond the noted differences in growth figures, there is a clear trend here. The Chinese economy is coming into land.

Capital Economics' Bain said: "We think this is probably as good as it gets, in terms of growth for this year, and it will be slower over the course of the year."

She categorised the 0.5% year-on-year drop in the company's growth predictions from 2017 and 2018 as a soft landing. The EIU, meanwhile, said the 2.2% growth drop it expects from 2017 to 2018 corresponded to a hard landing.

Morgan Stanley, in its report 'Why we are bullish on China', is projecting a 6.1% average 'real' GDP growth rate over 2016-2020, slowing to 4.6% during 2021-2025 and 3.1% in 2026-2030.

Hard or soft landing, the sizeable growth rates exhibited in the previous decade (see



Chinese GDP growth (National Bureau of Statistics)

graph, left) are not coming back.

The explanation for this change is not unexpected. It has been spoken of for years. China will transition from an export-led economy to one focused on domestic growth. Within this, there will be a move towards high-value-added industry, from the more basic manufacturing that supported the economy in its early evolution.

Such a transition will, inevitably, see growth indicators fall as the country looks within, as opposed to outside, its borders for consumers, while diversifying its economy.

After years of this transition being spoken of, why will it happen now?

No more growth spurts

The answer is multifaceted.

Cailin Birch, of the EIU, told *Mining Journal*: "What is important to note, looking underneath those growth numbers [6.4% for 2017], is that a lot of that is coming from debt. Both lending to consumers and, particularly, borrowing by regional governments to fund local spending is continuing at a very strong pace."

Morgan Stanley estimates debt to GDP in China rose from 147% in 2007 to 279% in 2016, close to Japan's 1980 level following its own period of rapid growth in the 1970s. China's debt is on course to reach 300% of GDP this year.

The debt problem has become worse of late, too.

Between February 2015 and June 2016, domestic credit in China increased by Yu40.3 trillion (US\$5.85 trillion), or around 54.9% of GDP, according to Bernstein. Such a rise coincided with the government's infrastructure stimulus of 2016, which came after 'real' growth fell back in 2015 – it was between

3% and 7% depending on which analyst one cites, compared with the official 6.9% GDP figure.

While nowhere near the same debt level, China's leverage increased substantially in 2008, as the government splashed the cash in order to boost an economy infected by the global financial crisis. The economy kept growing at a phenomenal pace after this, so why is the current debt situation any different?

In the recent past, every time the Chinese government has seen growth falling below expected levels, it has reacted. Bain said: "The government panics a bit and introduces some more stimuli, which tends to go into construction and infrastructure."

The problem is China has progressively had to issue more and more credit to generate less and less growth. In a report last year, the Economist said it took nearly four yuan of new borrowing to generate one yuan of additional GDP, up from just over one yuan of credit before the financial crisis. The more the government resorts to such measures, the more debt it requires to make a meaningful impact.

While Japan's debt to GDP level is now at 450%, China's income level, which far exceeds its Asian peer, means this ratio is unprecedented. Add in the fact that this Yuan-denominated credit is becoming less effective and it is unsurprising analysts, including the EIU's Birch, think debt-fuelled growth is unsustainable in the long term and, possibly, even the medium term.

In line with such a realisation, Beijing's growth strategy is changing.

While the 6.5% official GDP projection for 2017 may show only a small annual fall in growth, "policy makers are now signalling a willingness to accept slower rates of growth

and place more focus on preventing financial risks and asset bubbles," Morgan Stanley said.

All signs are the government would "not protect growth at all costs" and would shy away from stimulus measures in the event of a perceived GDP growth drop. This doesn't mean to say there will be no growth – all indicators point to an increase – it just means the growth will come from more sustainable sources.

And, the last reason for China's economic transition starting sooner rather than later comes in the form of domestic consumption and a move up the value chain, which has been occurring behind the scenes for some time.

"Long gone are the days when basic consumer products such as noodles and flavoured teas dominated the landscape," Morgan Stanley said.

The country is already the largest consumer market globally for automobiles, mobile phones and online retail and is set to get even bigger. The bank believes private consumption in China will double to US\$9.7 trillion by 2030, with the patterns in line with the typical Chinese consumer "getting richer, older and more tech-savvy".

According to Hofmaier, China is already producing products of "significantly more sophistication" than it was in the past, catering to this changing demand.

This can be seen in the country's high-value added exports, which have been rising steadily and now account for more than half of the country's total exports, according to Morgan Stanley.

In the future, many of these exports will stay at home as Chinese consumers get older and have increased amounts of disposable income.

While it still has some way to go before it can compete on all fronts – indigenous automobiles and large-bodied aircraft, in particular, are in need of improvements before they reach the heights of those coming out of the West – the country has a good base to build off.

All of these factors, combined, are leading many to believe the country could be about to make a meaningful move towards that transition in the near-term, with Birch believing the 19th National Congress of the Communist Party is a crucial event in this evolution, which could see the government introduce a "policy-led" shift towards this economic transition.

If the Chinese government puts such policies and timelines down on paper, history shows the transition will happen.

The commodity rub

While not everyone is convinced it will occur soon – Bain was hesitant to call it in the near-term – this evolution will end up affecting the commodity space.

The China of the future, one built around domestic production and consumption of ▶



China's urbanisation efforts are still far from complete



The 19th National Congress of the Communist Party later this year could prove crucial in moving China's economic transition forward

► higher value added products, is going to require a different commodity recipe to bake its economic cake.

Many have said iron ore and coal – normally associated with the earlier stage of an economy's development, and commodities benefitting from recent infrastructure stimulus programmes – will be the first hit by this transition, but this is not so clear cut.

Japan, which many analysts draw parallels with when looking at China's future economic evolution, is the reference point here.

Major GDP growth may be behind Japan, but it is still the third-biggest importer of iron ore and takes in more seaborne coking coal than any other nation, in line with its designation as one of the globe's most advanced steel producers.

For the time being, China will still require these early-stage commodities to get to its urbanisation target of 60% by 2020, up from 56% in April 2016. This means iron ore for steel, copper for wires, industrial minerals for paint pigments, for example, will all be needed.

Further out, its transition to higher value-added industrial development will mean steel – albeit a different kind – is required.

"The relatively standard crude steel production that underpins big infrastructure projects will be replaced by much more advanced steel for use in, for instance, the automotive industry and white goods," Hofmaier said.

This could mean demand for the highest-quality iron ore and coking coals continues. It could also lead to an uptick in alloy consumption, with the likes of niobium, vanadium, chromium and manganese having a bigger uptake in China.

Aluminium, normally included in the later-stage commodity bucket in terms of economic development but already used extensively in China, would likely also benefit from the development of its domestic aviation industry, while a move by auto manufacturers towards the luxury end of the car market will require the metal.

Gait, who admitted he would rather be exposed to base metals than the bulks at this point in China's economy, said commodities best suited to China's future growth were "related less to physical infrastructure" and "more around energy and the use of energy in the Chinese economy".

Within this, copper is one commodity set to benefit from China's development. This is not necessarily as a building material associated with early-stage economic development – although urbanisation of less-developed areas will require the red metal in this form – but as a raw material for the 'green' energy revolution.

One can also add nickel, cobalt and vanadium (again) in their battery-component derivatives to this list.

If the electric-vehicle revolution is to catch on as Gait and Bernstein envisage in their rapid adoption scenario – where electric

vehicles reach cost parity with internal combustion engines by 2025 and adoption follows at a similar pace to technologies such as smartphones – an additional circa-20.4 million tonnes per annum of copper, 1.8Mtpa of nickel and 700,000tpa of cobalt would be needed. This far surpasses the 8Mtpa, 900,000tpa and 100,000tpa required from 2002 to 2016 to make China into the economy it is today.

Already the biggest market for EVs with a sizeable domestic production hub, China would demand a lot, if not the majority, of these metals.

Platinum, also for its 'green' energy credentials, and diamonds and gems – for increasing amounts of Chinese consumers with expensive tastes and fatter wallets – could also be set for a prosperous Chinese demand spell, according to Gait.

While certain metals and minerals may be more suited to China's value-added future, its place as the biggest buyer of commodities is not going to change for some time. With certain coastal regions far more developed than others inland, there will also be a need for commodities normally associated with the early part of a country's economic cycle.

In order for these areas to develop, for China to attain a high-income status and for the country to follow on the path set in motion all the way back in 1978, the majority of commodities will be needed. ■