China Economic Update
by NAB Group Economics

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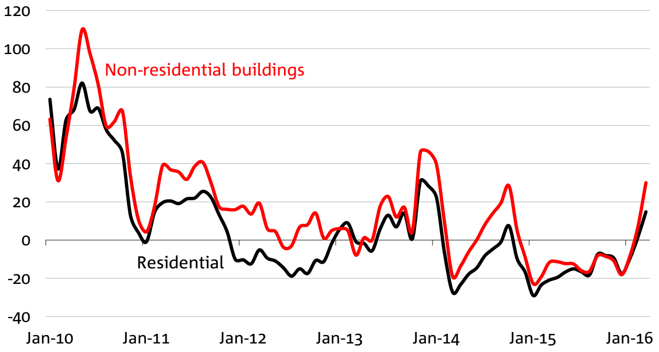
Steel's recent resurgence risks derailing industry reform

A credit-fuelled rebound in China's construction activity has breathed new life into the country's beleaguered steel industry. The sector has been suffering for a number of years – as excess capacity, falling consumption and prices along with the inefficiencies of smaller scale mills hit industry profits. We believe that the recent recovery in construction is unsustainable, but the short term gains threaten to derail necessary reforms to the steel sector.

China's construction sector has come roaring back

Until 2013, the property sector was a key contributor to China's economic growth – accounting for around 13% of GDP – however uncontrolled activity led to oversupply of housing and commercial floor space in a wide range of markets, which flowed through into falling property prices.

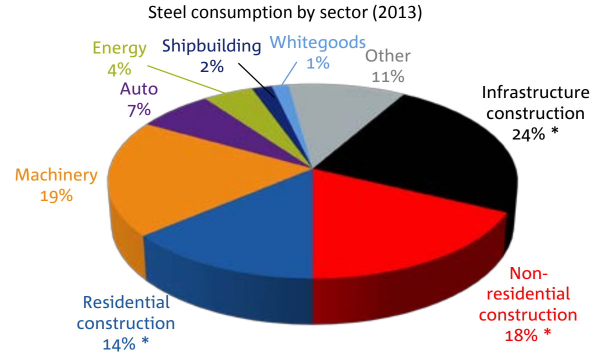
Activity in China's construction sector has recovered sharply in early 2016



Source: CEIC, NAB Economics

Total new construction activity – as measured by floor space starts – declined across 2014 and 2015 (recording falls of 14.4% and 17.7% respectively) as the combination of falling prices and policy changes (including measures that favoured alternative investment options) constrained property demand. This had a significant impact on demand for key inputs such as steel and cement – with construction accounting for almost 56% of steel consumption in 2013 (MIPRI) – and, by extension, demand for Australian iron ore and metallurgical coal.

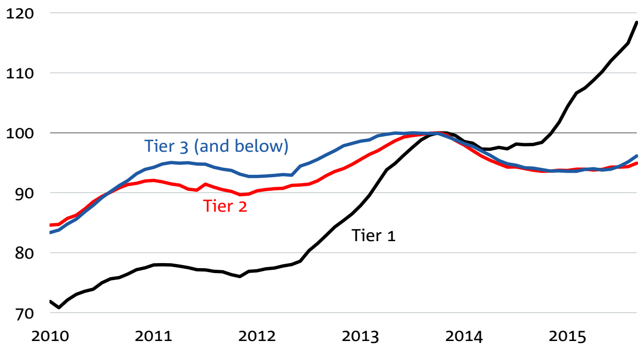
Construction the dominant sector for China's steel consumption



* Construction breakup based on 2010 estimate
Source: MIPRI, OECD, KPMG, NAB Economics

The weak construction trend reversed in early 2016 – with construction starts growing by over 19% yoy in the first quarter – returning near to the levels recorded in the same period of 2014. There is little to suggest that a wholesale recovery in property markets has underpinned this result. While average residential property prices have recovered and now exceed the previous peak of 2014 (by around 2.6%), this is a phenomenon of China's largest, tier one cities (Beijing, Shanghai, Shenzhen and Guangzhou) – where prices are over 18% above their previous peak. In contrast, tier 2 cities were still around 5.1% below their peak, and tier 3 (and below) cities were around 3.9% below.

Surging property prices are a phenomenon of China's largest cities – smaller ones not recovered to 2014 peaks



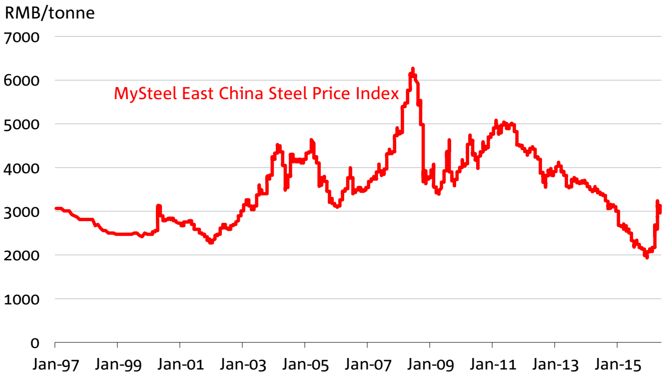
Sources: China Index Academy, Datastream, NAB Economics

At a fundamental level, little has changed in China's property markets – with excess supply persisting in many locations (with arguably the exception being the tier 1 cities – however these cities are home to just 5.1% of the country's population). Instead we argue that policy changes that have relaxed purchase requirements, looser credit and the poor performance of alternative investment options (following the share market correction and crackdowns on shadow banking) have started to re-inflate the property bubble that had somewhat deflated across 2014 and 2015.

Steel industry still requires major restructuring

The recovery in construction activity has underpinned stronger demand for key inputs, including steel. China's steel prices have jumped in recent months – following on from a downward trend from February 2011 through to late 2015, when MySteel's East China price index dipped below RMB 2000 a tonne (the lowest levels on record, dating to late 1990s). From this cyclical low, prices have surged back above RMB 3000 a tonne in late April.

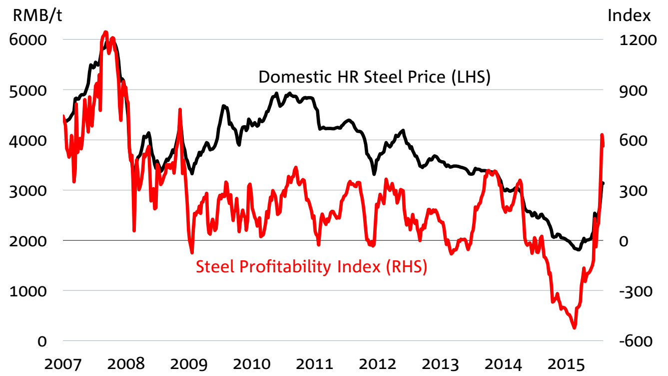
Steel prices suddenly reverse five year downward trend in early 2016



Source: Datastream, NAB Economics

Profitability for Chinese steel mills has similarly improved, despite the recent run up in iron ore prices. Falling steel stocks have supported prices that have increased more rapidly than raw material costs. The result has been that while steel prices are around the highest levels since September 2014, steel profitability in late April was at its highest level since mid-2009.

With prices rising faster than input costs, steel maker profitability is at its highest level in almost seven years



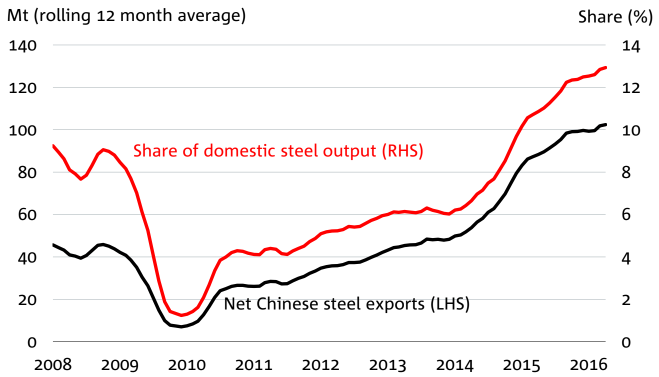
Sources: Bloomberg, NAB Economics

Despite the recent recovery in prices and profit margins, there remain significant long term challenges in China's steel industry that need to be addressed. According to the Ministry of Industry and Information Technology, China's steel production capacity is currently 1.13 billion tonnes – over 300 million tonnes larger than China's output in 2015. In comparison, the entire steel output of Japan – the world's second largest producer – was 105 million tonnes in 2015.

In February, China's State Council announced plans to cut crude steel capacity by between 100 and 150 million tonnes over the next five years (at the social cost of around half a million jobs in the sector) – however this alone will not be enough to eliminate spare production capacity. There is limited upside to China's steel consumption – with the China Iron and Steel Association suggesting that consumption has already peaked and will now enter a long term declining trend.

Export markets also offer limited opportunity in coming years – with Chinese producers already stretching the limit as trade tensions rise. Chinese steel export volumes have risen significantly in recent years – particularly as domestic construction has slowed – rising to almost 100 million tonnes in 2015 – again comparable to Japan's total steel output.

Rising Chinese steel exports add to trade tensions – limiting further upside



Sources: Datastream, NAB Economics

Previously announced cuts have had a limited impact on total capacity – with older plants removed often simply replaced with new production facilities.

In addition, air pollution associated with the steel industry remains a major concern. Of the ten cities that recorded the highest air pollution levels in the March quarter, six were in Hebei province – the country's largest steel producer – along with Beijing – which is surrounded by Hebei province. Ongoing high levels of steel production continue to threaten the health and wellbeing of residents in this region.

Conclusions

The sudden improvement in conditions in China's steel sector – with profitability back to multi-year highs – could draw idle capacity back into production. Such a move could impact both the short term – through worsening trade relationships and further pollution – and the longer term, if it is allowed to derail much needed reform to the sector. Chinese authorities need to remain focused on the long term strategic benefits of reform.

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