China - the devil is in the detail

All economic forecasting contains an element of uncertainty, but generally trends in an economy do not change radically from quarter to quarter.

Conventional wisdom is that after short sharp recessions, economies return through initially faster growth to the long-term trend path that prevailed before the downturn in activity. However, we have demonstrated in our previous articles that this does not happen after a major economic shock.

The economy recovers to a new long-term growth rate but starting from a lower level and hence follows a permanently lower trend path. During such an extreme fluctuation, the structure of the economy changes and the composition afterwards is different from its pre-downturn profile with the changed mix impacting differentially on the various types of maritime freight.

The above well describes the evolution of the Chinese economy since the downturn of 2008 and into the future. The crazy financial boom in the 2000s in customer countries induced an extreme exporting imbalance, followed by a dramatic crash in the demand for its exports. The necessarily rapid transition to domestic consumption, encouraged by powerful government policy, is equivalent to an 'economic shock' and any conventional forecasting model will fail to explain trade volumes.

This is particularly true in China, due to the 'days of plenty' induced imbalances in the financial system generated by the unsustainable build-up of provincial and local government debt, an uncontrolled shadow banking system and over-capacity of factories in some sectors- even before the crash.

Many economic analysts had been predicting Chinese economic growth will return to pre-recession levels in 2013/2014 and for growth in traffic volumes to/from China to absorb much of the surplus capacity that exists across most of the shipping sectors; which is set to get worse in some, as new tonnage currently on order enters service.

Saying we are in a period of uncertainty is an understatement*.

Revised growth rate

These same economists have recently revised their predictions and are looking at a target average growth rate of 7.5% per annum up to 2020. This is substantially below the 9.6% average growth rate since 1979 when economic reforms began.

There is an increasing amount of information emerging about the Chinese economy, which should give all those hoping for a recovery in freight volumes cause for concern. Recent analyses looking at the restoration of Chinese growth rates have highlighted that:

- A very significant proportion of domestic growth was attributable to investment in capital projects funded by state owned banks. Some of this investment has been in so called 'trophy projects', which are fine if they have a lasting contribution to the economy, but the concern is that many of these do not.
- Wage inflation and currency appreciation as a policy is making the Chinese economy less competitive. When the cost of transporting manufactured goods is added to the ex-works prices some of the price competitiveness the country has benefited from in the past is less significant. Some US importers have relocated their manufacturing to Central America, elsewhere in Asia, or brought it back to the US.
- As the Chinese economy evolves there will be a shift to producing higher value added, lower volume goods. This is consistent with the development of other countries in the region, such as Japan and South Korea and will affect both import and export volumes.
- On a positive note, as the population gets richer, the demand for petroleum products can be expected to increase despite green initiatives.

Chinese exports are not determined by growth in the domestic economy but rather by that of its trading partners. Understanding how the different sectors in customer countries, in addition to GDP, drive different types of cargo imports is essential.

Forecasters also need to differentiate between speculative and sustained demand. Many cargo forecasts (particularly in the liner sector) are based on the principle of a simple 'trade multiplier' (ie the multiple of trade to GDP growth) and that this stays constant into the future.

The industry's obsession with the multiplier leads many to base their future plans and investments on a potentially spurious relationship. While this may have been accidentally correct in the past during short periods of stability, all indications are that knowledge of the impact of change in economies, both trend and sudden, after economic shocks is critical to vessel and port investment decisions.

Complex factors

Is it realistic to expect growth in the Chinese economy to create sufficient demand for shipping so as to absorb the surplus capacity in the market? The part-answer is that there are a complex range of factors and uncertainties that impact this, which has to be explained by more than just a simple 'trade multiplier' based on historic GDP growth rates.

In the tanker sector this has to include assumptions about changes in the pattern of crude oil supply, refinery capacity, the construction of new pipelines (eg the new pipeline from Myanmar to China's Yunnan Province) and the changing mix of consumption of goods and services.

One thing is for sure, uncertainty of how the Chinese economy will develop in the coming years should make those contemplating investing in maritime assets look at comprehensive analyses of traffic growth. It's all about the detail. TO

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