Of Cabbages and Steel: China's Convergence Trade

By Joseph Taylor, VP, Senior Sovereign Analyst

KEY TAKEAWAYS

- The price convergence of cabbages and steel encapsulates China's dilemma over flagging economic growth and further stimulus.
- The government will continue to provide liquidity, but we expect more fiscal stimulus to bolster growth.
- Initiating another round of fiscal stimulus risks increased debt and wasteful spending, but inaction risks a sharper growth deceleration.

"The time has come," the Walrus said,
"To talk of many things:
Of shoes—and ships—and sealing-wax—
Of cabbages—and kings"

Lewis Carroll
Through the Looking Glass and What Alice Found There (1871)

The discussion of "cabbages and kings" was intentional silliness on the part of Lewis Carroll, but we have a serious point to make about cabbages and steel in China.

In March, one ton of domestic hot-rolled coil steel cost less than one ton of Chinese fresh round cabbage ($412 per metric ton of steel versus $575 per metric ton of cabbage).[1] What is that telling us? Too little cabbage, but more important, too much steel. With steel prices down nearly 25.5% year over year,[2] the price convergence highlights the government's dilemma over flagging economic growth and further stimulus spending.

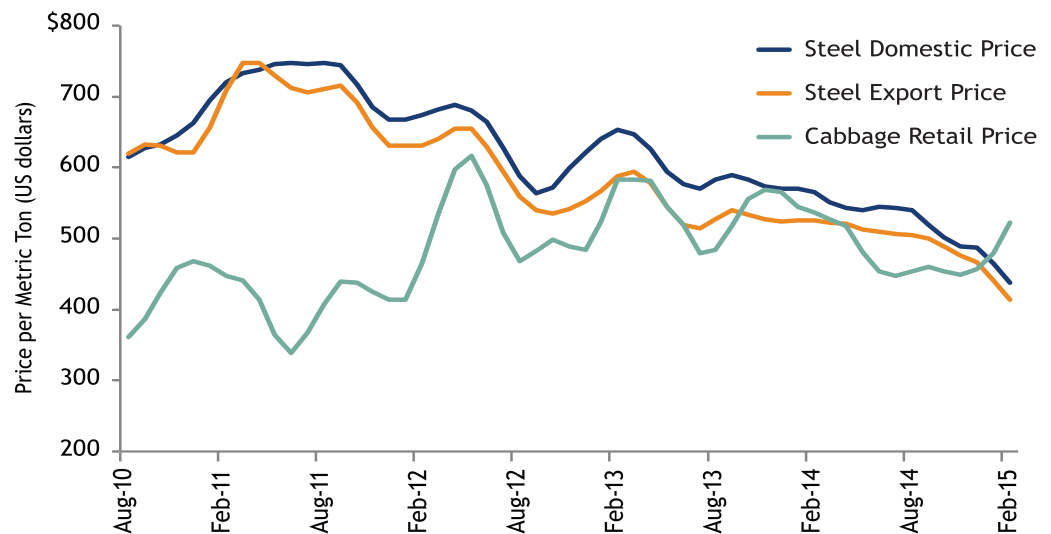
[1] Steel price from Bloomberg and 36-city average price for fresh round cabbage from CEIC.
[2] Bloomberg as of 3/31/2015.

Steel Overcapacity and Overproduction

Despite the well-documented slowdown in the Chinese economy, its steel mills are still belching out tons of steel. In 2014, China produced 823 metric tons, about half the total global steel production and almost ten times US production.[3] Chinese steel production has quadrupled in roughly the last decade. For years and without much success, the central government has attempted to consolidate the steel industry by eliminating smaller, less efficient mills. Since steel plants are a major employer, many local jurisdictions have been reluctant to close them. Instead, local governments have provided subsidies (in the form of discounted loans from local banks or below market energy prices, for example) to keep the production lines in motion despite sagging demand and worsening overcapacity.

CHINESE STEEL OR CABBAGES: WHICH IS WORTH MORE?
3-Month Moving Average

Source: *Steel prices from Bloomberg, cabbage prices from CEIC.*
Data as of 3/31/2015.



The Attempt at an Export Solution

Predictably, domestic steel prices continue to fall. The Chinese steel industry has resorted to exporting its way out of overcapacity, much to the irritation of steel producers in the US, EU, Australia and South Korea, all of which are agitating their respective governments to impose tariffs. Adding insult to injury, China offers the steel exports at a discount to its domestic price, undercutting prices everywhere else. Consequently, profitability in the sector is razor thin, notwithstanding the plunging prices of the principal input, iron ore. Without the subsidies from local governments, we suspect much of the steel industry would show substantial losses.

Will They or Won't They Stimulate?

Many have recently argued steel prices are set for a rebound based on Premier Li Keqiang's soothing remarks at the close of the National People's Congress in March. He lowered China's GDP estimate for 2015 from 7.4% to 7.0% but provided reassurance that a "host of policy instruments" could promote growth. In the week following the premier's announcement, the Shanghai Composite responded hopefully, with a 4% rise.

[3] *Source: World Steel Association (worldsteel).*

If the Premier's comments refer to new liquidity measures, recent history gives little reason to think the tack will translate into growth. The People's Bank of China (PBOC) has been providing liquidity since late 2013, beginning with the Standing Lending Facility. The Medium-Term Lending Facility, which provided 769.5 billion renminbi ($122 billion) in discounted loans to banks, followed in late 2014. More recently, the government announced a debt-swap program intended to push out the maturities of nearly half of the local government financial vehicle (LGFV) debt coming due in 2015—an amount equal to 1 trillion renminbi ($161 billion). We strongly suspect these instruments were designed to give banks breathing room on loans that might otherwise be declared nonperforming. All of these measures provided liquidity but did not, importantly, jump start new lending and investment.

WHAT WE EXPECT

China's revised GDP target of "around 7%" will be difficult to achieve without more fiscal stimulus, even with continued liquidity access.

Will the Chinese government resort to another round of fiscal spending? Doing so will increase debt and may encourage wasteful spending again. Not doing so may risk a sharper deceleration in growth, especially if the construction sector remains moribund. The economy is too dependent on a continuing expansion in construction for the government to ignore many more months of lackluster growth. We may learn about this "host of policy instruments" sooner rather than later. And they may ultimately look more like good old-fashioned fiscal stimulus than liquidity access.

In the meantime, there may be an arbitrage between cabbages and steel.

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