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China’s Subsidies End Prompts Forecasts for Slower Growth

By Bloomberg NewsFebruary 28, 2014

Chinese carmaker BYD Co. (1211) may be getting some bad news as it prepares to start selling in the U.S. next year. A planned reduction in government subsidies and a phase-out of interest-rate controls threaten to raise costs for it and thousands of companies across China.

Less than a decade after surging wages began forcing manufacturers to cheaper countries, President Xi Jinping is preparing to dismantle a web of subsidies that began under Deng Xiaoping in the 1980s. The measures could slow average annual growth to as low as 3 percent through 2022 from 10 percent in 2010. They also will mean higher prices for capital, land and water and swings in the cost of energy, potentially squeezing indebted state businesses.

Among those with “highly leveraged” financial profiles are power producer Huaneng Power International Inc. (902) and China Shipping Development (1138) Co., according to a Sept. 2013 report by ratings company Standard & Poor’s.

Societe Generale SA says as many as half of China’s steelmakers may have to shut down. Farther away, Australian iron producers such as Fortescue Metals Group Ltd. (FMG), which derives almost 100 percent of its revenue from China, could see lower profits.

“It is going to cause very substantial stress, particularly among state-owned enterprises,” said Nicholas Lardy, author of “Sustaining China’s Economic Growth After the Global Financial Crisis.” “These guys will have to up their game or sell assets if they can’t improve their performance, or eventually go out of business.”

Yuan Slides

The yuan fell by a record against the dollar today amid speculation that the government will widen the currency’s trading band and ahead of the March 5 meeting of the National People’s Congress, where officials will outline policy goals for this year including economic reforms. The yuan tumbled as much as 0.9 percent to 6.1808 per dollar, the biggest intraday drop based on data going back to 2007.

Support to industry totaled about 10 percent of gross domestic product, according to a 2010 study led by Huang Yiping, vice president of the National School of Development at Peking University and former chief Asia economist at Citigroup Inc. That equals about $593 billion.

For the steel, glass, paper, auto-parts, solar and food-processing industries, direct and indirect subsidies may exceed more than 30 percent of their industrial output, said Usha Haley, co-author of “Subsidies to Chinese Industry: State Capitalism, Business Strategy, and Trade Policy.”

Electricity, Coal

Without this assistance, which includes free or low-cost loans and subsidies for electricity, thermal and coking coal, natural gas, oil, land, pulp and soda ash, “most of the companies” could not survive, she said. They also receive help acquiring and developing technology, said Haley, a professor of management at West Virginia University in Morgantown.

The increase in business costs could drag China’s economic growth as low as 3 percent at times during the next three years, Huang said. That compares with an annual average pace of 10.5 percent during the decade through 2012.

The changes also may raise borrowing costs by as much as two percentage points by 2016 if fully implemented, said Lardy, a senior fellow at the Peterson Institute for International Economics in Washington. The benchmark one-year lending rate is 6 percent.

Larger Plan

The Communist Party leadership’s plan is part of a larger strategy likely to be discussed at the annual meeting of the National People’s Congress -- to transform a state-guided economy into one in which the market is “decisive,” the official Xinhua News Agency reported Nov. 12. It cited a communique from the third full assembly, or plenum, of the party’s 18th Central Committee.

The subsidies and a government-controlled exchange rate for the yuan originally were designed to help create manufacturing jobs and drag the nation out of poverty. They did, supporting textiles, toys, steel, auto parts, paper, and solar and wind power, helping make China the world’s biggest exporter.

Their reduction risks exposing fault lines for a corporate sector in which debt rose to about 151 percent of economic output in 2013, up from 97 percent in 2008, according to Goldman Sachs Group Inc. Haitong Securities Co. says the level is higher than in the U.S., India, Germany, Japan and South Korea.

Currency Distortions

“If they implement the reforms, growth has to slow down,” said Michael Pettis, a professor at Peking University in Beijing who specializes in Chinese financial markets. “If you eliminate the interest-rate distortions, the currency distortions and all of the other distortions, then you are eliminating the tremendous subsidies to growth.”

The “upper limit” on average annual expansion during Xi’s term as president, which probably will end in 2022, will be 3 percent to 4 percent, Pettis said. He is the author of “Avoiding the Fall: China’s Economic Restructuring.”

The International Monetary Fund, by contrast, sees China still expanding by 7 percent in 2018, in line with the 7 percent to 8 percent growth central bank Governor Zhou Xiaochuan has said the economy can sustain.

China is still coping with a cost shock from average inflation-adjusted wages that have tripled in a decade. That is showing signs of undermining competitiveness and threatening growth potential, the Asian Development Bank said last year.

Surging Pay

Factory pay in southern China's Guangdong province has surged 82 percent since 2008, hurting makers of goods including toys, furniture and textiles. That has forced companies including Hong Kong bra maker Top Form International Ltd. to shift some output to cheaper locations such as Cambodia.

A second shock triggered by the new measures probably would afflict state enterprises coddled by subsidies in industries including steel and coal that are less mobile and less competitive.

While big state-owned steel mills still have access to bank loans, private factories must find alternative financing, Ma Kai, an analyst at China International Capital Corp., said in a Feb. 20 phone interview from Tangshan, a city near Beijing where private steel mills cluster.

Annualized interest rates for the mills he talked to range from 12 percent to 18 percent. That is "a prohibitively high level as they are contending with slowing demand and falling prices," Ma said.

He declined to mention individual company names, saying that if those appear in the press, "it will immediately bring creditors straight to their door. Suffice it to say steel mills in general are under enormous pressure just to keep their heads above water."

Coal Companies

The change also will help bankrupt "a whole bunch" of coal companies, said Laban Yu, a Hong Kong -based analyst at Jefferies Group LLC, adding that Yanzhou Coal Mining Co. (1171) may be "scrounging for capital" at exactly the wrong time. The company's debt has ballooned 78 times to 43.6 billion yuan ($7.1 billion) at the end of 2012 from 2008, according to S&P.

Shandong-based Yanzhou didn't respond to calls or faxes requesting comment. Three phone calls to Huaneng Power went unanswered and the company didn't respond to a faxed request for comment. A man who answered the phone at China Shipping Development's investor-relations department declined to comment and the company didn't respond to questions sent by e-mail and fax.

Finance charges on 20.4 billion yuan of debt held by BYD, backed by Warren Buffett's Berkshire Hathaway Inc., probably will increase as interest rates are liberalized. That also may spur consolidation among China's more than 50 automakers, says Macquarie Securities.

Capital Cost

"BYD would likely be impacted by a rising cost of capital because it relies on debt to finance operations and makes very little money from manufacturing cars," said Janet Lewis, an auto-industry analyst at Macquarie in Hong Kong. "A long tail of about three dozen small car makers also would be squeezed."

BYD plans to introduce about four models for its U.S. debut at the end of 2015, Stella Li, senior vice president in charge of the company's U.S. business, said in an interview in Shenzhen, where the company is based. The new Qin plug-in hybrid probably will be the flagship.

In a Feb. 21 statement, the company said that even though it does expect interest rates will rise, it will feel only a "minimal impact."

It and other electric-vehicle makers may be able to prolong direct subsidies as pressure builds to rein in air pollution: On Feb. 8, the finance ministry announced that planned subsidy cuts for electric vehicles will be reduced for two years and aid will be extended to 2015.

Raw Materials

Across the globe, the slowdown in China from the government plan may undercut the demand for metals and raw materials that has driven global commodity markets for a decade.

The boom in exports to China that caused Australian mining investment to increase to about 7 percent of GDP from about 1 percent in the decades before 2001 probably will reverse, said Ramin Toloui, Pacific Investment Management Co.'s co-head of emerging-markets portfolio management in Singapore.

Weakening demand in China, the largest iron-ore consumer, could restrain profits for BHP Billiton Ltd., the world's largest miner, and Rio Tinto Group, the largest iron-ore exporting company after Vale SA (VALE:US), said Ross MacMillan, a Sydney-based analyst at Morningstar Inc. Vale said on Feb. 27 as it posted a $6.45 billion quarterly loss that "reforms" may make the Chinese steel industry "less buoyant."

Australian Impact

For Fortescue, Australia's third-largest iron-ore exporter, the impact probably would be even bigger because it is focused on one commodity, he said. The Perth-based company derived 98 percent of its revenue from China in the year to June, according to an Aug. 22 filing.

Even so, Fortescue Chief Executive Officer Neville Power said he expects demand from China to remain "extraordinarily strong."

The government's commitment to urbanization "means ongoing investments in key infrastructure such as affordable housing, transport, schools and hospitals," he said in an e-mail. "We continue to experience strong demand for our products."

Capital Allocation

China needs market-driven changes to increase the efficient allocation of capital and resources, which will help maintain average growth rates of 6 percent to 7 percent a year for two decades, according to "China 2030," a 2012 government-endorsed report published by the World Bank and the State Council's Development Research Center.

That's because as the low-cost labor and easy technology adoption that propelled China's previous growth disappears, the nation must generate more growth from productivity increases and innovation, said the report. Premier Li Keqiang gave his "unwavering commitment" to the study, then-World Bank President Robert Zoellick said in February 2012.

"Pain is unavoidable as China breaks away from the old growth model," said a July 2013 article in People's Daily Online, an English-language publication of the official Xinhua News Agency. "For instance, China needs to endure the collapse of private or state-owned companies in industries plagued by overcapacity."

Winners Expected

The planned measures probably will produce some winners as well. Deregulation in industries from banking to telecommunications and the decline of dominant state companies will open the way for private and foreign investors. Deutsche Bank AG estimates this will help the private sector record annual revenue growth of 13 percent in the next decade, more than double that for state enterprises.

Promised changes that include making initial share sales easier, granting licenses for more private banks and opening protected sectors to investment would be good for expansion, said Louis Kuijs, chief China economist at Royal Bank of Scotland Group Plc in Hong Kong.

"On balance the reform agenda is not so obviously bad for growth," he said. "The experience of recent years has shown that if done stepwise, the economy can absorb these types of price increases."

Hardship may precede gain, though, as the rising cost of capital and other resources drags on indebted companies. Sectors including utilities, metals and mining, construction, and engineering and building materials probably will be hit hardest because they have large borrowings relative to earnings, said Terry Chan, managing director and head of corporate research for Asia-Pacific at Standard & Poor's.

The effect on construction and engineering, health care, steel, metals and mining, auto and parts manufacturing, and high technology most likely will come from the rising costs of supplies, Chan said.

"If interest rates are increased, it's very hard for the steel industry," said Li Xinchuang, vice secretary-general at the China Iron and Steel Association in Beijing. "Steel companies here can only compete on price. It's a terrible situation."

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