

# China's building blues

Petrochemical markets in Asia hold their breath, as a state-induced break on the skyrocketing property prices in China seems to be working. **Platts** analyzes the impact

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The deterioration in the Chinese housing prices is real. According to the latest statistics for prices of old housing from the Chinese government for January 2012, prices in 54 of China's 70 major cities were down compared with December. Compared with the same month in 2011, prices in 37 cities were down compared with the same month last year.

In Beijing alone, housing prices per square meter for new apartments have fallen by 11% during 2011 to Yuan 13,173 (\$2,091), according to the Beijing Real Estate Association on Xinhua News.

For countries that have experienced a fall in housing market prices after a quick ballooning period, the implications of an implosion are often dramatic for the short term or even the long term. We just have to look at the experiences of Japan in the 1990s, and more recently in the US and Spain.

For China, it is still too early to tell – the word “bubble” is not officially confirmed and is still seen as moot. What is undeniable, however, is that property prices did blow up and at an extremely fast rate. According to Xinhua News agency on November 22 last year, the average house price in China tripled between 2005 and 2009, and in Shanghai and Beijing house prices rose another 40% in 2009 and a further 30% in 2010.

The Chinese government has been cautious about stopping the boom in housing prices, but as soaring prices had made it increasingly difficult for newcomers to acquire a home, the Chinese government decided to slowly step on the brakes.

Already as early as April 2010, the Chinese government attempted to cool the property market, but it was not successful in the beginning. It announced later in that year that from October 1, it would suspend bank loans for third home purchases, while all first-home buyers had to pay a down payment of at least 30% of the purchase price – unrelated to the size of the apartment – according to Xinhua News: before those measures a first-time buyers would have to pay a 30% down payment for properties above 90 square meters.

In Beijing, deposit requirements and second-home purchase restrictions were introduced, while in Shanghai and Chongqing local governments launched property taxes for houses.

According to Xinhua, sales of new homes in Beijing plummeted by 18.4% in 2011, citing the city's housing regulator. In terms of square footage, sales slumped 22.4%, to 9.56 million square meters in 2011, the first time in six years that it fell below the 10 million square meters.

History will tell if the Chinese government have been better able to manage the housing market and to ward off the imploding bubbles seen in Japan in the early 1990s, or the US and parts of Europe in recent years.

### WE BUILT THIS CITY

Housing and other construction requires large quantities of building materials, not just cement and steel, but also a large variety of petrochemicals. A major example is PVC which is widely used not only in sewer and rain water pipes but also in flooring and window frames. Methanol is used to produce formaldehyde-based glues, which are used in plywood and furniture. Styrene monomer derivative expandable polystyrene is widely used for the isolation of houses and offices, while high impact polystyrene, and acrylonitrile-butadiene-styrene, are used in home appliances.

As a result, PVC import volume tumbled in 2011 by 12.4% compared with the previous year to 1.050 million mt, according to statistics from Chinese Customs released January 22. Domestic PVC prices in China have suffered a drastic fall since August on the back of poor demand from the construction industry. Ethylene-based PVC makers lamented that high ethylene feedstock costs have squeezed their margins, while carbide-based PVC producers – typically huge consumers of electricity – were hit by rising power bills. Despite an increase in feedstock and utility costs, PVC prices continued to fall due to poor demand from the construction industry. As a result, several PVC makers have cut operating rates drastically since second half of 2011.

Nevertheless, as of late February, most market sources remain optimistic for PVC demand and prices, with many expecting that the Chinese government will keep the drop in property prices under control and will be able to prevent a crash. The Chinese government has set itself a GDP growth target of 7.5% on March 5, which would mean the slowest pace of expansion in China since 1990, but which is still much higher than in other parts of the world.

### Major petrochemicals used in construction

PETROCHEMICAL	CHINA'S POSITION	APPLICATIONS
PVC	net importer	Pipes, flooring, window frames, wall covers, appliances, shower curtains
ACN	net importer	Acrylic fiber rugs, covers
CPL	net importer	Nylon carpets
PET	net exporter	Polyester carpets
VAM	net importer	Glues, paints
Methanol	net importer	Formaldehyde-based glues for plywood
ABS	net importer	Appliances, kitchens
PS	net importer	Appliances
EPS	net exporter	Insulation material

The product that most feels the impact from a downturn in construction activities is PVC. In China, the construction sector takes off around 75% of total domestic PVC consumption. Hence, 2011 was a tough year for Chinese domestic PVC makers, which also had to suffer from relatively high feedstock costs that could not be passed on in their entirety. In addition to a cut in domestic demand, the eurozone crisis and US debt worries have further dampened the industries that focus on export markets.

“The government will ensure that the property prices will not crash, as the construction industry contributes a big bulk to the country's economic growth.” a Chinese industry source said mid February.

Many PVC producers welcomed the Chinese government's move to build more subsidized housing which they saw as boosting PVC demand – though not spectacularly. “This is good news to us, but we do not expect there will be a



sudden surge in PVC demand as these houses usually takes quite a few years to build and the requirement for PVC is much smaller than private property,” said one PVC manufacturer. Most market players noted that the PVC requirement for subsidized housing is much lesser than private houses. “Subsidized housings are much smaller than private houses and therefore we do not see that PVC demand will pick up much,” said another PVC maker.

The Chinese government aims to build 36 million low-income housing units by 2015 to help solve housing problems for low-income urban residents, newly employed workers and migrants from rural areas. As part of the plan, the government aims to complete around 7 million apartments in 2012 alone, with many other apartments under construction.

#### SM MAY FEEL PINCH

Spot styrene monomer demand in China is often said to be very much dependent on the well-being of the expandable polystyrene market domestically and abroad, which in turn relies on the construction and packaging industries. “This year the government will [continue] the policy of curbing housing prices, there is no doubt about it,” a Chinese EPS producer said early February.

EPS is widely used as a relatively cheap and effective insulation in houses. China

is also a major exporter, with 322,067 mt of EPS shipped out of the country in 2011, according to statistics released by Chinese Customs.

It is far from clear when the Chinese government might introduce any easing on credit and interest rates though.

“My guess is they would wait for a few months for the inflation to stabilize before taking any further action,” one trader said in February.

In 2011, one of the SM derivatives that saw the most significant slowdown in demand was ABS, with producers across Asia forced to slash operating rates. For the whole of 2011, China imported 1.854 million mt of ABS, down 14.6% from 2010 when imports stood at 2.169 million mt. The year-on-year fall in ABS imports was attributed to China tightening its monetary policy, which made it tough for many medium and small end-users to get credit, while at the same time they saw their exports hurt by weak demand in the US and Europe.

Some Asian trade sources said that the operating rates and demand for ABS will be the key to how the SM market goes in 2012.

ABS is widely used in appliances such as refrigerators and washing machines, and is vulnerable to economic downturn and a stalling housing market.

“SM consumers in China said that export orders were not looking good in the first and second quarters of 2012,”

the trader explained, but added that there was little room for SM prices to drop, because of high crude oil and feedstock prices.

“The question will be whether the downstream derivatives can catch up with the high [SM] prices,” he said.

For SM, 2011 has not been so rosy either for exporters into the China market.

China is Asia’s largest importer of SM, buying cargoes from all over the world. In 2011, China imported 3.608 million mt of SM – an impressive figure, but down 2% from the 3.687 mil mt in 2010, according to customs data.

Looking at this year’s SM demand-supply balance, some were seeing tight supply in the second quarter due to turnaround in Northeast Asia, while at the same China is starting up some new derivatives capacities.

However, most were not sure how this scenario would play out this year.

“Operating rates (at SM-consuming derivatives) will ultimately be determined by demand from both the domestic and export markets,” an industry source said.

#### METHANOL COOLS

Traditionally the biggest end-user of methanol has been formaldehyde, which is used in glues for the production of plywood and furniture. With a drop in construction demand in China, plywood demand was seen falling and this trimmed the demand for formaldehyde as well. This, among other weak downstream activities, has contributed to the weakness in CFR China methanol prices since the year began.

Even the Chinese government’s plans to supply the markets with 36 million public housing units by 2015 did not impress methanol traders.

“The formaldehyde market is not helped by cheap housing plans, as the government is still depended on developers to do that. But the developers will not have a [good margin] from public housing,” said a methanol trader, illustrating the cool reception for the housing plans in the methanol market.

China imported around 400,000 mt of methanol in January, an 18% drop from December according to data released by Chinese customs, as demand stayed persistently weak.

The price was fluctuating at \$365-385/mt CFR China in January, with the peak \$385/mt price level occurring just after the Lunar New Year at the end of the month.

But the projected post-holiday surge in demand failed to materialize partly due to the weakness in the construction sector, which pulled prices below \$370/mt mid-February. This situation was exacerbated by an increase of Iranian cargoes being offered to China in the face of tightening sanctions against Iran.

The combination of softer demand and increasing supplies has pushed the inventory level in eastern China to around 500,000 mt in the middle of February, which was higher than the typical inventory level of 300,000-400,000 mt.

Although formaldehyde has been traditionally the biggest consumer of methanol in China, its share has been falling due to a wide range of energy-related usages such as gasoline blending, and the production of dimethyl ethyl, a gas which can be used on its own as fuel or blended with LPG. Therefore, if energy prices remain firm, some loss in demand from the formaldehyde sector could flow into the other sectors if methanol prices became attractive for them.

#### UNCERTAINTY STALLS VAM

Demand for vinyl acetate monomer has also been hit by the weakness in the construction sector. VAM is used in emulsion paints, adhesives and a variety of other products used in the construction industry.

One Hong Kong trader noted mid February that as the construction sector was weak, downstream end-users did not want have too much inventory due to the uncertainty over the direction of both the domestic economy and the world economic situation as a whole.

This sentiment was also reflected in the activities of traders, who typically stock up ahead of the demand season, which usually starts from around March or April, with construction activities reviving after the Chinese winter.

However, these traders have been largely absent in recent months, with many uncertain where the market would be in one to two months' time.

This mentality was already apparent for a large part of 2011, which was reflected in the import statistics as well. China imported 252,420 mt of VAM in 2011, down 2% from 257,670 mt in the previous year, according to statistics from Chinese customs. China boosted imports from Taiwan, which was already the

biggest supply source for China in 2010, to 159,118 mt in 2011, up 27%. But all other major suppliers to China saw their volumes dropping. The second largest source was Saudi Arabia with 36,794 mt of shipments, down 18% year on year, followed by the US with 34,200 mt, down 39%, and South Korea with 17,179 mt, down 13%.

#### GOVERNMENT ON ALERT

The stance of the Chinese government toward the economy is changing since the fourth quarter of last year from one trying to prevent overheating to one that hopes to support the economy from deteriorating. Most obvious is the change in position of the country's central bank which, most recently on February 18 moved to lower Chinese banks' reserve requirement ratio for the third time since December, to ease the short-term credit crunch and secure growth in the wake of a lackluster external market. The reserve rate was reduced to 20.5 % from 21% previously, with effect on February 24 and released an estimated Yuan 400 billion (\$63.5 billion) into the market.

The danger of overheating is seen as less imminent, which is also reflected in the country's consumer price inflation trend. The official inflation rate in 2011 hit 5.4%, which was above the 3.3% in 2010 and above the Chinese government's target of 4%, but it was moving down

towards the end of 2011. Consumer prices rose at their slowest pace in over a year in December, slowing down to 4.1%, compared with 4.2% in November.

This will give the Chinese government more leeway to maneuver the economy, and make up for lost domestic and external demand as it has another target, namely to create firm economic growth as well.

However, the property price slide could be spinning out of control, as if the government has opened Pandora's box with its measures in trying to cool off the market. Once the sentiment among buyers and speculators has changed and they don't see buying property as a secure investment anymore, it will be difficult to change them easily.

Partly due to urbanization, but also due to speculation, a lot of money has been sucked into the China property market and a rapid deterioration in prices will not just hurt supplies of building materials, but will likely also cause a crunch in demand across the country for all kinds of products.

Alarm bells are ringing throughout the Chinese petrochemical industry, and market players are more cautious than ever.

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