CHINA ECONOMICS UPDATE

Why is China's commodities demand so strong?

- **China's recent commodity demand has been stronger than might have been expected given the weakness of its economy and commodity-intensive property sector in particular. This partly reflects a step-up in infrastructure spending and resilience in manufacturing. But the strength of oil demand is particularly striking: we think that it is due to a narrow rebound in passenger travel which isn't reflective of the overall state of consumer activity.**

- The composition of China's imports has shifted dramatically during the past year or so. Inbound shipments of intermediate goods, most notably semiconductors, have slumped as the pandemic boom in global demand for Chinese-made consumer products has fizzled. But China's imports of industrial commodities have gathered steam, consistent with a rebound in domestic demand. (See Chart 1.)

- **Industrial metal imports are up 6.9% y/y year-to-date in volume terms**. The most significant driver has been stronger demand for iron ore. This partly reflects a shift toward lower-grade iron ore, which means more ore is needed to produce the same amount of crude steel, output of which is up a more modest 2.6% y/y year-to-date. But after two years of declines, it is noteworthy that crude steel output is rising at all given the ongoing contraction in property construction and increasing use of recycled steel. Thanks to the latter, output of steel products is up a more substantial 6.3% y/y year-to-date.

- **Demand for these steel products is coming from two main areas. The first is construction**. Although fewer homes are being built, this has been offset recently by stronger infrastructure spending, which is up 10% y/y year-to-date. As a result, **overall construction activity across both property and infrastructure is now growing again following two years of stagnation**. (See Chart 2.)

Chart 1: Import Volumes by Product (2019 = 100, seas. adj.)

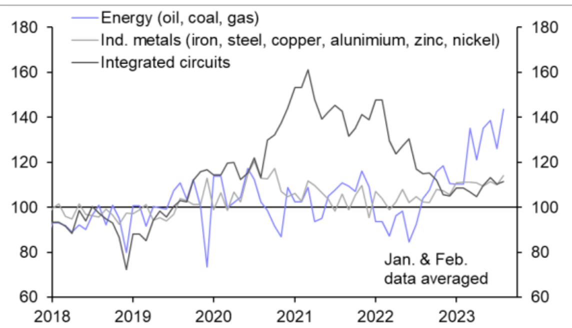
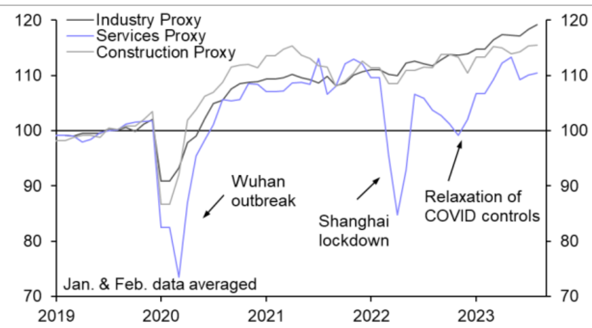


Chart 2: CE China Activity Proxy by Sector (2019 = 100, seas. adj.)



Sources: CEIC, WIND, Capital Economics

- **Second, manufacturing output has continued to see healthy growth**, largely shrugging off cooling external demand. That's especially true in steel-intensive sectors such as automaking. Copper imports have picked up too, helped by investments in making the State Grid more resilient to droughts and other climate risks.

- **But even more striking than the pick-up in metals imports has been that of energy imports**. Shipments of coal have seen the most abrupt surge, rising 84% y/y year-to-date. For the reasons discussed above, this partly reflects greater demand for coking coal (used in steel production). But the bulk of the increase has been in thermal coal, with utilities companies relying on the fuel more heavily to make up for the sharp fall in hydroelectric output this year.

Julian Evans-Pritchard, Head of China Economics, julian.evans-pritchard@capitaleconomics.com

- **Inbound shipments of oil, including refined products, are up a robust 19% y/y so far this year**. This has coincided with an increase in crude inventories. But implied petroleum product demand (refinery throughput minus net exports) has also jumped, up 13% y/y year-to-date. This demand measure has a close relationship with economic activity as indicated by the China Activity Proxy (CAP), our in-house alternative to the official GDP figures. But **since the start of the year, petroleum demand has been much stronger than the usual relationship with the CAP would suggest**. (See Chart 3.)
- There was a similar decoupling between the two series as China emerged from the initial COVID lockdowns in 2020. But there is an important difference this time: in 2020, the resumption of production at refineries outpaced the recovery in demand, leading to a build-up in inventories. In contrast, refined petroleum inventories have declined recently. (See Chart 4.)

Chart 3: China Petroleum Demand vs CE China Activity Proxy (2019 = 100, seas. adj.)

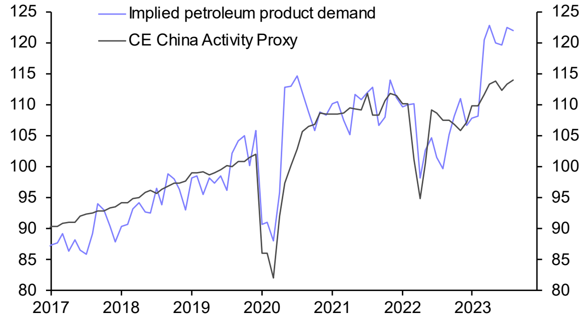
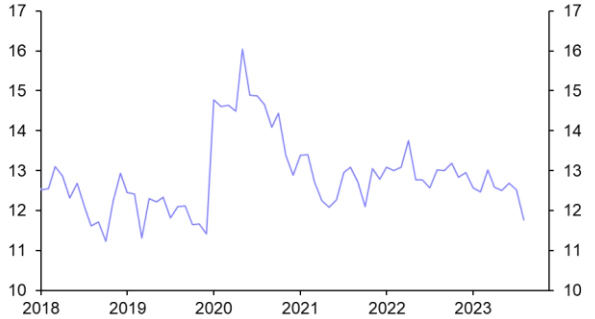


Chart 4: Fuel Processing Industry – Finished Inventories (days of sales)



Sources: CEIC, WIND, Capital Economics

- **Some of the increased demand for fuel has come from industry.** Domestic freight traffic is up 6.6% y/y ytd, as measured by weight multiplied by distance travelled. Freight throughput at Chinese ports has also strengthened recently, up 7.40% y/y ytd. The vessels carrying these goods and commodities need to refuel before their journeys. And petrochemical output is also seeing robust growth rates in the high single digits.
- **But the key part of the demand puzzle is passenger traffic**. Official figures show that intercity passenger travel has more than doubled so far this year, while intracity travel has continued to pick up. (See Chart 5.) Admittedly, both are still below pre-pandemic levels, so hardly consistent with elevated fuel demand. However, the official data only capture commercial transportation – e.g. trips that involve payment to a transport provider. As such, they fail to capture the recent shift in favour of travel in private vehicles.
- We can get some sense of what's happened to private vehicle usage by looking at satnav routing requests between cities. These figures point to a surge in trips this year. (See Chart 6.) This appears to be why petroleum product demand has risen to a greater extent than measures of wider economy activity – neither the CAP nor official GDP treat private vehicle journeys as output in their own right.

Chart 5: Commercial Passenger Travel

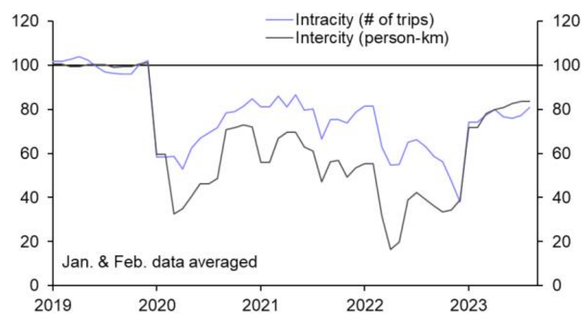
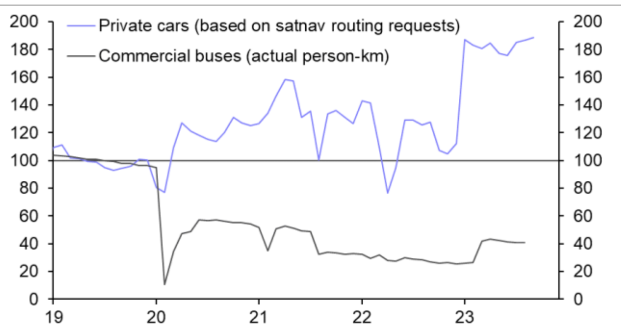


Chart 6: Highway Passenger Traffic



Sources: CEIC, MoT, Capital Economics

- A greater number of car journeys does tend to coincide with an increase in consumer spending. But the relationship is not stable. Following the removal of COVID restrictions, **it seems Chinese households have embarked on revenge travel more enthusiastically than they have revenge spending**. And what matters for the economy is not how far people travel but how much they spend overall. When it comes to consumer spending, we think the wider economic data offer a more reliable guide than petroleum demand.
- All told, the message from commodity markets is that China's economy is not doing as poorly as many of the dire headlines in recent months might suggest. The manufacturing sector is holding up fairly well; infrastructure stimulus is offsetting property weakness. But at the same time, China's oil demand clearly paints an overly flattering picture of the country's economic momentum.
- The good news is that, having slowed over the summer, **we think growth is set for a modest reacceleration over the coming quarters**. This may provide some additional support to metals demand given that it will likely involve a further pick-up in infrastructure spending. **But with oil demand already strong relative to economic fundamentals, it may not rise a great deal more – we anticipate only a 3% increase next year**.

CAPITAL ECONOMICS

TORONTO NEW YORK LONDON SINGAPORE

Email **sales@capitaleconomics.com** Visit **www.capitaleconomics.com**