China – sustained demand or a bubble about to burst?

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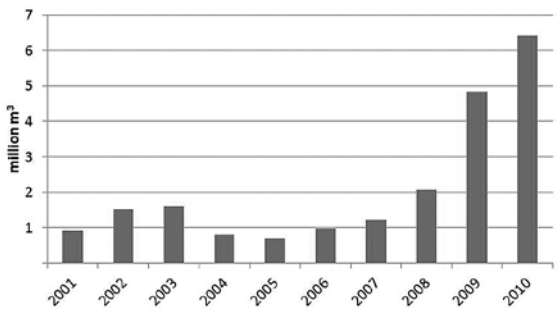
Introduction

The volume of wood heading offshore to China is one of the defining features of the New Zealand forest industry today. In 2010 China consumed over one quarter of all roundwood harvested in New Zealand, including 6.5 million m^3 of logs (Figure 1). A large number of enterprises and personnel are depending on Chinese demand to sustain their businesses. With ports and other infrastructure working at capacity, managers also need to be considering whether to invest for further growth.



Source: MAF

Figure 1. New Zealand Log Exports to China

China is currently experiencing a boom in housing construction. The area of construction has increased year by year, with the area in 2010 up by 19 per cent on 2009. This pace has been driven by boom in house prices, which have increased by 140 per cent nationwide since 2007, and by as much as 800 per cent in Beijing over the past eight years. The rise in China's residential investment is approaching 6% of GDP, which almost matched the 6.1% reached in the US at the height of its bubble, and 8.7% in Japan in the 1970's (The Atlantic, 2011).

Not surprisingly, there has been increasing concern about the sustainability of this demand, and whether this bubble is about to burst.

The Chinese housing sector is the main driver of growth in China in this economic cycle. A decline in residential investment will see a decline in GDP growth. And as growth slows in China, so does the demand for commodities, such as timber, steel, oil, aluminium and copper. Thus a shock to the housing market would not only have a major impact on China's economic activity, but also on global demand for commodities.

It is no secret that the Chinese government is viewing the current rising house prices with concern. Rising prices decrease affordability, run the risk of derailing the economic boom and give rise to social instability. And social instability is what the government fears most. In this regard one can only see the recent crack downs in China as a reaction to the Arab uprisings.

According to *The China Daily* (*The China Daily*, 2011), the government has adopted various measures to curb rising property prices, including restricting residents in 35 major cities from buying second or third homes, higher down payment requirements for mortgages, property taxes in Chongqing and Shanghai, as well as a raft of monetary policies that have raised developers' borrowing. To address the political concerns of high housing costs, the government announced plans to build more affordable housing in major cities. However running against the government are local vested interests. Developers have little interest in developing low cost housing, and local governments are dependent on land sales to continue to meet their financial requirements.

Moody Investor's service was reported to have downgraded China property sector from stable to negative (*The Business Insider*, 2011). The ratings agency's concern was that as the Chinese government impose more and more buying restrictions, they will slow down transaction volume and eventually impact the cash flows of these companies. Other analysts suggested that quite a number of these companies have a negative operating cash flow, even though they may have reported record profits (Also Sprach Analyst, 2011).

The Fitch Ratings Agency, as reported in a business magazine, also downgraded its outlook on China, rerating long term local currency from stable to negative as a result of the rapid growth in bank lending (*Bloomberg Business Week* 2011).

Derek Thompson, writing in the *Atlantic*, saw risky times ahead (Thompson, 2011). Quoting *McKinsey Quarterly*, the author referred to the likelihood of a wave of bankruptcies and interest rate rises, and an unwilling government to bail people out as it would be seen to be abetting risk takers.

The New York Times (The New York Times, 2011) recently asked ten leading experts for their opinion on China's housing bubble, five of which wagered a prediction. One felt there was high risk of a major correction, two

expected a moderate reduction in construction and economic activity and two said that any crisis in the real estate market was highly unlikely.

Evidence given of unsustainable market conditions was the high incidence of amateur investors, government enterprises becoming the biggest borrowers from state owned banks to buy land owned by the state; the booming art markets and general conspicuous consumption. Those expecting a moderate correction referred to the political risk for government if prices were to tumble. Chinese households typically have most of their wealth tied up in property. A modest decline in property values would lead to a serious decline in household wealth. To ensure continued political stability the government would be forced to intervene by shoring up the local banks and allowing the property sector to undergo only a minor correction. The government also has had previous experience with high inflation, which was brought under control through a range of interventions, although at great cost to growth and economic efficiency. Thus the commentator conceived a loss of a few percentage points in China's economic growth.

Those discounting the danger of an imploding housing market argue that the Chinese requirement of 20% or more down payments means that they are not as leveraged as their North American counterparts. And the government has plenty of capacity to deal with insolvencies in the banking sector.

The Economist Intelligence Unit (EIU) recently issued a longer term analysis of China's housing market (Economist Intelligence Unit, 2011). China's demand for housing was found to be driven by the migration from rural areas to cities, and by the rising incomes of its population. As incomes increase, more people have access to cars, and therefore able to commute further distances to lower density urban areas. Also, areas of lower density tend to have larger floor areas per head of population. Based on modelling population trends, the EIU found that the rate of urbanisation and income growth will see each of the top ten cities add as much floor area as the total housing stock of a number of European countries. It was conceivable that China would add the equivalent of Europe's total housing stock (excluding Turkey) in the next ten years.

Much of the future growth will be in the inland region, as manufacturing shifts from the coastal regions seeking areas with lower cost advantages. Meanwhile the coastal cities are entering a period of adjustment where their economies are moving away from exports as their main drivers of growth.

The EIU summarised the drivers for continued housing construction as:

i. Income growth per head growing at 9.8% annually

ii. Urban population growth forecast at 2% per annum

iii. Declining household size

iv. Gender imbalance forcing China's males having to save for bigger apartments in order to be considered "marriageable".

v. Shorter life span of buildings mean higher rebuilding rates

vi. Rising car ownership mean ability to commute from lower density areas, which will also act as a restraint to price growth

Nevertheless, China has a high floor area per head of population, especially if adjusted for differences in purchasing power and income. This points to a certain degree of uncertainty in the future outlook for housing. The risks came from:

i. The national rollout of property tax slowing demand for housing. Its implementation however was expected to be gradual.

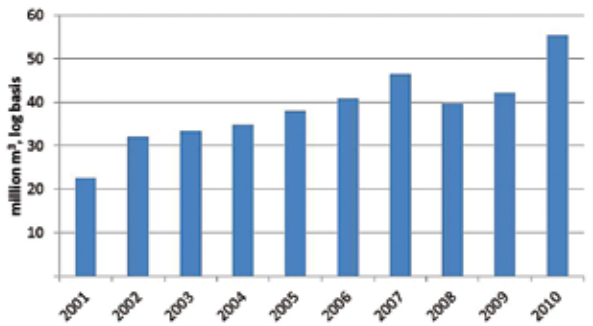
ii. Monetary tightening. The only a risk is if it's done in a heavy handed fashion. But this is only likely if inflation became a serious concern.

iii. Current vacancy rates. The high vacancy rates suggest a correction may be due, but this is unlikely to be deep or long lasting due to the demographic trends outlined above.

iv. Macroeconomic risk. The State's finances are relatively healthy and could prop up banks in the event of a downturn. In the extreme event of a major collapse, the government could also tap alternative revenue sources, such as state owned enterprises.

The forest industry around the Pacific Rim has greatly benefitted from China's insatiable demand for resources. China's total imports of logs grew from 14 million m^3 in 2002 to a peak of 37 million m^3 in 2008. Imports of sawn timber have grown continuously, reaching 15 million m^3 in 2010. Thus in 2010 total log and sawn timber imports were estimated to have reached a record of 55 million m^3 (Figure 2). A significant volume was sourced from North America which has suffered from the depressed state of the US housing market. As US housing recovers, one can expect a tightening in North American supplies.

Thus the New Zealand forest industry is riding some of the best market conditions since the fibre scarcity fears in the early 1990's. This is not to discount the possibility of some minor adjustments. The industry may be able to take some comfort that as demand decreases, so do



Source: GTI
Sawn timber converted to log basis by x1.43

Figure 2. China log and sawn timber imports

shipping rates, improving its competitive position with respect to Russian supply. Based on China's demographic trends however, the outlook for the New Zealand industry must be seen as very positive.

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PF Olsen sponsoring Kaharoa Kokako Trust

The Kaharoa Kokako Trust (KKT) is delighted to receive financial support from PF Olsen Ltd to continue its work of protecting the endangered wattle bird north of Rotorua.

The Rotorua-based forest management company has committed to being a major sponsor of the Trust for the next three years.

Kaharoa Kokako Trust chair, Anne Managh, says it is exciting to receive support from PF Olsen because both parties have a shared interest in ensuring healthy forest environments. It also marks the first sizeable funding contribution from a commercial business.

"Most of our previous support has come from the Department of Conservation and the Bay of Plenty Regional Council, so it is great for us to attract revenue from another source," Mrs Managh explains.

PF Olsen's Chief Executive, Peter Clark says it is fitting for his company to support the protection of this iconic forest bird.

"As a significant land and forest manager throughout New Zealand we have a strong commitment to environmental values. While it is clear that plantation forests provide valuable habitat for many native bird species, that is not the case for the endangered kokako."

"We applaud and admire the work of the volunteers who have put so much effort into predator control to protect the birds at Kaharoa and want to see this put onto a permanently sustainable footing," Mr Clark says.

The kokako population at Kaharoa has increased significantly in recent years due to pest control work conducted by volunteers.

In 1997 there were 26 kokako known to be living in the Kaharoa Forest. Now there are well over 120 birds, making it the fourth largest of 18 known populations in New Zealand.

Constant funding is required to ensure this protection continues, not just for the kokako but for the health of the whole forest.

The funding received from PF Olsen Ltd will go directly into building the 'Kokako Nest Egg', an investment fund set up by the Kaharoa Kokako Trust to ensure ongoing pest control in the Kaharoa Conservation Area.

KKT is aiming for a target of $150,000 to ensure that pest control can be sustained in perpetuity at Kaharoa.

"We encourage other private sector firms to help build the Kokako Nest Egg," says Mr Clark.