Iron ore price slump points to mounting Chinese economic problems

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A cold shiver passed through global financial markets as the price of iron ore in China plunged by 8.3 percent on Monday, the second biggest one-day percentage fall on record.

Billions of dollars were wiped off the market value of some of the world's biggest mining companies amid concerns that the plummeting iron ore price could signal deeper problems in the Chinese steel industry, and its economy as a whole. China is the world's biggest producer of steel, and imports almost two-thirds of the world's seaborne iron ore.

The iron ore price, which is seen as an indicator of the level of industrial and construction activity, has dropped by 22 percent since the start of the year and is at its lowest level since October 2012.

The sharp fall in ore prices coincided with the release of figures showing that China recorded an unexpected trade deficit of $22.98 billion for February, due to an 18.1 percent fall in exports for the month. In February last year, China registered a $14.8 billion surplus.

While the sharp drop was put down largely to statistical anomalies due to the Lunar New Year, the overall export figures for January and February combined were 1.6 percent lower than the corresponding period last year.

There is concern that while this month's sharp decline may be a one-off event, in the longer term, falling exports could contribute to a slowdown in the Chinese economy. The government has set a growth target for this year of "about 7.5 percent." However, for this to be achieved, exports will have to grow faster than the 7.6 percent rate of last year, which itself was below the government's target of 8 percent.

Slowing exports, due to near-recession conditions in major European markets, as well as stagnation in the US economy, is not the only problem confronting the Chinese economy.

Last week, the Shanghai Chaori Solar Energy Science and Technology Company, a manufacturer of solar panels, failed to make a $14.7 million interest payment. It was the first-ever domestic corporate bond default in the history of the Chinese People's Republic.

The company almost defaulted in January last year but was assisted when the Shanghai Municipality pressured banks not to press claims on overdue loans. This time the city government did nothing.

Following the company's warning on Tuesday last week that it would only be able to pay less than 5 percent of the interest falling due, a research note published by Bank of America Merrill Lynch said a default could be China's "Bear Stearns" moment. The reference was to the collapse of two Bear Stearns owned sub-prime hedge funds in July 2007, which signalled the start of a meltdown that culminated with the bankruptcy of Lehman Brothers in September 2008.

The comment brought an angry response from the official Xinhua News Agency which said Chaori could not possibly be compared to Bear Stearns.

The Bank of America Merrill Lynch note said that while it was doubtful the Chinese financial system would experience an immediate credit crunch because of this single default, "we think the chain reaction will probably start."

The note added: "In the US, it took about a year to reach the Lehman stage when the markets panicked and the shadow banking sector froze. It may take less time in China as the market is less transparent."

As yet this is a minority view among economic analysts, but there are signs that the default had an impact, with at least four companies postponing offers of bonds. One of the companies involved pointed to the Chaori default, saying it had "triggered severe upheaval in the bond market."

In an interview with *Bloomberg*, Mike Dragosits, a commodity analyst with the Canadian company TD Securities, said a reassessment of the state of the Chinese economy was underway. "People are starting to re-evaluate the China demand scenario, not only from the economic data, but also from this first ever corporate-debt default inside the country. How many more companies out there are going to default?"

The conditions for a collapse in the bond market have been created by a vast expansion in debt. Since the end of 2007, the amount of corporate bonds on issue has risen by more than 10 times. The amount of corporate debt could exceed that of America sometime this year, even though China's economy is only half its size.

The circumstances surrounding the Chaori collapse point to the wider problems in the Chinese economy. The solar panel industry is characterised by significant overcapacity and falling prices. But similar problems affect all industrial production. The producer price index, which measures factory gate prices, has fallen for 24 consecutive months as a result of overcapacity in all areas of Chinese industry, including coal mines, smelters, shipyards, glass manufacturing, cement and the steel industry.

Last month a senior official at the China Iron and Steel Association, Li Xinchuang, warned that "steel overcapacity probably exceeds our imagination."

In the past, Chinese authorities have bailed out loss-making companies but this policy is coming to an end, with major consequences for the steel industry. Chinese financial authorities have signalled that they will no longer provide loans for under-performing steel mills and those that cannot meet environmental standards.

Speaking on the sidelines of the annual session of the National People's Congress, the chairman of the China Banking Regulatory Commission, Shang Fulin, made clear the days of easy credit to finance steel production were over.

"We'll take measures with over-producing and backward industries," he said. "We'll encourage them to merge, to reorganise or even close down. For those enterprises which cause high pollution and consume a lot of energy … if they can't pass environmental assessment, the banks will simply not give them a loan."

A continued fall in iron ore prices will have a significant impact on global mining corporations as well as the main iron ore exporting countries, Australia and Brazil. Every time the iron ore price falls by $1 a tonne, two of the world's biggest exporters of iron ore, BHP Billiton and Rio Tinto, lose $120 million from their post-tax net profit.

Australian government finances will also take a big hit from a decline in tax flows from mining companies. According to Deloitte-Access Economics director Chris Richardson, the Australian federal budget loses around $300 million per year for every sustained fall of $1 in the price of iron ore.