Slowing Asia economies could further stifle petchems

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The European petrochemicals industry will continue to cut production to the point where it only has a handful of customers left, an industry observer caustically remarked during 2011.Behind his tongue-in-cheek gross exaggeration was a serious point: The eurozone's economic problems seem so deep, so intractable, that the industry perhaps feels unable to do anything other maintain operating-rate discipline and constantly cut costs.The good news in 2011 was that while Europe floundered, the emerging markets were still roaring ahead.But the consensus view over China has shifted since then, with the biggest change in sentiment taking place over the last few months – immediately ahead of Thursday's leadership handover.It used to be that the majority felt that plus 7% GDP growth over the coming 5-10 years was a given. Now many believe growth will be a great deal less than that, with a welter of economic and political experts coming forward to warn that there is a real possibility of economic implosion.The central concern is whether the new generation of leaders will be willing and/or able to totally dismantle an investment-driven growth model that, at long last, is widely recognised as being well past its sell-by-date.India's GDP growth might also be on a long-term decline, as a result of political problems that are preventing much-needed investment in new infrastructure.Concerns over corruption and its debilitating effect on the economy have also risen.One can search the emerging markets for havens of stability and, thus, reasons to be cheerful. Indonesia has, for instance, enjoyed eight consecutive quarters of GDP growth of slightly over 6% – not too fast or too slow and maybe, therefore, more sustainable.The country's 2012 demand growth for polyethylene (PE), polypropylene (PP), polystyrene (PS), polyvinyl chloride (PVC) and acrylonitrile-butadiene-styrene (ABS) will be 7.5%, according to the Indonesian Olefin & Plastics Industry Association (INAPLAS).Around 50% of Indonesia's polyolefins demand is covered by imports, with substantial imports of ethylene and naphtha also needed to meet the very steady, and very strong, demand growth.Hence, notwithstanding problems with bureaucracy and an unclear regulatory environment, Chandra Asri, reportedly, plans to build an $8bn refinery and expand ethylene capacity, while also adding a butadiene extraction unit. Honam Petrochemical, which owns PE assets in Indonesia, has plans for a 1m tonne/year grass-roots cracker.Indonesia has done a fantastic job to recover from the economic misery inflicted by the 1997-1998 Asian Financial Crisis. Along with Thailand and South Korea, it suffered enormously from the collapse of its currency against the US dollar. This led to soaring inflation and unsustainable debts dominated in the greenback.Since the crisis, the affected countries have switched from dollar debt to investment by foreigners in local equity markets and lending in domestic currencies.There is also talk of "macro-prudential policies" smoothing out the peaks and troughs of economic cycles.But, as the 10 November edition of The Economist said: "Wise monetary policy was also one of the reasons cited for the Great Moderation enjoyed by the G7 economies."Another was the supposed depth and sophistication of the rich world's financial systems, which, it was said, allowed households to smooth their spending, firms to diversify their borrowing and banks to unburden their balance-sheets." Both of these pillars of stability proved false comforts. Economists had not quite settled on an explanation for the Great Moderation before it inconveniently ceased to exist."The economist, Hyman Minsky believed that drops in volatility allowed firms and households to borrow more of the money they invested, the magazine continued."Stability, in Minsky's formulation, eventually becomes destabilising. Over-leverage does not require excessive optimism, merely excessive certitude; not fast growth, merely steady growth," it added.This sense of certitude might be why leverage is rising in Asia, ex-China and ex-Japan."Focus on the period starting in early 2007. Back then leverage began to climb again after a painful, 10-year deleveraging process following the Asian Financial Crisis," writes Fred Neumann, Hong Kong-based economist with HSBC, in a 24 October report."The reason is straight-forward: monetary conditions eased sharply around that time while macro-volatility stayed low."Leverage continued to climb despite rising economic volatility, which was, in part, due to extraordinarily loose monetary conditions, other than a brief dip in lending in 2009, he added.Volatility then fell after the Global Financial Crisis (GFC), boosting risk appetite, with monetary conditions remaining "hugely supportive", said Neumann."The message? For anyone looking into 2013, local demand growth in Asia, whether in terms of consumption or investment, should power ahead," he continued."Leverage is driving it all. But for anyone looking a little further out, the combination of easy money and low macro-volatility - a combination eerily reminiscent of the pre-GFC boom that was deemed the Great Moderation – may sit a little more uncomfortably.Asia's economies ex-China and ex-Japan can be broadly divided into two categories: Those that are highly dependent on export trade because of their relatively small populations, such Singapore and Taiwan, and those that benefit from much-stronger domestic consumption – for instance, Indonesia and Thailand.One can argue that countries such as Singapore are, as a result, much more vulnerable to a weak west and slower growth in China.But as Indonesia is part of the ASEAN-China Free Trade Area, which was launched in January 2010, it also has no duty protection from low-cost imports of finished and semi-finished goods from China.China's widely reported huge build-up of inventories of finished goods is a threat, as next year it might be tempted to relieve the pressure by boosting shipments to economies such as Indonesia. The dilemma would then be whether or not to seek trade-protection measures, such as anti-dumping and safeguard duties. Indonesia has a lot to lose from a tit-for-tat response, as it is a major resources exporter to China.It feels as if economic complexity and uncertainty are increasing."We recognise that these difficult conditions may have extended staying power, as the new reality is that we are operating in a slow-growth and volatile world," said Andrew Liveris, CEO of Dow Chemical, on the release of the company's third-quarter results.The positive story, which we shall cover in an article next Thursday, is that many industry executives have long recognised that responding to volatility involves much more than just cost cutting.

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