Entering the Hall of Mirrors

Illusion and Reality in China's Influence on Precious Metals Demand

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With China increasingly recognised as the key driver for commodities, "Enter the Dragon" has become a popular phrase at commodity conferences over the past three years.

This brings to mind the Bruce Lee film of the same title. The association might not seem obvious at first, but perhaps a more apt title for a discussion of the commodity markets in China can be drawn from the film's climax. Lee chases Han, an evil warlord, through his palace, following him into a hall of mirrors. Seeing Han's reflection all around the room, Lee must smash his way through a series of mirrors in an attempt to locate the villain.

Herein lies the analogy: while much is said and written about China's impact on commodity markets, this article will attempt to test the arguments to see whether they hold true or are merely smoke and mirrors.

First, a quick snapshot of China's position in the metals markets. It is hugely important to the platinum market in terms of net demand, as it is for copper. However, for gold and silver, China actually has a larger global impact on supply rather than demand.

Reflections on Silver

While burgeoning Chinese demand is seen as a major positive for commodities, it must be remembered that China is a significant supplier of some of them, which must be

taken into consideration before judging the country's net impact on any particular commodity.

Silver provides a good illustration. When China gradually liberalised its domestic silver market during the late 1990s, silver bulls grew increasingly excited, theorising that limited Chinese mine production growth, plus rising demand, would see China challenge India to become the world's largest importer of silver.

On 1 January 2000, China abolished the country's 50-year state silver monopoly and finally allowed the metal to trade freely.

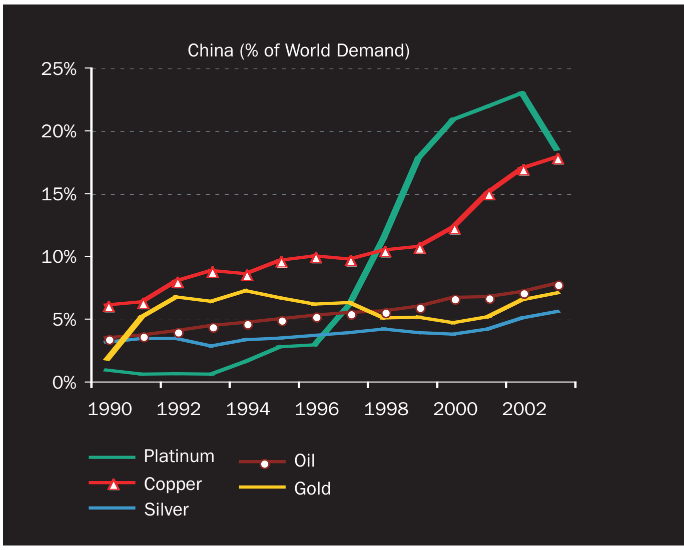
Unfortunately for the bulls, the rise in Chinese imports was completely swamped by a tidal wave of exports (see chart next page). This burst of supply was the cumulative result of a combination of rising silver production from expanding zinc/lead smelting capacity, a build-up in trader and producer stocks in anticipation of liberalisation and, crucially, exports from the People's Bank of China silver inventory, which had been built up over time from (mandated) purchases of domestic production and leftovers from the silver standard that had ended in November 1935.

Chinese exports consequently became a massive weight on the silver market from 2000 through to today. Indeed, for the year to April, official Chinese silver exports have risen by 56% year-on-year, spurred by the sharp rise in silver prices. The continuing rise in Chinese exports, notwithstanding some improvement in official records, appears to confirm that domestic silver inventories remain significant – and helps to explain why silver prices fall back so dramatically as soon as speculative buying dissipates.

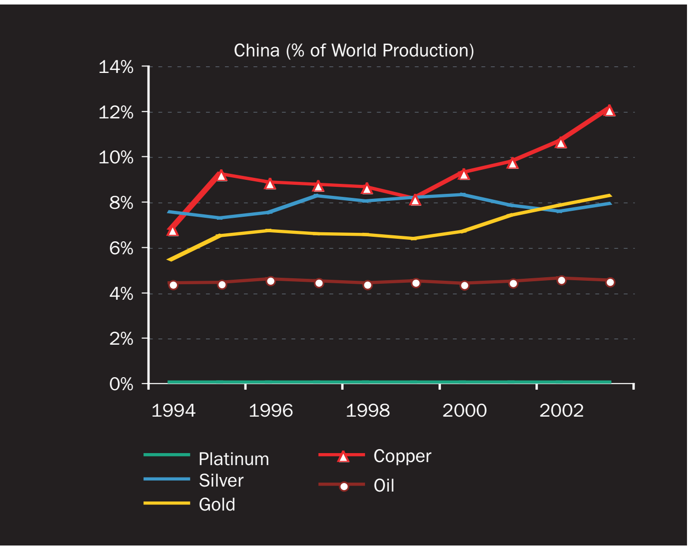
Beware the Armpit Theory

The expectation of a large and sustained fall in gold mine supply has been a major theme in the gold market. Strong local currencies, resource depletion, rising production costs and environmental pressures are resulting in falling mine output in South Africa and North America, a trend we expect to continue.

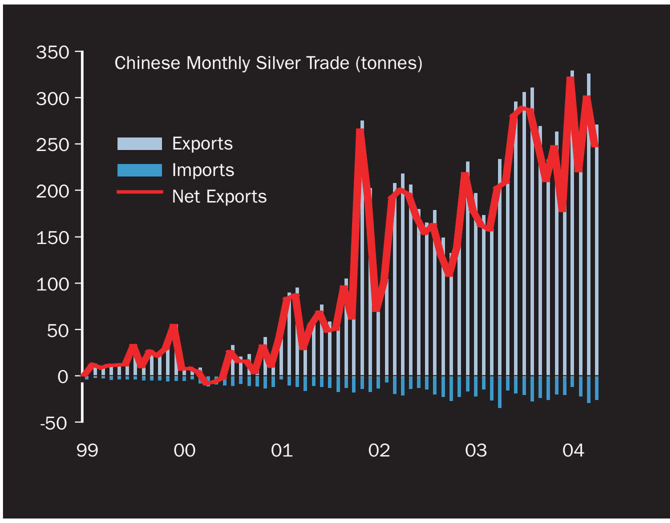
China as a Proportion of World Demand



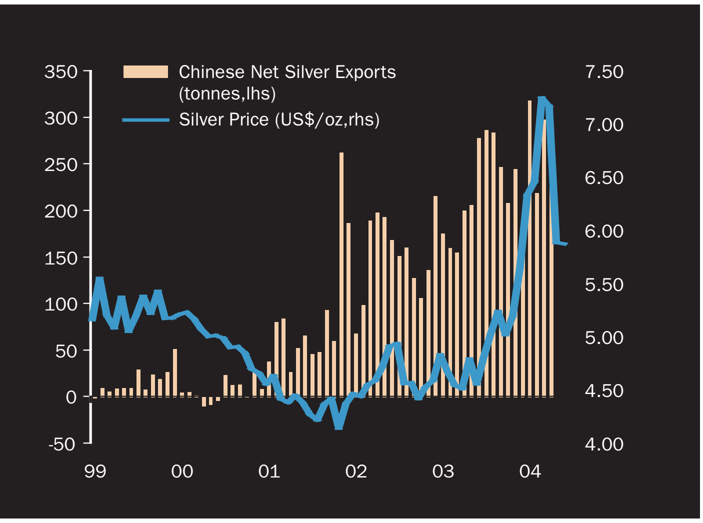
China as a Proportion of World Supply



The Silver Reality – exports swamp imports



The "China impact" is not always price-positive!



However, growth in South America, other African countries, Southeast Asia and more recently the former East bloc is offsetting the losses from the traditional producers. Importantly, the current and potential activity in countries such as China and Russia suggests that this trend is set not only to continue but accelerate, particularly given the current level of prices and availability of both equity and debt finance for project development. China has the potential to rise towards becoming the world's major producer of gold, given the number of already known deposits and increasing level of foreign interest.

This all brings to mind a marketing fable. In the early 1990s, a large US cosmetics company very confidently predicted that China would become the world's largest market for deodorant within the decade due to the presence of two billion armpits.

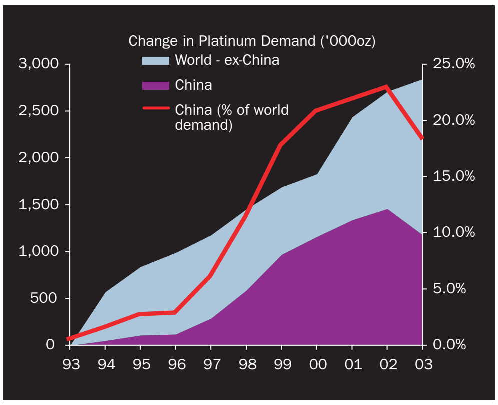
In reality, differences in climate, diet and attitude to body odour meant that a simple multiplication of the Chinese population (or armpits) by some ratio estimate for demand gave a wildly inaccurate projection. By 2000, not only did China still account for only a modest proportion of the world deodorant market, but deodorant itself accounted for less than 2% of China's RMB44.6 billion ($5.4 billion) cosmetics and toiletries market.

Is there a valid comparison between deodorant and the gold market? Some factors to keep in mind: first, China is already the world's third-largest consumer of gold jewellery. Second, it has actually already experienced a surge in gold demand – it increased fourfold from 40 to more than 210 tonnes from 1989 to 1992, driven by general market liberalisation, income growth, and depreciation of the renminbi. Notably, Chinese demand has stagnated around these levels ever since.

The Chinese experience was remarkably similar to that seen during the Indian gold demand boom that followed later in the 1990s, the difference being that Indian gold demand rose from around 200 tonnes to more than 700 tonnes, before weakening to its current apparent plateau of roughly 600 tonnes per year.

Part of the explanation for high demand in emerging markets is that, in the absence of alternatives, gold continues to play a key role as a hedge against both inflation and/or currency weakness. However, since the late 1990s, the trend in China (and, indeed, most Asian markets) has been for currency stability and disinflation. More recently, China's economic growth has resulted in upward pressure on its currency, while inflation has remained controlled until recently – not typically the environment in which we have seen gold demand surge in emerging markets.

China takes over platinum demand

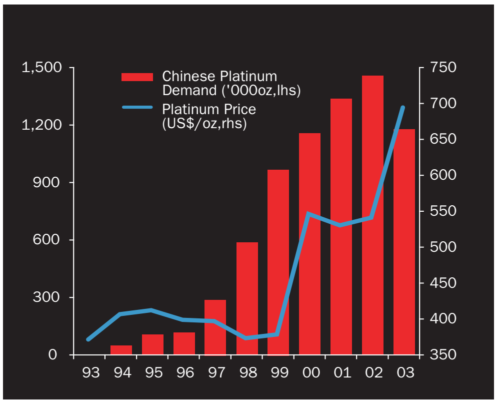


However, macroeconomics is not generally used as the justification for huge potential growth in Chinese gold demand: population is. China has the lowest per capita gold consumption in the world (see chart) – hence the argument is that, as market liberalisation continues, per capita consumption will grow. The typical extension of this is that given similar populations and a traditional affinity for gold, per capita consumption in China should rise to a level similar to India, which would represent a near three-fold increase.

However, rarely is reality this simple. As explained earlier, this 'armpit' approach to demand projections is critically flawed, as it does not take into consideration changing domestic spending patterns. A much more insightful comparison can be made by analysing the percentage of income spent on gold. In this comparison, the Middle East, the Indian sub-continent and other Asian countries clearly and predictably spend a considerably larger percentage of their income on gold. China is mid-table, while the western world countries spend the least of their income on gold.

Evidence suggests that, as economies develop, the range of spending and investing options expands considerably. This helps to explain why Chinese gold demand has stalled over the past decade despite the rapid income growth over this period. In the competition for growing Chinese disposable incomes, gold is very quickly losing market share. Given that China's economic development is likely to continue and the growing global influence of western culture (which tends to be negative for gold), we can expect China's income spend on gold to continue to decline. Indeed, this is not just the case for China but for the other large spenders as well!

Price Sensitivity Finally Appears!



This trend towards lower income spend on gold is the reason why we strongly believe that it is crucial to the long-term viability of the gold industry that western world gold demand is rejuvenated – both as jewellery and as investment. Not only does the west provide the greatest potential demand growth (for an increase in percentage spend), but it will also help to reinforce gold's existing position in emerging economies – and hence slow its declining share of disposable income. Such rejuvenation is a far from simple task, but that does not make it less vital.

The Birth of a New Luxury Empire

We noted with great interest comments in a recent feature article in *The Economist* concerning the rise of Chinese luxury consumers:

"The industry estimates that there are now around 10m-13m mainland customers for luxury goods … whereas people in the West are buying more discretely branded luxury goods identifiable only by those 'in the know', the Chinese favour prominent logos that shout, 'Look, I'm rich.' "

Platinum is of course the precious metal that has most benefited from the growing affluence of the urban China consumer. By tapping into the upper end of the consumer market, platinum is not greatly affected by the recent tightening measures aimed at over-investment in certain industrial and property segments. Further, as the comments in The Economist suggest, luxury consumers tend not to be particularly price sensitive, as it is the expense of the item that is a large part of the exclusivity in owning it.

That said, it is true that some price sensitivity has appeared in the Chinese market. Chinese platinum demand actually fell 19% in 2003, and anecdotal reports also suggest dampened levels of buying this year. However, it is important to put this in context. First, SARS affected demand levels for many consumer goods last year and, second, reports also suggest that it is not end consumers that are being discouraged by higher prices, but the falling profitability of the fabricators of platinum jewellery that is the key.

Industrial Precious Metals

We remain positive on the outlook for industrial commodities demand from China, notwithstanding some expected short-term weakness, driven by ongoing industrialisation, urbanisation and consumerism.

As can be seen in the charts, gold demand is dominated by jewellery and is very unlikely to change. The charts also show the relative size of the markets and demonstrate that since the platinum market remains much smaller than gold, it should not be blamed for the stall in Chinese gold demand.

However, the prospects of growing industrial demand for silver, platinum and palladium are strong. We have included photography as an industrial end-use for silver in order to ease the comparison across the four metals. That said, demand for silver in photography accounts for only around 12% (180 tonnes out of 1,470 tonnes) of Chinese silver demand, so it does not greatly affect the comparison.

China has of course seen extremely rapid growth in manufacturing in many areas, but for precious metals the key segments are electronics and autos. The medium-term outlook for continued growth in both segments remains strong, although autos are one of the segments that the government is targeting for a slowdown, which now appears to be having some impact. However, China's production of a wide range of electronic products, including computers, suggests continuing strong growth in demand for silver (largely used as a contact) and palladium (used in multi-layer ceramic capacitors).

On the auto side, not only would we expect growing production volumes over time (for domestic and, eventually, export markets) but tightening emission levels should also see higher loadings of PGMs. We would expect palladium to benefit most from this growth, but it should be noted that diesel engines are gaining market share, and this will also ensure increased demand for platinum.

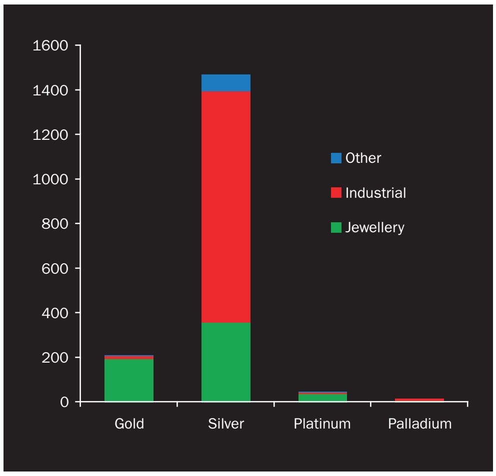
We are not convinced that photographic demand for silver will grow significantly as we expect many first-time camera buyers to move directly to the new digital technology – given the reduced cost of these cameras and the rapid increase in ownership of personal computers in China.

The Importance of Being Beijing

All elements of the precious metals markets, both domestic and external, were controlled by the People's Bank of China prior to start of liberalisation in the mid-1990s. Silver was the first market to be allowed to trade (largely) freely from 1 January 2000. Gold followed, marked by the opening of the Shanghai Gold Exchange (SGE) in October 2002. Platinum was liberalised in August 2003 when trading began on the SGE.

Trading of bullion on the SGE is free from both import tariffs and the 17% VAT. Silver is subject to the VAT but does receive a 15% export rebate. Exports are still regulated, with the Ministry of Commerce deciding upon silver export quotes.

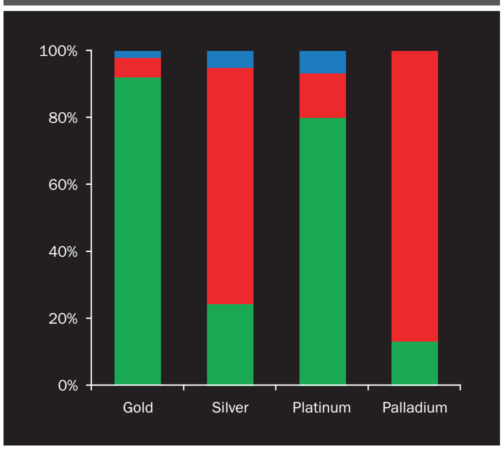
Chinese Demand by End Use (tonnes)



Domestic jewellery purchasers pay a 5% consumption tax (under review), while gold and silver jewellery imports are subject to a 23% tariff and other precious metals jewellery is subject to a 35% tariff.

One of the favourite gold bull hopes is that the People's Bank of China (and the Bank of Japan) will look to substitute their massive and growing reserves of US dollar denominated

Chinese Demand by End use (% of Total)



assets for gold. The argument for such central bank buying of gold is based, firstly, on the theory that the People's Bank has become over-exposed to the weakening US dollar, but may be wary of buying either yen or euros and, secondly, that the opportunity cost of holding gold has fallen significantly due to low interest rates.

In the first instance, it should be noted that the People's Bank of China, with 600 tonnes, is already one of the top ten largest gold holders and, indeed, holds a similar quantum of gold to the ECB (767 tonnes). The difference, of course, is in gold's share of the total reserves.

Quite apart from the various pros and cons of any central bank owning gold, the major flaw in this story is that even if the People's Bank of China wanted to increase their gold reserves to a significant level, the gold market is not physically large enough to allow that without a major price reaction. For example, if People's Bank wanted to match the proportion of gold in its reserves to that of the ECB (initially), that increase to 15% would equate to a purchase of more than 4,600 tonnes – nearly two years of mine output – virtually impossible to transact in anything other than a massive off-market transaction. While there are clearly large willing sellers of gold in Europe, this scenario does seem extremely unlikely at present.

Mirrors, Mirrors in the Hall

The five key points from our journey into this hall of mirrors are:

The silver illusion:
China does not automatically mean buy

Beware the armpit theory:
Trends in demand growth are rarely linear

The birth of a new luxury empire:
The new rich in China aspire to western style

Industrial precious metals:
Additional demand is likely for PGMs & silver

The importance of being Beijing:
Limited government influence remains. ■

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This article has been adapted from a speech given at the China Seminar hosted by the Association of Mining Analysts on 1 July 2004.