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China and the resource sector

How the resource sector will benefit from China's absolute economic momentum

By Sandy Chim

Recently, the world seems to be adopting a growing perception that China's economic growth is slowing down and is headed for a hard landing, with the underlying assumption that the country's current economic cycle is ending, and that this will, in turn, end the Super Cycle. Setting aside the debate about defining the Super Cycle and whether or not it is ending, and given the country's pivotal role in the fundamentals of the global economy, the resource sector needs to understand if China's economic growth is indeed slowing down in order to position itself for success in the coming years.

THE QUANTUM BASICS

For more than a century, the world's dominant advanced economies have been evaluated very effectively on the basis of growth rates rather than the absolute quantum of growth. In fact, growth

“China is the second-largest economy in the world, a position Japan achieved and maintained for several years.”

rates have served as a proxy for the direction of economic development worldwide. Figure 1 shows that since the turn of the century, growth rates (or contraction rates) have tracked the absolute quantum of growth or contraction of the US economy without fail throughout the cycles. As a result, the world has become accustomed to looking at economies through the lens of growth rates to evaluate the direction and health of any economy.

Given this decades-old confirmation of the validity of these status-quo analytics, the habit is hard to shake, even when we are confronted with quite different mathematical dynamics. While China's economy cannot be dissociated from global historical trends, it is now so large that we can derive quite different impressions, and arrive at potentially different conclusions, from examining its absolute quantum of growth versus its rate of growth.

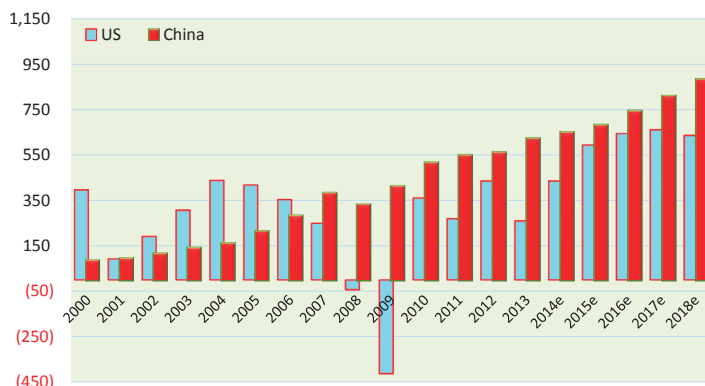
Figure 2 shows that China's real GDP was growing at its peak speed of over 14% a year in 2007, adding US \$385 billion to its economy that year, while in 2012, when it was 'slowing down' to grow at 7.7% (half of the 2007 rate), its economy actually grew

by US \$563 billion, about 50% more than 2007 in absolute value. Furthermore, in that same year, 2012, China's real GDP was about 30% higher than that of the US (which grew by US \$435 billion).

To say that China's growth was slowing down in 2012 at 7.7% p.a. versus 14.2% p.a. in 2007 is not wrong, but it is certainly misleading at this juncture. China was actually growing much faster in quantum at US \$563 billion p.a. in 2012 than at US \$385 billion in 2007. At the end of the day, it is the actual size of the economy (and not its growth rate) that drives the demand for resources in the global market. Building 50% more infrastructure requires 50% more steel, not 7.7%.

Figure 3 puts China's annual absolute growth in context by comparing China's growth with that of the US, the absolute largest economy, in this century. In the year 2000, real US GDP grew by US \$396 billion (China grew by US \$91 billion that year). In 2007, China overtook the US for the first time, growing US \$385 billion (while the US grew by US \$250 billion). In 2012, China widened its lead, growing by US \$563 billion (versus US \$435 billion for the US). The IMF's five-year forecast predicts that China will maintain its lead to become the largest annual contributor to real global GDP growth approaching US \$1 trillion a year towards the end of the decade. Out of some 200 countries surveyed by the United Nations, the World Bank and the IMF, just 15 have GDP of more than US \$1 trillion a year. In addition to being the largest and fastest-growing economy, China's absolute growth in the short to medium term is indisputably very significant.

Figure 3: Real GDP Growth in Billion US\$ - China v.s. US
 Historical and Forecast (2000 – 2018)



Source: IMF, Century Iron Mines

To further understand the importance of quantum demand, we should also look at its sheer cumulative size; this is what sustains the day-to-day production of every mine in the world. At its peak growth rate in 2007, China consumed about 700 million tonnes of iron ore p.a. But in 2012, when its growth rate had fallen by half, it consumed over 1.1 billion tonnes p.a. To the resource world, it is this 1.1 billion tonnes a year that matters; whether the growth rate is 14% or 7.7% is secondary at best, or even irrelevant. It is therefore more revealing to understand that the resource world is now dealing with real demand for 1.1 billion tonnes a year of iron ore. And this absolute number keeps growing as a result of the massive size of the Chinese economy, the world's economic engine.

Fast and slow are relative terms. The absolute quantum is, in the final analysis, the indispensable measurement tool that matters.

PROFILING CHINA'S ECONOMIC GROWTH

For the resource sector, the best part of China's economic growth story is its heavy weighting in fixed asset investment, which generates huge demand, on a historic global scale, for the base metal and bulk mineral markets. According to a report published by Woods MacKenzie, in October of last year, by 2017 China will be consuming more than half of the world's supply of base metals, while the remaining 200 countries will make up the remaining 48% of the market (down from 54% currently). On the bulk side, China already buys about 70% of global seaborne iron ore.

Given the success and effectiveness of these established policies of investment-led economic development, and their sustainability at the current rate and level of growth, the Chinese government is not expected to change course for many years to come – at least until urbanization (or in some cities, re-urbanization) reaches about 70-80% of its population. This means urbanizing some 300 million people, and only then shifting the balance to consumerism. This does not mean the price of commodities will continue to rise (with the occasional correction), but demand has

Figure 1: USA – Rate of Real GDP Growth v.s. Real GDP Growth in Billion US\$ from 2000 to 2013

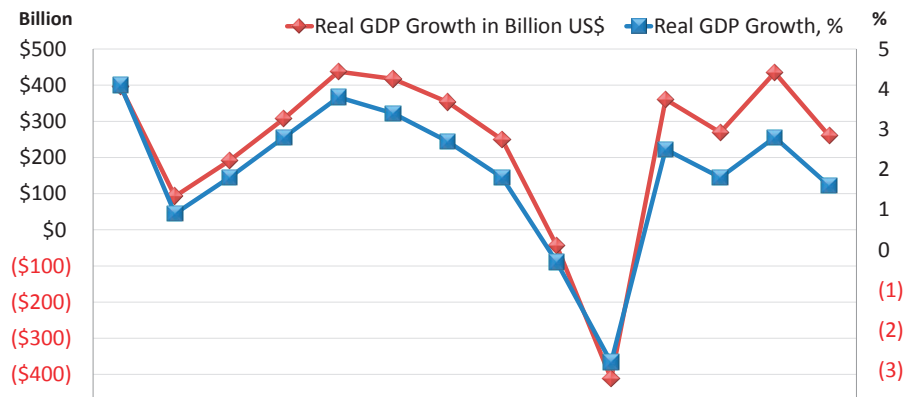
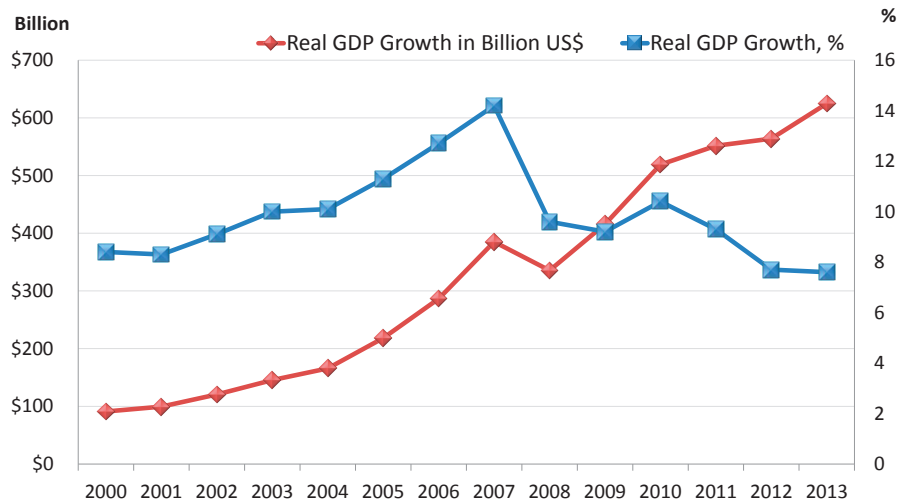


Figure 2: China – Rate of Real GDP Growth v.s. Real GDP Growth in Billion US\$ from 2000 to 2013



Source: IMF, Century Iron Mines

certainly not stopped, and will continue to rise. The world can count on this good news of growing demand for development of resources, which China needs and lacks.

SOME REALITY CHECKS ON CHINA'S REAL GDP GROWTH

China is the second-largest economy in the world, a position Japan achieved and maintained for several years. Having overtaken Japan in that position in 2010, the IMF forecasts that China will have reached a GDP of nearly US \$9 trillion in 2013, which is about 80% larger than Japan's. Though GDP is a pretty good measure of the size and strength of an economy, it would be useful to our understanding of this global engine of economic growth

to look at other economic and financial parameters as reality checks.

Also in 2010, China became the world's largest manufacturer, overtaking the US, which had maintained its supremacy for 110 years. In heavy industries such as the auto market, the growth in China has been just as spectacular. It surpassed Japan in 2006 as the second-largest auto market in the world and the US in 2010 as the world's largest. Yet the gap in auto ownership per capita between China and the US remains huge. According to the World Bank, in the year in which China overtook the US as the largest auto market, China's auto ownership per 1,000 people was only 58, while the US was at 797. The potential for the expansion of this market in China

Figure 4: Largest Banks in the World by Market Capitalization

(These 4 Chinese banks have total assets of US\$9.2Tn)

Rank Apr '13	Bank name	Market cap (US\$ billion)	Rank 2012
1	Industrial and Commercial Bank of China <i>(Also the largest by assets, US\$2.8Tn)</i>	 233.6	1
2	China Construction Bank	 207.6	2
3	HSBC	 202.4	4
4	Wells Fargo	 200.2	3
5	JPMorgan Chase	 187.6	6
6	Agricultural Bank of China	 142.9	5
7	Citigroup	 141.8	9
8	Bank of America	 133.2	12
9	Bank of China	 130.0	7
10	Commonwealth Bank	 122.3	10

Source: *Relbanks 2013 statistics*

as the gap closes – which it inevitably will – is significant.

For the last couple of decades, the Chinese manufacturing industry has been closely tied to the rest of the world, providing it with low-cost consumer products. This trade has contributed hugely to China's massive foreign exchange reserve in US dollars. Though its export markets have shrunk substantially since the beginning of the international financial crises, China still managed to accumulate nearly US \$4 trillion in foreign exchange reserves (US \$3.7 trillion in October 2013, more than the total of the four runners-up: Japan, Euro Zone, Saudi Arabia and Switzerland). This certainly confirms China's international economic standing on a historical scale.

Banking is a very important pillar of any advanced world economy. The health of a country's banking system is a robust indicator of its economic health as a whole. The banking industry in China is closely related to the country's foreign exchange operations. When economic reform began

in China about 30 years ago, its banking system was underdeveloped. As part of the program, it created state-owned specialty banks from the then monobank structure. Over a number of years, through several banking reforms, China was able to launch initial public offerings of stock in five of its top banks, between 2003-2005, raising close US \$70 billion. Less than 10 years later, four of these banks have made it to the top ten in the world (Figure 4) by market capitalization. The strength of China's banking industry is a manifestation of a strong economy, well positioned for further growth and expansion and commensurate with its economic achievements.

THE EMERGENCE OF THE REDBACK (THE CHINESE CURRENCY OR RMB)

One recent development that has come from the success of China's Economic Reform is of great importance to the resource sector and to China: the emergence of the Chinese RMB currency in world trade markets. The Canadian province of British

Columbia recently became the first government in the Western world to issue a bond denominated in RMB. These developments will have a powerful influence on mineral resource trading.

A few years ago, at the outset of the international financial crisis, the strength and reliability of the greenback, as an international settlement currency, was called into question, despite its long-standing history. Special Drawing Rights and other mechanisms were discussed to diversify away from the risk of holding or relying too much on the weakening greenback. No one at that time was imagining the possibility of turning to the redback as a hard currency for trade settlement. But over the last few years, and as surprising as the unannounced beginning of the Super Cycle about 10 years ago, the RMB is emerging with such strength that HSBC is predicting that by 2015, it will be the third-largest global trading currency after the US dollar and the Euro, and that it will be fully convertible in five years. This will be a monumental milestone in

China's economic development, representing the collective strength of a massive and sustainable level of domestic output and international trade.

A free and major hard currency can open a whole host of new possibilities of future development, ranging from access to capital, to influence in setting terms of trade and settlement.

The impact of these new developments will be significant, and you can be sure that experts are scrambling as we speak to devise the new quantitative economic modeling systems that will allow us all to keep up with them. One predictable development is that those who are predicting doom and gloom for China's economic growth will need to go back to the drawing board. ■

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