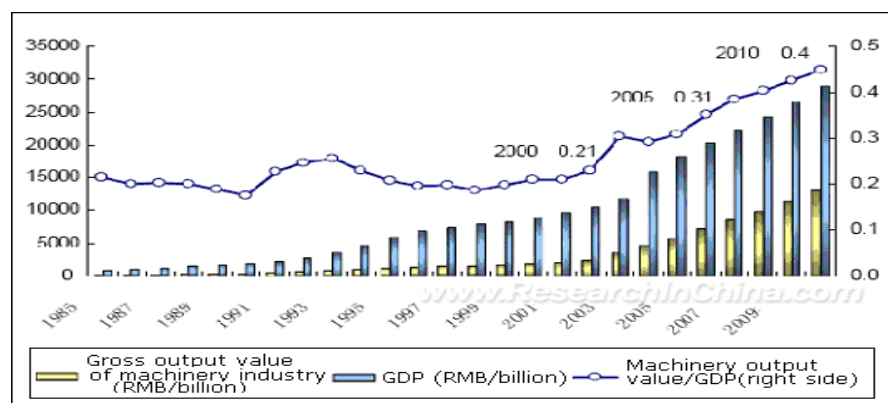


## The Chinese Metals Industry

### A Roundup of 2008 and The Outlook for 2009

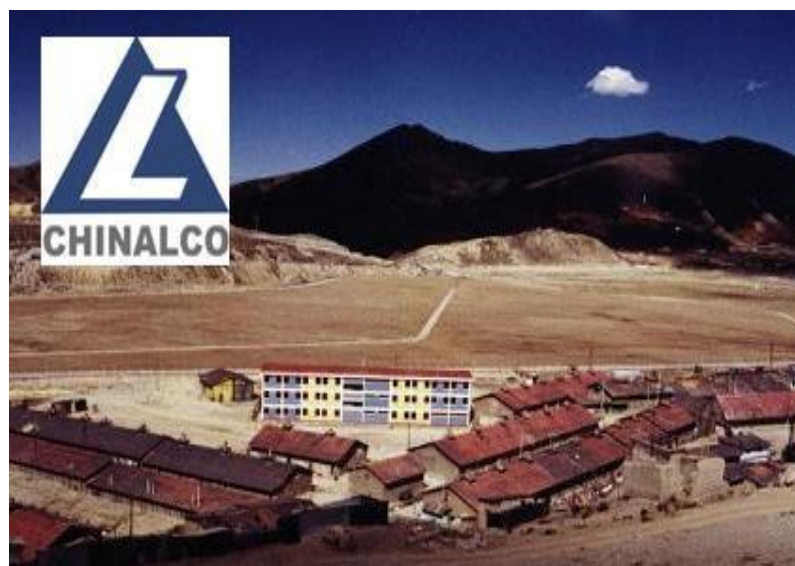
The year has been a rollercoaster ride for most industrial metals, culminating in sharp price drops as the global financial crisis gripped major economies. As the world's largest consumer and producer of metals, China's demand was the main factor behind skyrocketing metals prices over the past few years through to the beginning of 2008.



China's metals consumption is expected to continue to grow in 2009, but at a slower rate than in previous years. In addition, the Chinese government is likely to implement positive fiscal and monetary policies to support the metals industry in 2009, in a move to maintain sustainable economic growth.

#### Iron ore and steel

In February, Chinese steel mills settled on benchmark iron price hikes of 65% to 71% with Brazilian iron ore producer Vale, as demand for the raw material went through the roof. In the middle of the year, Australian iron ore miners Rio Tinto and BHP Billiton agreed to even larger increases in contract prices with Chinese steel mills of between 79.88% and 96.5%. The separate deals were a breakaway from the traditional rule of agreeing to unify benchmark price changes. However, demand for iron ore has since dwindled, and there is a general consensus in the industry that benchmark iron ore prices will decrease for the 2009/2010 contract year, which starts on April 1, 2009. Most insiders and industry analysts believe that benchmark prices will fall by between 30 percent and 50 percent, mirroring the gap between 2008/2009 benchmark prices and current prices of Indian iron ore on China's spot market.



Aside from contract prices, the main news in the sector this year was the Aluminum Corporation of Chinalco teaming up with Alcoa to acquire a 12% stake in Rio Tinto's London-listed arm, which was widely interpreted as a Chinese government-backed move to block a proposed takeover of Rio Tinto by BHP Billiton. The takeover bid was withdrawn in late November, much to the relief of Chinese steelmakers. It is still expected that Chinalco will increase its shareholding in Rio next year to further secure iron ore supplies for the country's steel industry.

Meanwhile, 2008 saw Chinese steel mills begin to source iron ore from an increasing number of emerging overseas iron ore miners and enhance cooperation with domestic suppliers after Vale suspended shipments in late September. Both trends are likely to continue into next year as Chinese steel mills will swim against the

tide to reduce their reliance on the three mining giants. Looking to the downstream market, China's steel product prices surged to record highs in June, driven by robust demand from both the domestic and international markets as well as high raw material prices. However, weak demand pulled prices down over the second half of the year until mid-November, forcing steel mills to cut production in September. Due to un inspiring forecasts for the global economy, China's steel product exports are set to further slide in 2009 despite the Chinese government's scrapping of steel product export taxes. Meanwhile, domestic demand for steel products is expected to recover in the second quarter of 2009 at the earliest, following implementation of the central government's RMB 4 trillion (\$585.12 billion) economic stimulus package.

Steel product prices will continue to fall in early 2009.



During 2008, China's steel industry witnessed further consolidation, which saw the establishment of conglomerates Guangdong Iron and Steel Group, Hebei Iron and Steel Group, Shandong Iron and Steel Group and Guangxi Iron and Steel Group. Further sector consolidation can be expected in 2009 due to encouragement from the central government and as steel mills look for a way to weather the downturn. Part of the Chinese government's consolidation plan includes establishing steel production bases in several Chinese coastal cities, and 2009 will see construction work start on Baosteel Group's Zhanjiang project, Wuhan Iron and Steel Group's Fang chenggang project, Shandong Iron and Steel Group's Rizhao project, and Nanjing Steel's Lianyungang project.

In addition, long-awaited steel product futures contracts may also be launched on the Shanghai Futures Exchange (SHFE) in 2009, which will help steel companies manage large price fluctuations on the domestic market.

## **Aluminum**

In the first half of 2008, domestic aluminum smelters were hit by the severe snowstorms in southern China, power shortages, the Sichuan earthquake on May 12 and high raw material prices, which all affected profitability.

Meanwhile, aluminum prices were volatile over 2008 and halved from the beginning of the year to RMB 9,730 (\$1,423.31) per ton on Dec. 25, falling below the production costs of most Chinese smelters on weak demand and a market surplus. Many smelters will post losses for 2008 and with the global financial crisis yet to fully unfold, they will likely face a tough time again next year. To date, more than 2 million tons worth of domestic aluminum smelting capacity has been suspended.



China is expected to produce 13.50 million tons of aluminum in 2008, up 8 percent from the previous year, although the growth rate is much slower compared with that of previous years. It is likely that next year's output will grow, and the market is expected to stay in a surplus. But, potential upsides for the industry in 2009 include power price cuts, the State Reserve Bureau's (SRB) increase of aluminum reserves, and further cuts to export taxes and increases in export tax rebates for primary aluminum and certain aluminum products.

## Copper



Domestic and global copper prices continued an overall downtrend in 2008, and were relatively volatile. Chinese copper prices dropped by more than 60 percent from the beginning of the year to RMB 22,880 (\$3,346.89)/t on Dec. 25. Long-term contract copper concentrate treatment and refining charges (TC/RC) for 2008 reached a low of 47.2/4.72, and spot TC/RCs even dropped to 30/3.0 in the middle of 2008, which put domestic copper smelters between a rock and a hard place. Many did stay afloat through profits from sales of sulfuric acid, a by product of copper smelting, although some small-sized smelters were forced to cut production by one-third to reduce losses.

Tight copper concentrate supply at the beginning of this year has since developed into a surplus in recent months, with spot TC/RCs shooting up to 90/9.0 in December. Chinese smelters are expected to settle on higher long-term TC/RCs for 2009 of about 77/7.7, which would support a growth in Chinese copper output in 2009. Copper prices on both the Shanghai Futures Exchange and London Metal Exchange will continue falling on slack demand thanks to the economic downturn and even lower production costs in the first half of 2009. However, a recovery is expected later in the year, as increased investment in China's power grid projects will boost copper consumption. It is also expected that the Chinese government will reinstate copper tolling in 2009 as an additional support measure for domestic copper smelters, which would allow them to import copper concentrate and export refined copper at preferential tax rates.

## Nickel

In 2008, spot nickel prices on the Shanghai Yangtze Nonferrous Metals Market fell from a high of RMB 271,000 (\$39,619.88) per ton on March 6, to between RMB 96,500 (\$14,116.03) and RMB 106,500 (\$15,578.83)/t Dec. 25, as demand from the downstream stainless steel making industry crumbled. According to Beijing-based Antaiko Information, China's annual stainless steel output is expected to reach around 7.1 million tons in 2008, down 2.2 percent from the previous year. China's nickel production, measured by nickel metal content, is expected to stand at 200,000 tons in 2008, down 6.1% year-on-year, while nickel consumption, also measured by nickel content, is forecast to reach 315,000 tons, equal to that of 2007.



In late October, Jinchuan Group, Asia's largest nickel producer, slashed its nickel production target for 2008 from 120,000 tons to 100,000 tons. The fall in nickel prices in 2008 and suspended operations of stainless

steel factories also forced Chinese producers of nickel pig iron to scale back production in early September. By late October, more than 95 percent of China's nickel pig iron producers had shut down their facilities, which resulted in huge stockpiles of laterite at China's ports. On Dec. 19, laterite stockpiles at China's ports reached 6.9 million tons.



In 2009, China's demand for nickel may continue shrinking because of declining stainless steel output. As such, spot nickel prices on the domestic market will remain weak, between RMB 41,100 (\$6,000) and RMB68,500 (\$10,000) per ton. Only 60 percent of China's total 12.05 million tons of stainless steel production capacity will be in operation next year, and about 6.64 million tons worth of newly-added domestic stainless steel production capacity will remain idle. According to Antaika Information, China may produce 229,000 tons of nickel, measured by nickel metal content, and nickel consumption may fall to 313,000 tons in 2009.

## Zinc and lead

Zinc prices on the SHFE fell from a high of RMB 23,000 (\$3,364.44) per ton in March to the year's lowest point of RMB 8,400 (\$1,228.75) per ton on Dec. 8. As demand dropped considerably after the outbreak of the financial crisis, major domestic zinc producers cut production and postponed new production facilities from coming online. For example, Huludao Zinc Industry Co. Ltd. and Yunnan Luoping Zinc, Electricity Co. Ltd. and other major Chinese zinc smelters cut output by between 25 percent and 30 percent of their total production capacity.

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If market conditions worsen next year, and more production facilities are closed, the government may resume export tax rebates on high-grade zinc or lower export tax rates for certain zinc products in a bid to boost exports.



Lead consumption is expected to grow by 8 percent year-on-year to 2.75 million tons in 2008, according to Antaike Information. China's lead production is expected to grow by 9.3 percent year-on-year to 3.05 million tons in 2008, leaving the market in a surplus. The outlook for China's lead industry is uncertain for next year, with the possibility of a market surplus as demand may slide with China's expected slower rate of economic growth. The country may also see an increase in lead production as there are many newly-built lead smelting facilities on hold at present, which may commence operations next year.

## Gold

Since its debut on the SHFE on Jan. 9, gold futures prices saw volatile fluctuations throughout the year, closing at RMB 185.84 (\$27.18)/g on Dec. 25, down 16.66 percent from its first day of trading. The Hong Kong Futures Exchange also launched gold futures trading on Oct. 20 this year, although few investors have been tempted by the new products due to the likelihood of minor gains at best and the immature gold trading system.

Domestic spot gold prices in 2008, which tracked SHFE prices, and tightened finances, have forced China's gold mining and refining companies to slow production. China's gold output in 2008 will only reach around 275 tons, instead of the previously forecast 300 tons. International and domestic gold prices in 2009 are expected to rally upwards, given the supply shortfall, and the increasing demand for gold, which is popular during recession-time. However, the possible strengthening of the U.S. dollar against the Euro in 2009 may support a higher U.S. Dollar Index, which would undermine the upward movement of international gold prices.



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