FOCUS ON
The Chinese Slowdown: Every Cloud Has a Silver Lining

Produced by the Economic Analysis and Research

EXECUTIVE SUMMARY

- *The slowdown in China (GDP at +6.9% in 2015) should be viewed as an evolution of its economic structure, more oriented in the future toward internal consumption and less on export and investments.*
- *This adjustment has impacted the global economy and particularly a few countries of Latin America that have suffered a decline in their commodity exports (especially metal ores).*
- *The effects have not been the same for all: this Chinese realignment may be advantageous, however, for those sectors where demand from the Chinese market is expected to increase, especially agro-food products.*
- *The beneficiaries include not only a few Latin American countries but also Italy. Italian companies may seize on two opportunities:*

  (i) exploiting changes in the eating habits of the Chinese population by exporting high-quality processed foods to the country;

  (ii) supplying machinery for the processing of agricultural raw materials to the Latin American countries to increase the output of those farms goods (raw materials and intermediates) that might be absorbed by the Chinese market.

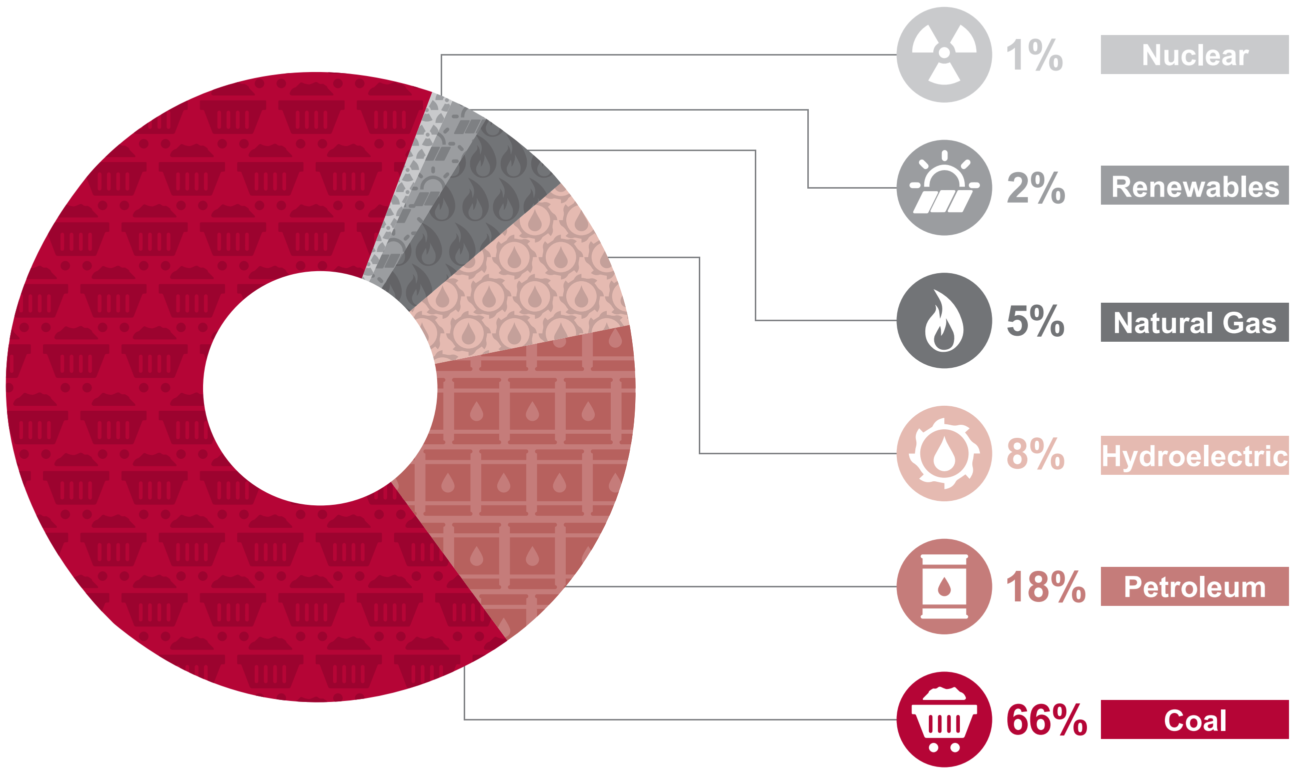
CHINA: SHIFT TOWARD A MORE MATURE, BALANCED MARKET

Since 2010 China has become[01],the world's largest consumer of energy and, in 2013, the world's largest trader. It is the principal importer of commodities such as iron and copper ore and the no. 2 importer of petroleum after the United States.

Due to the growth driven by state investments, especially in heavy industry, China now needs to seek a better balanced economic structure. The government's objective is to reduce the incidence of investments on GDP (equal to 50%) and to resolve environmental problems, associated with the heavy use of coal as a primary energy source (Chart 1), through:

- stronger stimulus to domestic consumption (to the detriment of investments and exports);
- the production of higher quality goods and development of the services sector;
- the use of renewable energy sources.

CHART 1. *China's energy mix: coal still predominates*



Source: EIA, British Petroleum

[01] *Source EIA*

What are the possible consequences of that strategy?

First of all, a slowdown in growth, is already evident: after double-digit rates in the first decade of the 2000s, China grew at a rate of 6.9% in 2015 (the lowest since 1991), and is expected to reach 6% in 2017[02]. Let's bear in mind, however, that these rates are still double or triple those of the healthiest advanced economies and are based on a gross domestic product that is almost ten times what it was 15 years ago[03].

Secondly, reduced Chinese imports of commodities. In particular:

- the stimulus to domestic consumption and urbanization will bring a change in eating habits: primary goods (like rice and soybeans[04]) will be partially replaced by processed food products (e.g. cheese, meat);
- the objective of producing with higher value added will result in lower demand for the base metals used in heavy industry (iron and copper ore) in favor of metals used in producing consumer goods (like zinc and aluminum);
- the focus on environmental protection will increase the use of renewable energy sources and natural gas in lieu of carbon.

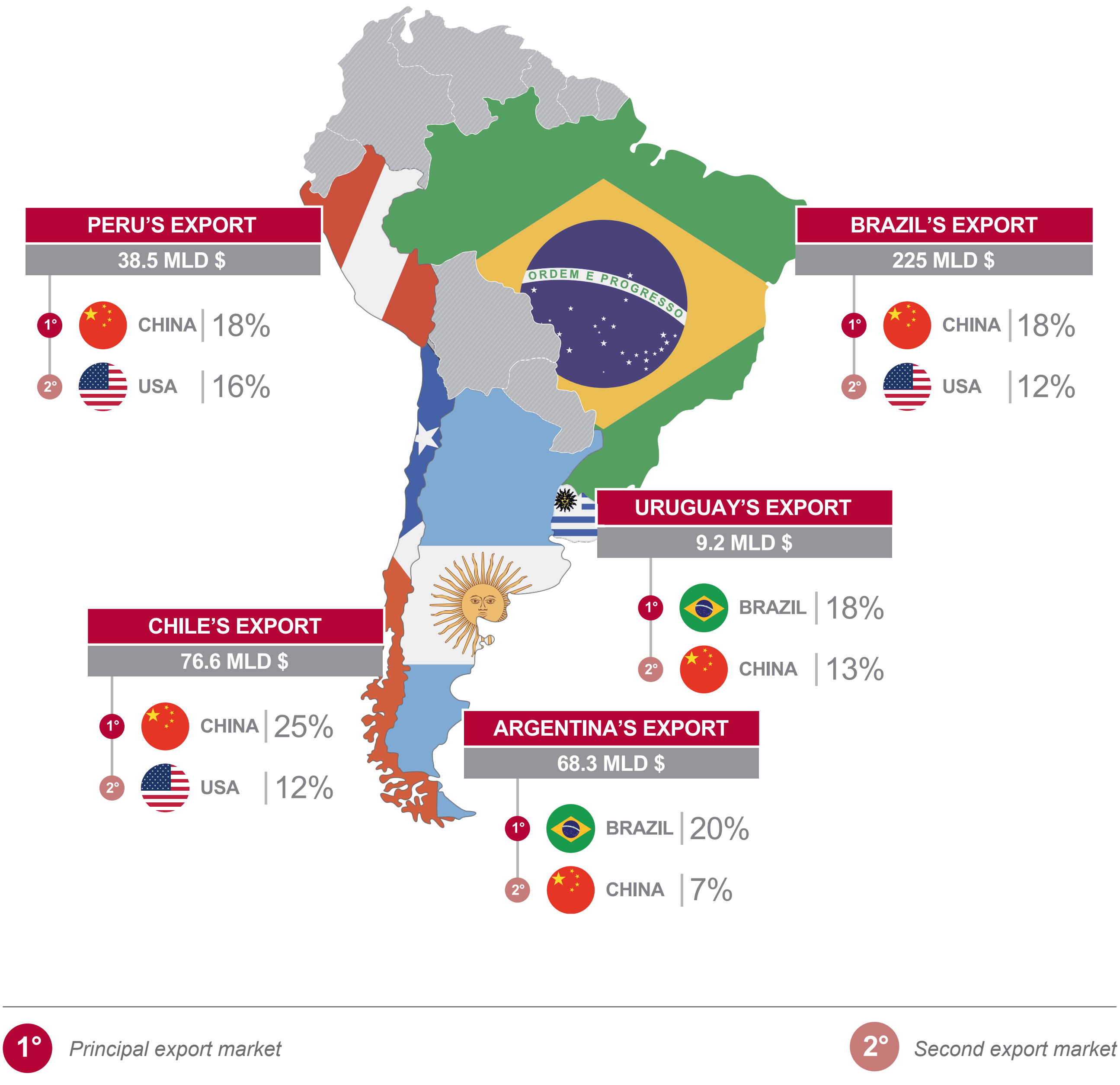
LATIN AMERICA: PROS AND CONS OF DEPENDENCE ON CHINA

Among the countries most impacted by this new trend in China are those of Latin America, principal suppliers of commodities to the Chinese market. **The decline in Chinese demand and the consequent reduction in commodity prices, in fact, are negatively affecting performance in this area**. The International Monetary Fund estimates that Latin American GDP growth should decline 0,3% in the 2015-16 period, after growth of 3.7 in the past ten years.

[02] *Source IMF, WEO January 2016.*
[03] *The nominal GDP of China was 1.2 trillion dollars in 2000 against 11.4 trillion in 2015 (source IMF).*
[04] *China is currently the no. 4 producer of soybeans worldwide. The increased soybean imports projected by the USDA (from 65% to 71% of total world soyean imports) is destined primarily for livestock breeding rather than public consumption. Source USDA.*

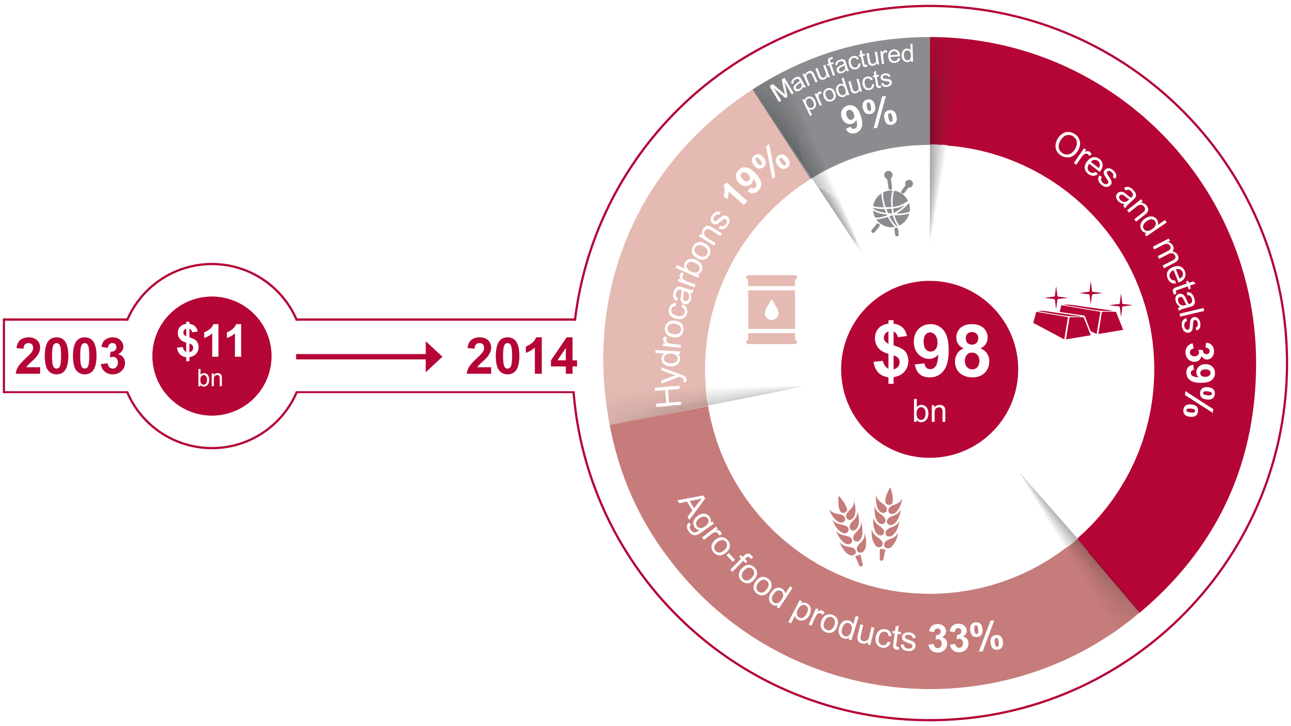
China represents a primary outlet market for the Latin America countries (Chart 2), whose exports have increased by an average (CAGR) of 22% in the past ten years. The countries contributing most to this growth were Brazil, Chile and Venezuela. The primary products exported are ores (Chile and Peru), hydrocarbons (Colombia and Venezuela), and agro-food products (Uruguay, Argentina and Brazil).

CHART 2. *Latin American exports to the world: principal importing markets*



Source: UNCTAD

CHART 3. *Latin American exports to China (USD billions) and breakdown by sector (2014)*



Fonte: Unctad

The new Chinese growth model might have different effects on the Latin American countries, depending on the goods exported and their degree of dependence on international trade. Negative for the base metals used in heavy industry and the construction sector (suffering from the real estate bubble of recent years in the urban centers), positive for agro-food goods and the metals used in the production of consumer goods (zinc, aluminum). In particular (Table 1):

- Chile is one of the economies most exposed because of its strong dependence on copper, especially for the segment used by the construction/infrastructure sector;
- Brazil and Peru are caught in the middle, since they export both products in the food sector (soybeans, fish products) and minerals (copper, iron ore);
- Uruguay, which exports primarily food products, should derive the greatest advantage, along with Argentina.

TABLE 1. *Latin American exports to China by country*

	COMMODITY				AGRO-FOOD PRODUCTS				
	Iron ore	Copper	Copper ore	Zinc	Soybeans	Meat	Fruit	Fish products	Dairy products
ARGENTINA					68%	3%		3%	
BRAZIL	30%				41%				
CHILE	5%	48%	29%				4%		
PERU	9%	14%	49%	9%				3%	
URUGUAY					42%	28%			5%

Positive impact from an increased Chinese demand for agro-food products and the development of new technologies utilizing a few types of ores/metals; in the case of soybeans, the increase derives from greater demand for livestock feed.

Resulting impact of the two offsetting trends: the slowdown in the construction market and in heavy industry and the growing demand for products linked to new technologies that imply the use of certain metals (e.g. copper, zinc).

The negative impact caused by the slowdown in the construction market and heavy industry.

Source: SACE processing of UNCTAD data

THE POSITIVE EFFECTS FOR ITALIAN COMPANIES

The new context taking shape will therefore bring a general increase in Chinese demand for food products, especially by the medium/high-income class of the population living in urban areas. Let us see in detail what factors suggest new advantages for Italian companies:

TIPS: THE MOST PROMISING SIGNS

- *The wealthier part of the population in major Chinese cities is proportionately large, such that even a small elite represents a high consumer spending potential;*
- *A growing number of coastal cities is displaying strong signs of westernization of its consumer spending in the food sector (pasta and typical products like extra-virgin olive oil and Parmesan cheese);*
- *New flows of Chinese tourists will sustain a demand for foreign products when they return home, thanks to direct contact between Chinese consumers and Italian cuisine;*
- *The market continues to grow exponentially, and local legislation will gradually become less complex, facilitating the entry of new importers and distributors into the market;*
- *Growing consumer demand for safe foods in China will act as a stimulus to import finished products and develop techniques for preserving fresh foods;*
- *The reduction in tariffs on luxury products approved in 2015 includes high-quality food products, especially wines.*

We can assume that these changes will create two types of opportunity for Italian companies:

Exploiting the changing eating habits of the Chinese population, increasing exports of high-quality processed food products to China;

Supplying machinery for processing agricultural commodities to the Latin American countries seeking to increase productivity for those goods (raw materials and intermediates), which could benefit from the changing Chinese economic context.

1st OPPORTUNITY

As Italy can hardly compete with Latin America in the large-scale production of "primary" food products (soybeans, meats, cereal grains), it must leverage on its ability to produce high-quality processed foods through a strategy of selective market penetration.

How is Italy positioned in the Chinese food market?
Italy exported € 320 million in agro-food categories to China in 2014, a figure that could reach €410 million in 2018, according to SACE estimates.
The principal product exported is wine, accounting for over 23% of the total, followed by chocolate (22%) and baked products (10%); in wine, Italy must compete with the French, who enjoy a privileged path for the resolution of technical and customs problems. In olive oil, though it represents only 7% of food exports to China, Italy is the no. 2 exporter after Spain. The remaining products, such as fresh and processed meats and dairy products, represent only small volumes but offer great room for growth, as confirmed by trends in recent years (Chart 4)[05].

[05] *Source ICE, China's F&B and Wine Industry Overview.*

CHART 4. *Italian exports of wine, olive oil and dairy products to China*

WINE	Ranking ►	5th
	Principal Competitors ►	France, Australia, Chile
	Italian Exports 2014 ►	€ 76.1 mn
	Consumption (CAGR 2014-2018) ►	+17%
OLIVE OIL	Ranking ►	2nd
	Principal Competitors ►	Spain and Greece
	Italian Exports 2014 ►	€ 21.6 mn
	Consumption (CAGR 2014-2018) ►	+16%
DAIRY PRODUCTS	Ranking ►	19th (5th in the cheese category)
	Principal Competitors ►	New Zealand, Australia, United States and France
	Italian Exports 2014 ►	€ 14.5 mn
	Consumption (CAGR 2014-2018) ►	+18%

Source: Istat, ICE

The development of the Chinese food market depends on the level of logistical infrastructure supporting the distribution network, which is concentrated in the more densely-populated areas. One fast-growing distribution channel with great potential is online: suffice it to say that on "Singles' Day" last year (11 November)[06] e-commerce giant Alibaba had sales of 14 billion dollars in a single day. According to Forbes estimates, there might be 750 million online users/consumers by 2020 (there were 360 million in 2014).

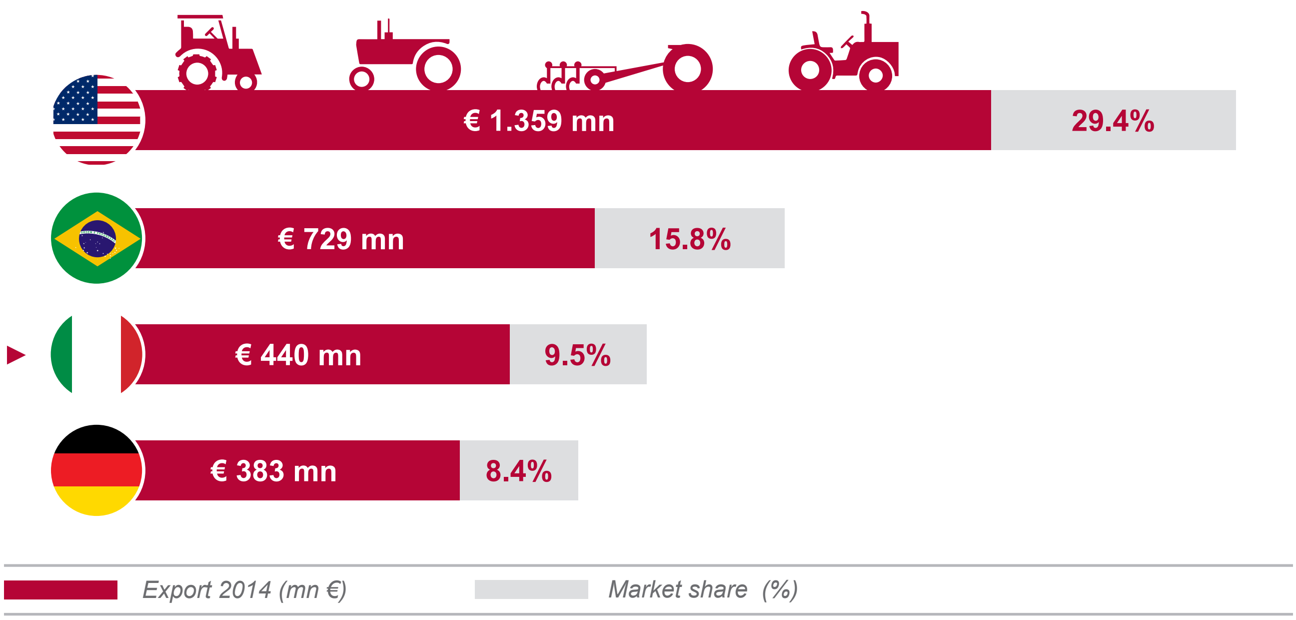
"Traditional" distribution channels require the intermediation of local partners (importers and wholesalers). To penetrate the retail market, one possible channel is the hypermarkets or specialized supermarkets, which have long experience in marketing imported products and serve a clientele inclined to purchase "niche" products. For now, Italian exporters must conclude ad hoc agreements (with mainly foreign companies) to utilize existing distribution and logistics networks and platforms[07].

[06] *Event mirroring Cyber Monday, the online shopping day in the United States, which unlike China's "single day" registered sales of "only" 6.5 billion dollars.*
[07] *Generally speaking, there are as yet few Italian retail networks that can be utilized; these include Autogrill and Eataly.*

2nd OPPORTUNITY

Italy plays an important role in the export of farm machinery and food processing equipment to Latin America; in fact, we are the no. 3 exporter of this machinery after the United States and Brazil (Chart 5). This demonstrates that Italian companies are well positioned and must continue to expand their market share by leveraging on technologically advanced, personalized products, not to mention after-sale assistance. To facilitate access to the local markets and increase competitiveness, exporters must also seek financial instruments that enable their customers to enjoy extended payment terms and, at the same time, insure against the risk of default.

CHART 5. *Exports of farm machinery and food processing equipment to Latin America*



Source: UNCTAD

CONCLUSIONS

The current context of economic slowdown in the emerging countries, particularly in China and a few Latin American countries, is creating **opportunities for Italian companies, especially in processed food products for the Chinese market and machinery for the processing of farm products for the Latin American countries**.

By exploiting the tradition and quality of their food products (the "Italian food" brand), Italian companies must adopt strategies of market penetration to reach those 30 million high-income Chinese consumers[08].

Therefore, in addition to technical and commercial solutions, it will be important for Italian companies to procure the financial solutions necessary to increase their competitiveness. In this area, SACE can offer extensive expertise and a network of local and international offices to support companies right from the initial phases of negotiation with instruments that enable them to (i) export their products by granting customers extended payment terms and (ii) insure themselves against commercial credit risk, both short-term (for agro-food products) and long-term (for machinery exports).

[08] *I.e. individuals with an annual income in excess of 34,000 dollars; they are expected to number 60 million by 2020 (source McKinsey).*

PREPARED BY

Giovanni Salinaro and Tiziano Spataro

CONTACTS

Customer service: +39 06 6736000 - info@sace.it

Press Office: +39 06 6736888 - mediarelations@sace.it