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China, 'Prisoner of Success,' Facing Ore Price Gain (Update1)

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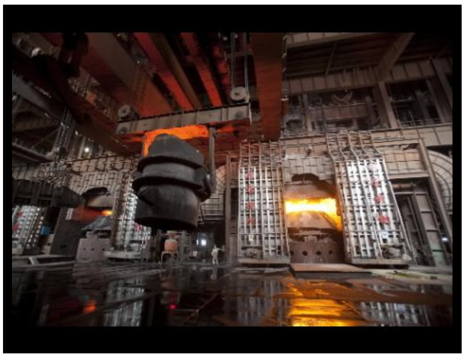

Oct. 30 (Bloomberg) -- China's biggest adversary in this year's iron ore price talks is China.

The nation's 4 trillion yuan ($586 billion) stimulus package has sparked **record imports** of the steelmaking material and prices may jump 14 percent next year to the second-highest on record, according to a Bloomberg News survey of analysts.

China's steelmakers such as Baoshan Iron & Steel Co., the biggest, have made the country the world's largest iron ore buyer and steelmaker, accounting for half of global output. The surge in demand for the ore may now squeeze earnings.

"They're prisoners almost of their own success in that the stimulus package has worked," **Peter Richardson**, chief metals economist at Morgan Stanley, said in an interview in Melbourne. "A rise is inescapable."

Vale SA, Rio Tinto Group and **BHP Billiton Ltd.**, the world's three-largest producers, are boosting shipments from mines in Brazil and Australia as mills in China, Japan, Europe and the U.S. restart furnaces to meet demand for steel used in cars, construction and washing machines. China overtook Japan as the world's largest buyer in 2003 and now accounts for more than half of the seaborne trade, worth about $160 billion last year.

"The market is against China," UBS AG commodity analyst Tom **Price said** from Sydney Oct. 22. UBS has tipped a 20 percent price gain. "It's still the new kid on the block. There's no long-standing, repeated-game relationship between China and the producers yet."

Rio shares rose 4.6 percent in Sydney trading today, while BHP gained 0.9 percent.

Start of Talks

The **price** of annual contracts for Australian iron ore fines, a benchmark grade of the ore, may climb to about $70 a metric ton, according to the average estimate of 11 analysts in the survey. **Cash prices** are trading at about 24 percent more than benchmark, according to Goldman Sachs JBWere Pty, signaling contract prices may climb. Producers are scheduled to start talks this week with Japanese steel mills on next year's contracts.

"Iron ore prices may rise 25 percent next year because the recovering global economy is helping boost steel output from Japan and South Korea, as well as because of sustained demand from China," said **Helen Lau**, a Hong Kong-based analyst at OSK Securities Hong Kong Ltd.

China, which hasn't formally accepted the 33 percent cut agreed this year by its Japanese and South Korean rivals, may seek another reduction, citing falling mill profits and a potential drop in output should the stimulus be wound back.

Rio Arrests

Tensions are high after Chinese authorities arrested four London-based Rio Tinto's iron ore executives, including Australian **Stern Hu**, for allegedly stealing commercial secrets and bribery. Hu and **Ge Minqiang**, **Wang Yong** and **Liu Caikui** remain in detention since their arrest in July. Rio may be shunned by China in this year's talks, UBS analyst Price said.

To be sure, iron ore China’s **imports** have exceeded real demand by 50 million metric tons this year, the China Iron and Steel Association said this month. The nation’s cabinet in August said it was studying curbs on overcapacity in industries including steel, where output reached a record this year.

“Next year, it’s clear there will be oversupply of iron ore,” **Shan Shanghua**, general secretary of the China Iron and Steel Association, said Oct. 16 in Qingdao.

Wuhan Iron & Steel Co., the publicly traded unit of China’s third-biggest steelmaker, said this week full-year profit may drop more than 50 percent because of the recession. Hebei Iron & Steel Group, China’s second-biggest mill, said this month mills may lose money next year as well.

Profit ‘Struggle’

Shanghai-based Baoshan Steel may post earnings per share of 0.13 yuan in the fourth quarter, according to the mean estimate of three analysts compiled by Bloomberg, down 24 percent from the 0.17 yuan for the three months ended Sept. 30. Yesterday, Baoshan had the highest profit in five quarters on lower costs.

“Chinese steelmakers are struggling to make a profit,” said **Xu Xiangchun**, chief analyst with Mysteel Research Institute. “To help cut their production costs, CISA and the mills may demand a price cut if they think there will be an oversupply in the iron ore market next year. But so far, we haven’t heard that they have decided on the direction for price talks.”

Iron ore imports rose 36 percent to 469.4 million tons in the first nine months from a year earlier, the nation’s customs office said Oct. 14. September’s imports were a record. Steel production is the key driver of iron ore demand with 1.6 tons of ore used in every ton of steel produced.

Currencies Climb

“The iron ore market will continue to strengthen in the months ahead,” Barclays Plc analysts led by **Christopher LaFemina** said in an Oct. 21 report. “This year, iron ore demand has been stronger than the market had expected. We expect demand to improve further.”

A 32 percent gain in the Australian currency and a 34 percent climb in the Brazilian real against the dollar since the start of the April 1 contract year may also prompt producers to demand an increase to cover currency losses as ore is traded in dollars, analysts at UBS, Citigroup Inc. and Goldman Sachs said.

“You need at least 20 percent just to catch up on exchange rate changes since the last settlement,” UBS’s Price said.

Global steel output may jump 12 percent next year to a record 1.4 billion tons and production may grow 4 percent annually through 2015, Goldman Sachs JBWere Pty said in a Oct. 6 report. **China’s economy** expanded at 8.9 percent, the fastest pace in a year, in the third quarter as stimulus spending and record lending growth helped it lead the world out of recession.

“We see a fundamental tightness in the market,” said **Alan Heap**, director of global commodity analysis at Citigroup, who has predicted a 15 percent gain in prices next year. “The stimulus packages all around the world have been a key thing in rescuing global markets. The Chinese stimulus package had a much larger physical component to it than most of the others.”

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