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How China's Steel Makers Export The Five Year Plan And Undermine Market Forces

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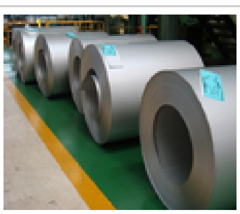

Grim news from South Wales about the possible closure of the Tata steelworks has focussed press attention on China's steel industry once again. In China, however, the 4,000 job losses in prospect in Port Talbot are dwarfed by the potential for 400,000 in forthcoming years. For every Welsh steelworker currently facing redundancy there are 100 Chinese workers in the same position.

The problem, moreover, is the same everywhere. In Australia, the second largest steelmaker –

Arrium – is on the ropes, with nearly 7,000 jobs at risk, and worldwide there are idle steel furnaces and redundancies across the board.

There is little doubt that China's overcapacity is a key contributing factor, but the sheer scale of the problem invites pessimism over anything changing very soon. The Economist recently reported the staggering detail that over three years, China made more steel than the UK had since the industrial revolution. For further comparison, the difference between steel produced and steel consumed in China in 2014 was 112 million tons, nearly 10 times total UK output.

It is tempting to see this as just another story of the inevitable rise of China, powered by cheap labour to a position of industrial dominance, but on inspection, things are not quite so simple.

China has been building capacity aggressively over the last twenty years, rising from 25.6% to 49.4% of global output between 2004 and 2014, while global production went up by nearly 57% in total. In 2014, China produced 68 tons of steel, for every 1 ton produced in the UK and every 9 tons in the US. Taken as a whole, China supplies a significantly greater proportion of global demand for steel than OPEC members supply of global demand of oil.

With the Chinese economy slowing, an overhang has developed that dwarfs world steel markets, being larger than the 2nd ranked steel producer's entire output. In a normal market this would prompt bankruptcies, consolidation and a Schumpeterian process of capacity destruction, slowly bringing supply back into contact with demand. But China is not a normal market, it remains, and will always likely remain, a planned economy.

Indeed, looking at the world's largest steel companies shows an interesting pattern that reveals something important about how China works. Most big steel producing countries have two or three significant companies; Japan has three, Korea has three, etc. China, exceptionally, has 26 of the world's 50 largest steel producing companies, and fully six of the top ten. What is more, these companies are regionally distributed, usually named after the city or province where they were originally established. And, of course, they are all State Owned Enterprises (SOEs) for which the normal rules of the market don't apply. Some of them have accumulated huge debts, are loss making, but nevertheless carry on producing anyway.

What this peculiar arrangement reveals is something that is not widely understood outside of China, which is that although these companies are all state owned, there is a very high degree of regional and institutional differentiation in their governance. Formally China appears to operate under strict central direction, but in practice the provinces exercise significant discretion over economic decision making. The implication of this state of affairs is simply that when it comes to consolidating China's steel industry, and reducing capacity by 100 to 150 million tons – along with the accompanying job losses – there are many institutional hurdles yet to clear.

Adding another layer of complexity is the fact that the enormous expansion of steel production in China was an important aspect of their rapid growth after they joined the WTO in 2001, and not primarily a response to rising global demand for steel. It was, in fact, mainly rising Chinese demand that Chinese manufacturers were servicing by producing steel for construction, infrastructure and automobiles. And in building up huge productive capacity they now need to consolidate on a scale that has simply never before been attempted anywhere.

Therefore, a state directed expansion drive has given China an enormous economic and political liability that is not easy for them to address, and the ripples from this giant investment splash will be washing around the world for years to come.

When considered in aggregate, China's rapid, state directed, growth has given rise to the illusion of a buoyant market for steel, when an important consequence was the cultivation of a global market distortion of unprecedented scale. And this market distortion will not resolve itself until the overcapacity is purged.

Unfortunately, although China's Five Year Plans (FYP) are implicated in creating the problem, the 13th FYP is crucial to resolving it. The consolidation will be managed through the planning framework, and will come up against considerable provincial and institutional resistance along the way. All of which makes the detail of the 13th FYP – being unveiled over the next few months – crucially important to steel producers everywhere, and ensures that market forces will have to wait for better times.

Currently, China plans to eliminate the majority of the overcapacity only by 2020, and is already warning of threats to social stability as a consequence, raising questions about their determination. At the same time, tariffs have been going up around the world and the prospects are looking grim for a pick up in demand for steel. China's response so far has been to point the finger at falling global demand and to call for global cooperation to resolve global overcapacity.

The prospect, however, of global consolidation, will not be welcomed by those who believe that China in large part created this problem, and therefore China must resolve it. But unfortunately global consolidation is highly likely at some level, simply because many global steel companies are not routinely supported by governments and the price effects of Chinese overcapacity are both significant, and long lasting.

The final irony is that although campaigners against the closure of the Port Talbot steel works will inevitably blame the economics of the free market, responsibility actually lies with the interventionist tendencies of Chinese state planning.
Source: Forbes

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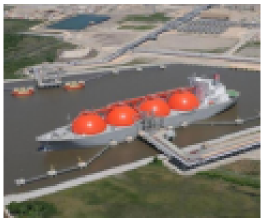

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