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China's Steel Sector: Supply Reform

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Should China manage to balance state support for restructuring and the most efficient and effective market mechanisms, it could potentially establish the most competitive steel mills in the world.

Key summary points

- Capacity has been a long-standing issue in the Chinese steel sector
- The Chinese government's ambitious capacity-cutting plan has seen mixed results
- We believe that the market is the best mechanism to select the survivors and the losers
- China could establish the most competitive mills, if it balances market and state support

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Capacity has been a long-standing issue in the Chinese steel sector. According to World Steel Association (WSA), more than 320 steel-related policies and measures were implemented in China from 1990 to 2016, of which about half were aimed at capacity control. However, these have been far from successful due to disharmonising policies between the central government and local governments; China's policy to reduce capacity has been considered the story of "The Boy Who Cried Wolf".

In February 2016, the Chinese government revealed its ambitious restructuring plans for the country's steel industry, aimed at tackling overcapacity and boosting efficiency of the sector. The government plans to remove 100-150 million tonnes of steel capacity and 800 million tonnes of outdated coal capacity by 2020. In November 2016, the Ministry of Industry and Information Technology (MIIT) officially confirmed this plan as the major target for China's steel industry under the 13th Five-Year Plan. At the beginning of 2017, the Chinese government announced that it successfully cut steel capacity by 65 million tonnes in 2016 and plans to reduce another 50 million tonnes of capacity in 2017. To achieve this target, the central government is tightly monitoring provincial governments' restructuring actions. Also to facilitate the country's supply-side reform measures, the US\$5.9-billion Siyuanhe Steel Industry Restructure Fund was established on 7 April 2017 in Shanghai.

For the share of China's 10 biggest steel producers to reach 60% of the country's total (compared to 35% in 2015), a series of mergers and acquisitions (M&As) is expected in the steel industry. For a start, Baoshan Iron & Steel has merged with Wuhan Iron & Steel, creating China's largest and the world's second-biggest steel mill in terms of combined crude steel production (61 million tonnes in 2015). About 10 million tonnes of outdated steel capacity has been removed in the process and a total of 15.4 million tonnes will be cut by 2017. The consolidation is expected to increase competitiveness, especially in value-added sectors such as the automobile market, and improve profitability through cost savings.

China's steel-sector restructuring is likely to drive more consumption of imported iron ore as the Chinese steel sector will encourage large integrated steel mills to produce high-grade steel products. These steel mills, such as Baosteel, are nearly completely reliant on imported iron ore for their production. Also, the shutdown of IFFs is projected to boost demand for iron ore, given that the steel demand that had been met by IFFs should now be substituted by integrated steelmakers. Some steel companies are trying to upgrade IFFs to electric arc furnaces to avoid facility closure; the proportion of this would be less than 10%, according to market participants.

Developed economies' experience in restructuring their steel industry demonstrates that the government plays a key role in the process. However, the government's role should be limited to the early stages of restructuring, such as providing financial support to help reduce excess capacity, resettling redundant employees, and reducing barriers to exit for loss-making companies. We believe that the market is the best mechanism to select the survivors and the losers. Also M&A should be part of companies' strategy to enhance competitiveness rather than a government's decision. Should the government's appropriate support for restructuring and the most efficient and effective market mechanism harmonise, we will see China establishing the most competitive steel mills in the world.

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