China Business

Chinese industry: Ambitions in excess

seen in many sectors

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Shi Zhengrong became known as the "sun king" around the time he was named China's fifth-richest man in 2006. Barely three years later, Suntech, his New York-listed company, was the world's largest solar panel-maker, producing enough solar cells each year to power 1m energy-guzzling US homes.

To struggling manufacturers in the US and Germany, Suntech was part of an unstoppable juggernaut that undercut markets (https://www.ft.com/content/008cfcd2-cf72-11e2-be7b-00144feab7de), flooded the world with ultra-cheap products and put competitors out of business. Indeed, the European Commission is threatening to raise import tariffs (https://www.ft.com/content/48563e7a-cf72-11e2-be7b-00144feab7de) on Chinese producers for allegedly selling solar panels in Europe for less than they cost to make.

But China's business model is far from unassailable. In March, Suntech filed for bankruptcy protection (http://www.ft.com/cms/s/0/c4164d20-916a-11e2-b839-00144feabdc0.html). From a market value of $16bn at its peak, the company is now worth about $180m. The sun king has been dethroned as chairman (https://www.ft.com/content/3647937a-92da-11e2-9593-00144feabdc0).

In fact, the solar industry is only the most pronounced example of broader overcapacity in China. Its rise and fall has followed a pattern that is becoming familiar across the world's second-biggest economy.

The problems stem from China's industrial policies and a vast array of subsidies that allow whole sectors to spring up overnight. Ambitious local officials are keen to lavish government money (http://www.ft.com/cms/s/0/cd356b12-d129-11e2-a3ea-00144feab7de.html) on what they hope will be success stories that can further their careers.

"When you have administrative measures you get huge overcapacity and this country has created overcapacity in a whole lot of areas," says Hank Paulson, former US Treasury secretary, who often visits China. "It's not just clean technologies; steel, shipbuilding we can name all the areas."

From chemicals and cement to earthmovers and flatscreen televisions, Chinese industry is awash with excess capacity that is driving down profits inside and outside the country and threatens to further destabilise China's already shaky growth.

It is not a new problem; it was exacerbated by Beijing's response to the financial crisis in 2008 and continues to worsen despite years of government efforts to curtail it. China produces nearly half of the world's aluminium and steel (https://www.ft.com/content/6b4a1288-c880-11e2-acc6-00144feab7de) and about 60 per cent of the world's cement but new production is being added rapidly, even as the economy cools.

China's output expanded 7.8 per cent last year – its slowest pace in 13 years – and after a brief rebound in the fourth quarter, growth has slumped further in the first half of this year.

Aluminium prices have dropped precipitously in recent years (http://www.ft.com/cms/s/0/5912a91e-0ed0-11e2-9343-00144feabdc0.html) and more than half of China's aluminium producers operate at a loss. Despite this, smelters are being built nationwide, even though producing the metal requires huge amounts of energy, water and bauxite, all of which are scarce in China. Foreign producers are also being forced to close because of the excess supply spilling out of China.

Only about two-thirds of cement capacity was used last year, according to a survey from the China Enterprise Confederation.

For global manufacturers, the China effect over the past decade has been fearsome. It has destroyed jobs and capacity all over the world, shuttering factories in competitor nations.

But in almost every sector where China's low-cost goods have come to dominate, something strange has happened. Once the bulk of global manufacturing in a given industry has moved to China, overcapacity quickly follows and these sectors begin to cannibalise themselves. Suntech was a prime example.

Li Junfeng, a senior energy policy adviser at China's state planning agency, likens the country's solar sector to a patient on life support and says at least half of global solar capacity needs to be shut. "Overcapacity results in low-price competition; all industries experiencing overcapacity have this problem," Mr Li says.

An older example is the mobile handset market, which the Chinese government set out to dominate a decade ago with national champions sporting names such as Panda, Konka and Ningbo Bird.

Even in China not one of these companies is a household name today. But many analysts had once predicted these low-cost producers would rise to become the Chinese equivalents of Nokia, Ericsson and Motorola.

The Chinese government, particularly local authorities, poured vast subsidies into these companies in the hope of turning them into global forces but they all eventually lost the race to develop new technology.

"There was a lot of talk back then about how these companies would become great new Chinese technology giants and they certainly threatened their international competitors by eating away at the low end of the value chain," says Anne Stevenson-Yang, research director at J Capital Research. "But over time Chinese companies tend to remain factories that manufacture huge amounts of low-end, undifferentiated stuff."

Several studies have found that the ability of Chinese industry to dominate global manufacturing in certain sectors is largely due to subsidies, most of which are provided by local and provincial governments.

In a recent study, Usha and George Haley, US-based academics, studied how Chinese steel, glass, paper and auto parts producers turned from bit players and net importers to the world's largest manufacturers and exporters in just a couple of years.

In each of these highly fragmented, capital-intensive industries, labour accounted for between 2 and 7 per cent of costs and the vast majority of companies enjoyed no economies of scope or scale.

“Our findings contradict the widespread belief that China’s enormous success as an exporting nation derives primarily from low labour costs and deliberate currency undervaluation,” says Usha Haley. “There is enormous overcapacity and no gauging of supply and demand and we found that subsidies account for about 30 per cent of industrial output. Most of the companies we looked at would probably be bankrupt without subsidies.”

Besides direct cash infusions, many local governments in China provide very cheap land, cheap credit, discounted utilities and tax breaks to state-owned and private companies that set up in their backyards.

In a research report on government subsidies to non-state owned Chinese companies, Matthew Forney and Laila Khawaja from the research consultancy Fathom China found that most companies surveyed received some form of direct subsidy.

“The bottom line is that officials who climb the [Communist] party ladder fastest are usually those who oversee the most flashy investment projects and the fastest growth,” Mr Forney and Ms Khawaja say. “Offering subsidies to private companies looking to expand can help localities clinch an investment deal that brings jobs and tax revenue.”

Some of the most heavily subsidised companies in China are automakers (https://www.ft.com/content/132e3b68-b8a6-11e2-869f-00144feabdc0), such as Chery, BYD and Geely. Some analysts predict they will ultimately meet the same fate as the handset makers.

Overcapacity in the auto industry is rampant and in the case of Geely, which bought Volvo in 2010, more than half of its net profits came directly from subsidies in 2011. In fact, subsidy income for Geely that year was more than 15 times greater than the next biggest source of net profits – “sales of scrap metal” – according to analysis from Fathom China.

In the case of Mr Shi the sun king, subsidies and grants from a local government were crucial in convincing him to return to China from Sydney, where he lived in the suburbs and drove a Toyota Camry to his job as an executive in a solar start-up company. Mr Shi and Suntech both declined to comment. In 2000, the government of Wuxi, near Mr Shi’s birthplace in eastern China’s Jiangsu province, was eager to establish a solar industry so officials set out to lure him back with promises of support.

“Suntech is a seed sown by the Communist party committee of the Wuxi government,” Mr Shi said in a speech in March 2011 to welcome Yang Weize, the former Wuxi party secretary, to Suntech’s new headquarters in the city. “During Suntech’s start-up phase we experienced intense pressure but Wuxi continuously watered and nurtured this seed.”

Thanks partly to his success in fostering Wuxi’s solar industry, Mr Yang was promoted in 2010 to become the party secretary of Nanjing, one of China’s largest cities. Throughout the country, party officials take note of this kind of meteoric rise and arrive at the conclusion that they too can reach great heights by subsidising businesses.

This drives intense inter-regional competition and a race to the bottom between local governments, which often decide not to enforce environmental, safety and labour laws in order to keep jobs and taxes (and kickbacks) in their jurisdictions.

Another big problem for almost every industry is that companies' investment and growth plans have been predicated on the belief that the government would never allow growth to drop below 8 or 9 per cent.

This perception was encouraged by Beijing's response to the 2008 crisis, when it launched a Rmb4tn ($650bn) stimulus, unleashing a construction boom to prop up stumbling growth.

Today, as growth slips towards 7.5 per cent and lower, China's new leaders do appear more determined than their predecessors to tackle overcapacity.

"We intend to accelerate the transformation of the economic development model and vigorously adjust and optimise the economic structure," said Zhang Gaoli, the executive vice-premier in charge of the economy and a member of the all-powerful Standing Committee of the politburo, in a speech this month. "We will strictly ban approvals for new projects in industries experiencing overcapacity and resolutely halt construction of projects that violate regulations."

However, Beijing has tried for years to tackle this problem but meets fierce resistance from local governments trying to protect their local "seeds". Analysts and officials say bankruptcies such as that of Suntech are still unusual and tend to happen only when a company is beyond rescue or local officials want to seize ownership. But the scale of overcapacity and the slowdown in Chinese growth suggest many more people will suffer the fate of the sun king.

Mr Shi remains in Wuxi and is still the largest single shareholder in Suntech but, according to Chinese media, he is the subject of an investigation into his role in the company's fall.

"The problem with subsidies everywhere is they tend to support activity not outcomes and they become more of a problem when they're just subsidising inefficiencies," says John Rice, vice-chairman of General Electric, who heads GE's global operations from Hong Kong.

"If you do that in perpetuity it just increases the size of the anchor that drags down growth."

Additional reporting by Leslie Hook

Steelmakers struggle to shut down capacity

When economic growth in the west evaporated during the global financial crisis, China rode to the rescue with a colossal stimulus package that helped the global economy out of the downturn, *writes Leslie Hook*.

Powered by a binge in government spending on infrastructure and construction, as well as an injection of cheap credit into industrial sectors, China's economy steamed along, growing 8.7 per cent and 10.3 per cent in 2009 and 2010.

But today the price of that stimulus is becoming more apparent. Five years on, many of the industries that were beneficiaries of the stimulus – from steel to shipbuilding to metals smelting – are bloated with overcapacity.

For these sectors, the recent slowdown in China's economic growth spells serious losses and a painful process of elimination.

"Five years ago, steel was an industry of huge profits," explains Zhang Xiaogang, who heads Anshan Iron and Steel, China's fourth-largest steelmaker.

"Precisely because it was so lucrative, there was a lot of repetitive construction and a huge amount of assets pouring into the field, causing the overproduction nowadays."

Those boom days derailed the long-planned consolidation and reorganisation of China's steel sector, which has for decades been an illusive goal for Beijing's policy makers.

Today, even though China's steel production is running at record levels, only about 80 per cent of the country's production capacity is being used. Industry chiefs and government officials say more excess capacity needs to be shut down in order for the sector to come back into balance.

But this is easier said than done. Previous efforts to consolidate the steel sector have been sidelined repeatedly.

Regardless of their profitability, steel mills have proved to be almost impossible to close down because of their role in providing employment and providing tax revenues to cash-strapped local governments.

"It is very difficult to find an effective remedy for China's production overcapacity problem," says Mr Zhang.

"Which company are you going to tell to shut down? Do you choose the ones that are losing money, or are heavily polluting, or are violating industry standards, and make them close? This part is quite hard."

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