

Created destruction

Making sense of capacity cuts in China

Investors have been cheered by sweeping cutbacks. They should look more closely



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STOCKMARKETS have been on a tear over the past 18 months. Shares are, on average, up by a third globally. Commodities have rallied. And the optimism has infected corporate treasurers, who, for the first time in five years, are spending more on new buildings and equipment. Plenty of factors have fed into the upturn, from Europe's recovery to early hopes for the Trump presidency. But its origins date back to a commitment by China to demolish steel mills and shut coal mines.

On the face of it, that is an unlikely spark for a change in sentiment. Normally, growth comes from the investment in new facilities, not the closure of those in use. In fact, China's case is a rare one. By taking on extreme overcapacity, its cutbacks have provided a boost, for itself and for the global economy. The risk,

however, is that the way the country is going about the cuts both disguises old flaws and creates new ones.

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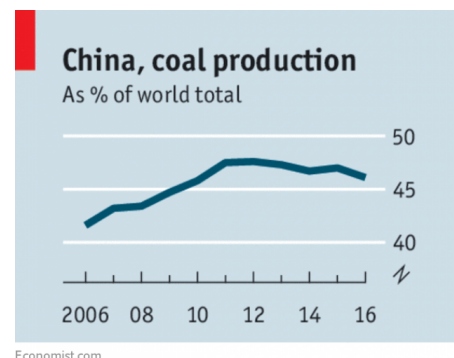
Steel crazy after all these years

China needs lots of material to build all its homes, trains and tunnels. Even so, it produces more than it can use. It accounts for roughly half of global production of steel, coal, aluminium, glass and cement. By one oft-cited gauge, China's unused steel capacity equals the total annual output of the next four biggest producers (Japan, India, America and Russia) combined. As the excesses piled up in

China over the years, they weighed on global prices, depressing profits for all.

However, unlike their international rivals, Chinese firms could carry on expanding, confident of state support.

Then, in early 2016, China unveiled plans to cut its steel and coal capacity by at least 10% over five years, reducing potential global supply by 5%. The government's theory was that it could turn the vicious industrial cycle into a virtuous one. With less production, prices would rise, leading to higher profits and, ultimately, a healthier economy. There were plenty of doubts about China's ability to follow through; after all, pledges to cut capacity had featured in officials' plans since the early 2000s, and over-investment had continued unabated.



But the idea that things might be different this time has gradually caught on (see article (<http://www.economist.com/news/finance-and-economics/21728623-one-biggest-and-more-controversial-trends-global-economy-capacity>)). Coal and steel prices have soared, as have profits in those industries. That set off a dramatic shift in market sentiment about China. Convinced that Xi Jinping, China's president, has the will and ability to impose capacity cuts, investors have shed their fears that damaging deflation might be China's next export. The yuan has appreciated; nominal growth is just shy of a five-year high. Economic policymakers in Beijing have regained some of their standing, which had been dented by a stockmarket crash and a ham-fisted currency devaluation in 2015. Global markets are reassured by the steady hand of Chinese central planners.

That confidence may be misplaced. Investors are overlooking two shortcomings in China's approach. The first is the nature of top-down diktats about supply, which lack flexibility and therefore tend to generate volatile outcomes. China wanted to puff up prices. But the surge that it has caused has gone well beyond what it intended, raising concerns that high prices will lead once more to surplus capacity. Local officials, still hungry for growth, have dusted off their plans for big new coal mines. Officials have started to warn about a speculative bubble in the steel market. In Chinese ports stocks of iron ore, a vital ingredient in steelmaking, are near record highs.

The second problem is that enforced production cuts are not a genuine solution to overcapacity. That firms listen to the government in China should never have been in doubt; the problem is that they still do not pay sufficient heed to the market. In many cases the cuts are not all they appear. In the coal industry, for instance, officials last year simply decreed that mines should operate for just 276 days—a limit that they unwound this year.

More fundamentally, China has done little to tackle the underlying causes of overcapacity. The banking system continues to direct cheap capital at favoured projects and companies. State-owned firms can still be reckless in their investments, safe in the knowledge that they can always be bailed out. And the government's policy of earmarking bits of the economy for development sets off mad rushes into them. Even as China is fighting to rein in excess capacity in heavy industry, it is laying the groundwork for the same affliction in new fields such as robotics and advanced manufacturing.

China has done more to turn around its industrial sector than many expected, to the benefit of its own economy and the wider world. Investors are right to conclude that its planners are powerful. Even so, a tendency towards overcapacity still lurks, and Chinese officials are still fallible.

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