



Capacity runs riot

If there is one word that has been on the lips of most steelmakers for some time now, it's 'overcapacity'. Very often another word is not that far away: China. In this article, leading US law firm Wiley Rein's **Alan Price***, **Christopher Weld***, **Laura El-Sabaawi*** and **Adam Teslik*** take an in-depth look at overcapacity in the global steel industry and outline possible solutions to a growing problem

THE global steel industry is confronted with unprecedented overcapacity¹, which is severely distorting the world market and threatening the viability of steel producers worldwide. Since 2000, the global steel industry has added more than 1.2 billion tons of capacity, for an estimated total of more than 2.3 billion tons². Capacity growth surpassed demand growth during this period by nearly 500Mt³. China alone added a massive 990Mt of capacity from 2000-2015 (more than three-fourths of the total global increase)⁴, leading the European Chamber of Commerce in China to recently conclude that Chinese "steel production has become completely untethered from real market demand."⁵ Capacity has also grown substantially in Turkey, India, Korea, the Middle East, Latin America and Russia⁶. As a result, recent estimates put excess capacity at a startling 700Mt⁷. China leads in excess capacity, with a staggering 425Mt⁸.

Impact of the crisis

This "growing gap between global steelmaking capacity and demand has led to deterioration in the financial situation of steelmakers, and has raised concerns about the longer-term economic viability and efficiency of the industry⁹." As

countries like China try to export their way out of domestic overcapacity crises, North American steel industries are suffering in particular. US steel imports increased by 61% from 2010 to 2015¹⁰, and the US steel industry's capacity utilisation dropped to an alarming 62.1% late last year. Increased imports and overcapacity generally have caused steel prices to collapse, with steel late last year¹¹ "cheaper than at any time in the past decade."

Jobs are also being lost, including those of nearly 15,000 American steelworkers in the past year¹². From September 2015 to February 2016, 41% of announced closures, cutbacks and layoffs in the global steel industry occurred in the NAFTA countries, and 28% in Europe¹³. Only 10% happened in Asia, even though it has the vast majority of world steel capacity¹⁴. In other words, those most responsible for the overcapacity glut are exporting its adverse effects.

Continued increases in capacity

The crisis seems set to worsen, with global capacity set to grow by another 103Mt from 2016 to 2018¹⁵. This growth will continue to outpace demand¹⁶, which dropped in 2015 and will increase by only 0.7% this year¹⁷.

China leads in terms of planned capacity

increases. While China's government has announced plans to reduce the country's steel capacity by 100Mt to 150Mt, including during the recent 2016 US-China Strategic and Economic Dialogue¹⁸, it is doubtful that even these limited closures will be realised. The China Iron and Steel Association predicts that Chinese capacity will increase again this year¹⁹ despite a drop in Chinese steel demand²⁰. State-owned or -supported producers will be responsible for much of the new capacity, with state-owned producers Baosteel, Shandong Iron & Steel and Guangxi Steel Group starting up new production lines or mills, among others²¹.

Even if China were to in fact shutter the promised capacity, "[s]ignificant overcapacity [would] remain in China's steel sector," as Chinese industry executives acknowledge²². For example, there is the issue of "capacity creep" – steel producers generally increase effective capacity by 1.5% to 2% annually, through process improvements that do not involve expansion of nameplate capacity²³. As a result of this alone, China will add roughly 93Mt to 138Mt of effective capacity over the next five years, wholly offsetting China's announced reductions, even if they occurred.

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Much of global steel capacity growth is not market-based

Growth in global steel capacity has not tracked demand. After approximately 5% annual growth in the first decade of the century²⁴, steel usage grew by less than 1% in 2014, fell last year, and will grow by less than 1% this year²⁵. Production and ultimately capacity should respond to this marked slowing, but continued steel expansion in certain regions shows just how government intervention “hinder[s] adjustments that would normally occur in competitive markets²⁶.”

China’s capacity growth in particular cannot be explained by market-oriented development cycles. Chinese steel demand peaked in 2013 before dropping by 8% over the next two years²⁷. It will decline by another 4% this year, with similar declines expected at least until 2020²⁸.



Steel capacity growth also is not supported by profitability, as the relatively low profits earned by many producers, especially in China, further show the disconnect between capacity growth and market forces. China’s dramatic increase in capacity occurred despite financial returns well below those achieved by other steel industries globally, and even other industries in China²⁹. “China’s steel industry has one of the lowest operating margins compared not only to the steel industries of many other economies, but also relative to other domestic industries.” One recent report estimated that the debt ratio of China’s major steel mills rose in 2015 to 70.1%, bringing the total debt of just the country’s ‘big mills’ to US \$499 billion³⁰.

Another estimated that the Chinese steel industry has roughly US \$520 billion in debt³¹. Often at government direction, this debt is continually refinanced, expanded and ultimately swept off the books into ‘asset management’ or other state-created firms designed to absorb bad corporate debts and cover losses³².

Capacity continues to grow largely as a result of intervention by governments, many of which significantly subsidise their steel industries, resulting in enormous capacity increases. Political intervention also has acted as a barrier to capacity closures, as governments artificially prevent the market from self-correcting for non-commercial purposes. The most striking example is again in China, where unprecedented capacity growth largely results from massive government ownership and control³³. The Chinese government has ownership interests in nine of the 10 largest steel producers in China³⁴, maintains a high degree of decision-making authority over the industry, and intervenes extensively in the operations of individual companies. Local governments in China have directly instructed mills to increase exports and foreign exchange earnings³⁵. Through various policies and industrial plans, the Chinese government for decades has directly subsidised its steel producers, creating the world’s largest steel industry.

Even Chinese government policies purportedly intended to decrease steel capacity have had the opposite effect. For more than a decade, a series of plans claiming to address overcapacity and the extensive environmental degradation it has caused have instead operated as disguised industrial subsidy programmes³⁶. Rather than encouraging unprofitable and polluting capacity to exit the market, the policies have supported the construction of massive industrial parks and the large-scale installation of new capacity under the auspices of “eliminating outdated capacity,” developing a “circular economy”³⁷ and alleged environmental initiatives. The policies have provided subsidies for modernising and even expanding, not reducing, capacity. As a result, steel producers that should have gone out of business have remained and upgraded³⁸.

The plans often have purported environmental goals. Under that guise, they subsidise renovations that upgrade and often enlarge capacity – a net negative for overcapacity and the environment.

For example, a 2005 policy on developing the ‘circular economy’ was couched in environmental terms, but directed authorities to “strenuously develop high-technology industries...; eliminate outdated industrial processes, technology, and equipment; [and] bring about the upgrading of traditional industries³⁹.” Similarly, a 2006 initiative sought to “promote adjustment of the industrial structure in overcapacity industries” by introducing higher environmental, safety and industrial standards⁴⁰ and eliminating facilities that did not meet them. But it planned to eliminate only certain small furnaces, while providing support for the renovation of large enterprises. Again, in 2013, China issued a Guiding Opinion on “resolving... serious overcapacity,” which also provided support for industrial upgrading in accordance with the very standards it claimed should force capacity out. It directed financial institutions to “expand support for overcapacity sectors to implement structural adjustments and industrial upgrades” and “for technological renovations⁴¹.”

The minimum capacity requirements in many of these plans have only spurred producers to expand capacity above the thresholds⁴². Such minimums drive a “survival of the largest” approach where, perversely, smaller steel mills are forced to expand to comply with industrial policies and are subsidised to do so. It is more difficult for these super-sized facilities to adjust their output in accordance with market conditions, so their output remains high regardless of actual demand.

China’s 2013 Opinion also explicitly encourages the use of foreign markets as a release valve for excess capacity, through both exports of Chinese steel and relocation of Chinese mills abroad. It calls for “overseas investments and reorganisations to transfer excess domestic capacity” and support for “the transfer of capacity abroad⁴³,” attempting to shift the economic burdens of harmful domestic policies onto trading partners.

The Chinese government also has intervened directly to prevent capacity closures. Four Chinese steelmaking companies that halted operations last year due to staggering losses now plan to re-start, after major investments by a state-owned company⁴⁴. And reports persist that local governments refuse to allow steel mills to close for the sake of local employment

and income⁴⁵. For example, despite 192 billion yuan that Bohai Steel cannot repay, its owner – the Tianjin government – has asked banks to continue lending to Bohai, promising that it will pay the interest⁴⁶.

Multilateral development banks and national export promotion agencies exacerbate the effects of government interference by loaning steelmakers billions, creating and maintaining capacity. For example, the Brazilian National Development Bank is providing Companhia Siderúrgica do Pecém (CSP) US\$ 1 billion to build a new plant⁴⁷. As CSP is partially owned by POSCO and Dongkuk Steel, Korea's Export-Import Bank is also reportedly lending it support. And in the United States, new Arkansas producer Big River Steel received an \$800 million loan and export credit insurance from a German government-owned bank and export promotion agency, in return for purchasing German equipment for its mill⁴⁸.

Solutions to the crisis

Without immediate action to solve this crisis, the viability of many steel industries around the world will be threatened. Most notably, to achieve a real solution, China must act, and act meaningfully. Given its overwhelming contribution to the crisis, China must shutter a substantial portion of its massive, state-sponsored steel capacity. China's current plan to reduce capacity by 100Mt to 150Mt is insufficient – 300Mt to 400Mt of closures are needed to make an appreciable improvement. And it appears unlikely that even the planned closures will occur, given China's track record and policies that purport to lead to closures, but instead consistently encourage upgrades and expansion.

To achieve the much-needed, permanent closure of capacity, policymakers must eliminate underlying market-distorting practices. Governments may need to facilitate the permanent closure of excess capacity, but otherwise must remove ownership and control, as well as other direct or indirect involvement in the steel industry. This includes:

- Eliminating subsidies;
- Eliminating policies that prevent or forestall adjustments mandated by the market;
- Removing industrial planning and decision-making, including China's minimum standards;
- Prohibiting multilateral and export

bank lending on steel projects;

- Removing government intervention, including export restrictions, in raw materials markets; and
- Removing import tariffs and trade-distorting non-tariff barriers.

Governments must also take additional steps:

- Not use foreign markets to relieve the domestic impact of a country's own overcapacity, through encouraging exports or the relocation of mills.
- Vigorously enforce the anti-dumping and countervailing duty laws to ensure that imports compete fairly, and continue to treat China as a non-market economy, given its government's continued disruptive intervention in its economy.
- Ensure market-based, competitive home markets, including properly enforcing anti-trust and competition rules and removing import barriers that insulate domestic producers from competition.

are not comprehensively addressed, this crisis and its effects, including unfair trade practices and resulting trade friction, will persist and worsen. Action is critically needed now to address the long-term supply-demand imbalance plaguing the global steel industry and to ensure the continued viability of American steel producers. ■

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Industries with significant excess capacity should commit to consolidation and restructuring. Consolidation and restructuring must be market-based, not driven by government policies intended to promote domestic manufacturing bases or cover the transfer of subsidies to failing enterprises. Consolidation of market-oriented producers will not enable them to compete against companies that can rely on subsidies instead of profits and do not have to generate a return on investments to survive. Restructuring should enable companies to adjust production levels to the market and should include the implementation and utilisation of viable, market-based bankruptcy procedures to ensure a well-functioning exit process.

If the long-term issues associated with overcapacity and other market distortions

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