



## COMMENTS ON CHINA'S STEEL INDUSTRY ADJUSTMENT POLICY (2015 REVISION)

### I. INTRODUCTION

The following comments on China's draft *Steel Industry Adjustment Policy (2015 Revision)* (the "Adjustment Policy" or "Policy") are submitted on behalf of the undersigned steel industry associations of North America, Latin America, and Europe. Our countries and China have a common interest in a healthy and balanced global steel industry that operates in accordance with market principles and World Trade Organization ("WTO") rules. China's policies for its steel industry have a direct impact on our steel industries, our economies, and other markets around the globe. We therefore appreciate the opportunity to comment on the draft Adjustment Policy.

The Adjustment Policy has the explicit goal of moving the Chinese steel industry towards a new economic model in which the market plays a "decisive role" in the allocation of resources. We strongly believe that such a transition is essential to the long-term stability of the global steel industry. Despite this overarching goal, however, the Adjustment Policy contemplates the continuation of extensive government control and direction over the Chinese steel industry. The measures described in the Policy reflect ongoing government intervention in the management and operation of steel companies and the allocation of resources in the industry. As a result, the Policy is largely inconsistent with the goal of subjecting the industry to market discipline.

Another key feature of the Policy is the recognition that the Chinese steel industry has "severe" overcapacity. We commend the explicit recognition of this fact. This overcapacity has not only caused serious problems for China's own steel producers, but it has also destabilized the global steel industry and created trade friction between China and many of its major trading partners. While the Policy recognizes the need to reduce China's steel capacity substantially, it does not create effective mechanisms or offer effective incentives to do so. The absence of concrete steps towards fundamental market-driven reforms and significant capacity reductions will render the Policy ineffective in addressing this fundamental problem.

## **II. THE ADJUSTMENT POLICY PROVIDES FOR CONTINUED GOVERNMENT DIRECTION AND CONTROL OVER CHINA’S STEEL INDUSTRY**

In releasing the Adjustment Policy for public comment, the Ministry of Industry and Information Technology (the “Ministry”) explained that the Policy was drafted to “make the market play a decisive role in the allocation of resources.” At the same time, however, the Ministry articulated the conflicting objective of “more effectively bring[ing] about the role of government” and “guid[ing] the next ten years of the steel industry’s development.”<sup>1</sup> Unfortunately, the specific measures contained in the Policy indicate that market forces will not be permitted to play a “decisive” role in the development of China’s steel industry, and that the role of the market will remain secondary to the role of the government. Indeed, similar to previous Chinese policies for the steel industry, the Adjustment Policy demonstrates that the government intends to continue its top-down management of all major aspects of the industry’s development, both domestically and globally. This includes everything from the number and location of enterprises in the industry, to the products that they should produce and the technologies that they should use to produce them. Specifically:

- The Policy dictates the specific structure and development of the industry, including size, output, and location. For example, the Policy calls for the creation of three to five “ultra-large” steel groups that are internationally competitive, as well as a group of “regional market players and market segment leaders.” The Policy directs these favored enterprises to dominate the market, with the government “supporting the unification of strong and dominant enterprises” and encouraging them to “implement strategic reorganizations” throughout the production chain. In terms of output, the Policy sets a goal that the production of the top ten steel groups should account for no less than 60 percent of China’s production by 2025. The Plan also calls for relocating steel production away from urban centers in order to concentrate production “in more competitive enterprises and in regions with comparative advantage.”
- To achieve these goals, the Policy encourages mergers and acquisitions to “form an industry structure of coordinated development between major leading enterprises and specialized small and medium enterprises.” The pace of these mergers and acquisitions should be “accelerated,” presumably with government support and supervision.
- The Policy also dictates the Chinese industry’s product mix and its strategies for research and development. Steel producers are to “increase the development and application of critical high-strength, highly corrosion-resistant, and highly specialized steel products” (including “400MPa reinforcing bar”), while the government is to “promote the collaboration of industry, academia, researchers, and end users” and “support the development of strategic emerging industries.” Moreover, the Policy provides that revenue from sales of “new products” by large and medium sized enterprises should exceed 20 percent of total sales revenue and that research and development expenditures should be no less than 1.7 percent of revenue from primary business activities.

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<sup>1</sup> Opinion Regarding the Release of the Steel Industry Adjustment Policy (2015 Revision) (Comment Draft) (公开征求《钢铁产业调整政策（2015年修订）（征求意见稿）》的意见).

- The Policy sets targets for certain technology improvements and provides for state support to achieve such improvements. For example, “industrialization and automation integration technologies ... should be gradually perfected,” the percentage of enterprises using the “manufacturing execution system (MES) should exceed 80% ... [and] the level of e-commerce transactions should reach 20% of the industry’s total sales.” To fund these technology upgrades, the government is to “rely[ ] on major national construction projects, major scientific research projects, and basic improvement projects” to help “create research and development and promotional platforms and coordination mechanisms for important common steel industry technologies that spread both risks and benefits” among favored enterprises.
- To carry out these and other provisions, the Policy calls for the government to continue “supporting,” “encouraging,” and “promoting” a wide variety of the steel industry’s commercial activity. Such language appears to signal a green light for the Chinese government at all levels to continue providing subsidies and other assistance to the industry – which, among other things, has allowed loss-making, inefficient enterprises to operate long after they should have exited the market. These policies are at the heart of steel trade friction between China and its trading partners, including the countries of North America, Latin America, and Europe. They also undermine the Policy’s stated goal of limiting the subsidization of steel companies by local governments.

Moreover, the Policy does not remove the primary barrier to market reforms in the Chinese steel industry – state ownership. The Policy’s prescription to experiment with “mixed ownership structures” in the steel industry may be a useful first step, but it falls far short of what is necessary to remove state control from the management decisions of commercial enterprises in China. As similar policies applied to state-owned enterprises in other industries in China have shown, private capital may have been injected into the industry, but enterprises have remained subject to government interference as long as the state has retained a substantial stake and government officials have held positions in firm management. Additionally, there is the risk that ownership by quasi-state entities, such as government-controlled pension funds and labor unions, may simply mask actual control. As long as the industry is subject to substantial state ownership, the government, and not the market, will play the decisive role in the allocation of resources.

Similarly, while the Policy’s call for loosening restrictions on foreign investment in the industry may be a positive step, few, if any, details are provided as to what such loosening means, and it remains unclear whether a foreign entity may now own a controlling stake in the major Chinese steel producers. According to the Policy, foreign investment in the industry is to help “create robust mechanisms for the sharing of technology, resources, brands, sales channels, managerial concepts and financial services.” Identifying specific objectives for the role of foreign investors indicates that they will likely remain subject to *de jure* or *de facto* restrictions that prevent them from operating autonomously in the Chinese market. Finally, given the level of state ownership in the industry, even if greater participation by foreign investors is permitted in a few small- and medium-sized enterprises, this will not drive market reform in the industry.

In short, the Adjustment Policy continues to allow the Chinese government at all levels to intervene in the development of the steel industry and in the management and operation of individual steel companies – from the acquisition and supply of raw materials, to market entry, to

the purchase and application of products by end users. As a result, this Policy would appear to do little to alter the fact that China's steel producers operate in an environment where basic market forces do not apply and where commercial decisions are mandated or directed by the government. In this respect, we believe that the Adjustment Policy does not depart meaningfully from previous steel industrial policies and is not likely to resolve the serious challenges facing the Chinese and global steel industries.

### **III. THE ADJUSTMENT POLICY DOES NOT MEANINGFULLY ADDRESS CHINA'S STEEL OVERCAPACITY**

One of the Adjustment Policy's stated objectives is to resolve the problem of "severe excess production capacity" in the Chinese steel industry. According to the Policy, production capacity should decrease to "reasonable" levels, and the industry's capacity utilization rate should rise to 80 percent by 2017.

These are laudable goals. We believe that overcapacity in China is the greatest challenge facing the global steel industry today and is directly responsible for the surge in steel imports into our regions in the past several years. According to the United States Trade Representative, China accounted for more than 75 percent of the growth in global steel production capacity between 2000 and 2013.<sup>2</sup> The China Iron and Steel Association estimates that there are approximately 1.25 billion metric tons of crude steel production capacity in China, compared with 823 million metric tons of actual production in 2014. This equals more than 425 million metric tons of excess capacity.<sup>3</sup>

As investment and economic growth in China have moderated towards a "new normal," there is growing consensus that China's annual demand for steel has likely peaked. Yet, to date, China has continued to increase both its steel capacity and its steel production, resulting in growing levels of excess capacity and sharp increases in Chinese steel exports to global markets. Overcapacity and its underlying causes are not unique to the steel industry and plague a number of Chinese industries in which the state has played the leading role in development. However, China has recognized that steel overcapacity in particular is a serious issue and has committed to establish mechanisms that limit capacity expansion and reduce existing overcapacity.<sup>4</sup>

While the Adjustment Policy acknowledges these objectives, we believe that it fails to provide for any effective means to significantly reduce China's excess steel capacity. In order to achieve the goal of 80 percent capacity utilization by 2017, China would need to reduce excess capacity by approximately 225 million metric tons, or 112.5 million metric tons per year, assuming production remains unchanged. For production and capacity to reach "reasonable" levels, current levels would need to fall significantly further. This is a daunting challenge that may require mandatory closure of significant melting and rolling capacity, followed by a long-term commitment to remove government interference from the industry and ensure that commercial decisions and industry development are dictated by basic market forces. The

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<sup>2</sup> United States Trade Representative, Report to Congress on China's WTO Compliance (2014) at 11.

<sup>3</sup> China Iron and Steel Association (中国钢铁协会), *Analysis of Key Points for the Development of Steel Enterprises in the Thirteenth Five Year Plan Period* (钢铁企业“十三五”发展重点分析) (Mar. 19, 2015).

<sup>4</sup> United States Trade Representative, Report to Congress on China's WTO Compliance (2014) at 6, 97.

Adjustment Policy's emphasis on "perfect[ing]" market exit mechanisms is thus welcome, but the apparent limitation of market exit to "outdated production capacity" or producers that do not meet certain administrative standards is inadequate. A better, more comprehensive approach would be to allow all firms that are not competitive without state support to exit the market through legal channels, such as market-based bankruptcy procedures, social insurance, and worker adjustment programs, which reduce the government's incentive to keep unprofitable enterprises in the market.

To reduce excess capacity, the draft Adjustment Policy advocates industry consolidation through mergers and acquisitions (as previous Chinese steel policies have done), as well as the introduction of industry standards that may, in theory, be difficult for many producers to meet. Specifically, as noted above, the Policy aims to concentrate 60 percent of production capacity in three to five ultra-large, globally competitive enterprises, along with several leading enterprises in regional or specialty markets by 2025. The Policy also calls for discriminatory or punitive utility prices and mandated closures for enterprises that cannot meet certain regulatory standards for safety, resource efficiency, and environmental protection.

We agree that steel producers should be held to the highest standards of safety, resource conservation, and environmental protection, and we support China's efforts do so. But such standards will not meaningfully reduce China's excess steel capacity. Likewise, while consolidation may reduce the number of steel producers in the market, it does not necessarily reduce the amount of steel production or capacity. In fact, these policies may perversely incentivize local governments to subsidize the expansion and upgrading of local enterprises to prevent their closure or consolidation into enterprises from other cities or provinces. In this way, these policies may actually result in increased production capacity, rather than the swift reductions that the industry requires to achieve balance. Indeed, consolidation and reorganization of the steel industry has long been an objective of the Chinese government, yet production capacity has continued to expand and overcapacity has only grown more severe.

Particularly troubling, the Adjustment Policy does not appear to target significant volumes of excess Chinese steel production and capacity for elimination at all. Rather, it appears that some excess capacity is to be transferred abroad through government-supported foreign investments and acquisitions. In this context, industrial upgrading and consolidation efforts are intended mainly to increase domestic steel producers' international competitiveness, not to reduce the overall capacity levels of China's global steel firms. In 2013, the State Council explained that the government should "encourage strong enterprises to 'go out' through various means to improve the distribution of manufacturing locations and reduce domestic production capacity."<sup>5</sup> Provincial governments have followed with similar directives. Hebei Province, for example, has announced its intention to reduce provincial overcapacity by transferring 5 million tons of steel capacity abroad by 2017, and 20 million tons by 2023.<sup>6</sup>

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<sup>5</sup> Guiding Opinion of the State Council Regarding Resolving the Contradictions of Excess Capacity (国务院关于化解产能严重过剩矛盾的指导意见), Guofa No. 41 of 2013.

<sup>6</sup> *Major Chinese Steel Province Encourages Enterprises to "Go Out" to Transfer Excess Production Capacity* (中国钢铁大省鼓励企业“走出去”转移过剩产能), Xinhua (Nov. 19, 2014).

The Adjustment Policy echoes these objectives, suggesting government support for “domestic enterprises to hasten overseas expansion and engage in acquisitions or setting up steel enterprises in foreign countries ... [and to] construct market sales channels on a global scale.” It appears that instead of eliminating excess capacity, the Policy includes plans to relocate some of it overseas and/or export excess production. Steel exports from China have already risen to record levels in the last year, indicating that Chinese producers, under increasing pressure at home, are actively targeting foreign markets with their excess production. The implication of such policies is that China will support its steel enterprises both domestically and internationally, enabling them to compete in foreign markets on advantageous terms and to profit from the existence of China’s overcapacity. This will only perpetuate irrational capacity expansion and cause harm to private companies that cannot compete against state-owned and -supported Chinese enterprises operating without the need to generate a sufficient return on capital.

As a result of this policy, steel producers elsewhere will be forced to compete with even greater volumes of Chinese excess production both in third-country markets and at home. Whether China’s plan is pursued through shipping domestically produced steel through newly acquired overseas distribution channels, or through transferring excess production capacity overseas, it is not an acceptable outcome for the North American, Latin American, and European steel industries. Policies and state support encouraging steel enterprises to transfer excess capacity or production to foreign markets should be eliminated. Such policies may violate WTO subsidy rules and may be inconsistent with China’s commitments in trade dialogues to restrict and reduce steel overcapacity.

Given the severity of the problem, the Chinese government may need to play an active role in eliminating steel overcapacity in the short-term. Ultimately, however, the only way to make meaningful and permanent reductions in excess steel capacity is to remove government involvement from the industry and allow basic market forces to determine industry outcomes. Such outcomes include: (i) the nature and quantity of firms entering and exiting the market; (ii) mergers, acquisitions, and reorganizations among steel producers; (iii) capacity and production levels; (iv) research and development spending; (v) the products that are developed, produced, and sold; (vi) the products that are consumed in the market; and (vii) the supply of raw materials and natural resources.

To create a fair and competitive market environment, the government should surrender state ownership and control. Other countries around the globe have done so through fair and transparent auctions of state-owned assets – a model which may be appropriate for China as well. In addition, the Chinese government at all levels must end subsidies and other support for steel enterprises, including assistance to create new capacity or to prop up loss-making or inefficient capacity. This includes allowing capital markets to operate without interference in order to stop the flow of state-directed financing to steel enterprises that cannot operate profitably. Finally, Chinese steel producers should be exposed to fair competition in the global marketplace through the removal of tariff and non-tariff barriers and other discriminatory measures in China’s home market, including the elimination of all export restraints on raw materials.

#### **IV. CONCLUSION**

The steel industries of North America, Latin America, and Europe appreciate and fully support the Adjustment Policy's stated goals of reducing overcapacity, allowing the market to play a decisive role in the allocation of resources, and building a fair and competitive market environment for China's steel sector. Achieving these goals according to clearly stated timelines is necessary for the long-term stability and health of the Chinese and global steel industries. However, we believe that the Policy does not introduce market-oriented reforms that are sufficient to achieve these goals and will therefore not adequately address the significant problems facing the Chinese steel industry. Unfortunately, the Adjustment Policy continues to reflect a top-down, state-dominated approach to reforming the steel industry – thereby maintaining an environment where market forces do not apply. In our view, the only way to achieve the Policy's stated objectives is to eliminate government interference in the industry and allow basic market forces to dictate industry outcomes.

April 20, 2015

**American Iron and Steel Institute (AISI)**

**Canadian Steel Producers Association (CSPA)**

**The Committee on Pipe and Tube Imports (CPTI)**

**The European Steel Association (EUROFER)**

**Latin American Steel Association (ALACERO)**

**Mexican Iron and Steel Industry Chamber (CANACERO)**

**Specialty Steel Industry of North America (SSINA)**

**Steel Manufacturers Association (SMA)**