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In China's Floundering Steel Sector, the Burden of Politics

By REUTERS

HANCHENG, CHINA — In a ramshackle township in Shaanxi Province, Communist Party banners urge workers at a nearby steel mill to seek “progress” and avoid making “backward steps.”

The slogans on the red banners highlight difficult times for the Chinese steel sector, which has seen margins plummet and has racked up a mountain of debt as it tries to serve the twin masters of the state and the market.

Beijing has tried to address problems in the steel sector — which accounts for 3 percent to 4 percent of gross domestic product — by forcing state-owned mills to consolidate or to migrate toward more complex, higher-value goods.

If there is one solution the country has not pushed, it is allowing the worst performers in the steel sector to go out of business. Nor does that seem likely in the steel industry, which Mao Zedong identified nearly half a century ago as a symbol of Chinese economic and political prowess.

“The big state-owned steel mills are motivated not so much to seek profits but to seek government support,” said Jiang Feitao, a steel policy researcher at the Chinese Academy of Social Sciences. “There is actually no mechanism to put them out of business, no sense of the survival of the fittest, and that is probably the biggest problem facing the sector.”

Chinese steel mills have expanded ferociously since the country began introducing market reforms in 1978, and annual crude steel output rose 9 percent last year to a record 683 million tons. The country now produces 45 percent of the world’s steel and has 6 of the world’s 10 biggest producers. While many analysts acknowledge that growth could slow, they also say that demand is nowhere near its peak.

But an obsession with size and technological advances has saddled Chinese steel mills with a surfeit of high-end capacity and the equivalent of $400 billion in debt, leading to a drain on profits.

The Shaanxi plant, for instance, which can produce seven million tons of steel per year, is a joint venture of Longmen Iron and Steel Group, a state-owned company, and General Steel, a company listed in the United States. There is little sign of a slowdown at the facility. “Demand has never been the problem,” said Zhang Jia, a sales manager at the mill. “The problem has always been costs.”

Although still robust, China’s total consumption growth rate last year of 8 percent was nearly half the average annual growth rate of 15 percent over the previous decade.

Excess capacity is projected at 110 million tons this year, about 14 percent of total capacity. That will mean that margins, which were already thin in 2011 at 3 percent, will continue to be squeezed. By comparison, the average for other industrial sectors in China was 6 percent.

Over all, the Chinese steel sector lost money in the first quarter of 2012, according to the China Iron and Steel Association, which expects growth in demand to slow to 4 percent this year. The top Chinese steel maker, Baoshan Iron and Steel, also known as Baosteel, saw a 43 percent slump in 2011 net income, while Anshan Steel posted a loss of 2.15 billion renminbi, or $341.2 million.

“The money earned by steel mills from the steel business every year isn’t even as much as depositing money in the bank,” said Zhou Jicai, head of Jiyuan Iron & Steel, a state-owned company in Henan Province. Last year, a standard deposit in a Chinese bank would have earned 3.5 percent in interest. Average returns on equity from the steel sector were 3.51 percent, but were as low as negative 7.98 percent at Anshan Steel.

Encouraging the country’s steel giants to compete with foreign companies has contributed to a glut in supplies of high-end products that has eroded profits further. The biggest Chinese producers have borrowed heavily to pay for new equipment, while small, private mills have commandeered smelters across the country to fill the low-end niche.

Data for small mills are hard to find, but analysts believe their profits to be healthy. Last year, rebar was selling at the same price as hot-rolled coil, which is far costlier to produce.

Although Beijing has criticized the private sector as “blindly expanding,” it is doing so, in part, because of government policy. The focus on consolidation has created a vicious circle, analysts say, with smaller private mills expanding as rapidly as possible to avoid becoming merger targets, often with the support of local governments.

A case in point was Rizhao Steel in Shandong Province, whose capacity rose to more than 12 million tons in 2010, a tenfold increase from 2003. The expansion was driven mainly by the company's desire to protect itself from a government-led consolidation plan.

China has urged its largest mills to buy overseas mining projects to help bring down costs of raw materials, but the mills have proved reluctant to do so because of high prices. Some are seeking to build steel plants in other emerging markets.

Chinese steel exports, a small fraction of total business in the country, have not recovered to pre-2008 levels, and the national steel association routinely points to an increase in international protectionism. Brazil, Europe and the United States, for example, have all added anti-dumping taxes on Chinese products. That being the case, the domestic market is expected to remain the primary focus of the industry.

"China is still in the middle of a construction period, and demand for steel will at least remain strong," said Henry Yu, the founder and chairman of General Steel. Mr. Yu said the company was particularly confident about demand from the country's west, where road and factory construction are strong.

Only one major Chinese enterprise — Bayi Iron and Steel, which is owned by Baosteel — covers Xinjiang, a large region in the far northwest of the country. Baosteel plans to move two advanced, but unprofitable, iron-making furnaces to Xinjiang and to double Bayi's capacity to 15 million tons per year by 2015.

Also in Xinjiang, Shandong Iron and Steel has nearly completed a 2.5 million-ton steel project, and Xinxing Ductile Iron Pipes will build a special steel plant with 3 million tons of annual capacity.

The consulting firm Mysteel said that 91 billion renminbi would be spent in Xinjiang from 2011 to 2015 to raise annual steel capacity to 32 million tons but that demand from the western part of the country would not be able to prop up the sector for very long.

"The supply tightness is expected to ease by 2013, and the region could also face a glut given the current investment frenzy," said Hu Yanping, an analyst with the Custeel consulting firm. "It will also be hard to ship out the surplus steel products due to limited transportation capacity."

Despite recent losses in the steel industry, bankruptcies are not expected to be widespread, analysts say, as neither Beijing nor local governments are willing to risk such blows to their reputations, employment levels and tax receipts.

Small, regional state-owned companies like Jiyuan Steel and Valin could be vulnerable to takeovers, but debt-ridden industry giants are not likely to volunteer for punishing restructuring programs. Anshan Steel's protracted merger with Benxi Iron and Steel is still mired in bureaucracy five years after it was proposed.

Specialists say that problems in the industry will not be solved until Beijing ends its desire to create state-owned Goliaths rather than address underlying political problems.

Indeed, Chinese steel giants, which have benefited from cheap loans and easy access to lucrative contracts, have served the needs of local governments, hiring hundreds of thousands of workers and providing cradle-to-grave welfare services.

Mr. Jiang of the Chinese Academy of Social Sciences said that mills could thrive if they were just allowed to do so. "The steel sector could develop very steadily as long as there is no great policy interference," he said. "But there has been a lot of policy interference."