Reflections on restructuring of the Chinese steel industry

March 2016
Executive summary

The planned 100-150mt of steel capacity reduction in China over the next 5 years is a step in the right direction to reducing overcapacity in an industry incurring unsustainably high losses. However, the risk is that the targeted reduction will not be sufficient to ensure sufficiently high utilisation rates required for industry sustainability. In addition, unless the central government ensures that the right systems are in place with the authority to enforce removal of a sufficient quantity of unprofitable capacity, the risk is that the pace of capacity reduction will be too slow.

- The Chinese steel industry is facing challenges very similar to those faced by the European steel industry in the 1970’s and 1980’s
  - Steel demand plateauing or declining after many years of strong industrialisation-driven growth
  - Unsustainably high losses
  - Overcapacity and high fragmentation of supply: too many producers chasing too little demand
  - Provincial governments in China (national governments in Europe) interested in maintaining capacity, investment, production and labour even in the face of losses
- The Davignon II plan implemented in Europe in the early 1980’s reduced capacity by 20 %, improved utilisation rate by 10 percentage points and returned the industry to profit. In contrast to previous, ineffective policies, success of Davignon II was due to well designed and defined policies with clear targets and control systems, and the authority to enforce them
- The European experience highlights the need for clear instruments and authority to realise required capacity cuts in China. In addition, the targeted reduction of 10-15% over 5 years risks being insufficient, especially if demand continues to decline
At the beginning of the 1970s, the European steel industry faced challenges that are very similar to those facing the Chinese steel industry today.

**Europe – beginning of 1970s**
- Steel demand peaked around 1973
- Weak demand partly offset by higher exports (ca. 25% of ASC)
- Overcapacity, with utilisation rate declining to around 65%
- Accumulated losses of ECU 3 billion ($3.4 billion) in 1977 (ca. $25/t)
- Highly fragmented industry
- National interest in maintaining capacity, investment, production and labour
- Limited power of European community

**China – today**
- Steel demand has effectively peaked
- Weak demand partly offset by higher exports (ca. 18% of ASC)
- Overcapacity, with utilisation rate down to 75%
- Accumulated losses of RMB 9.2 billion ($14.8 billion), Jan-Nov 2015 (ca. $25/t)
- Highly fragmented industry
- Provincial interest in maintaining capacity, investment, production and labour
- Relatively strong authority of Central Government
European steel demand peaked around 1973; Chinese steel demand has effectively peaked since 2013

Europe* - crude steel consumption kg/capita (LHS), yoy growth % (RHS)

China - crude steel consumption kg/capita (LHS), yoy growth % (RHS)

* Western Europe (EU15)
The losses in China are similar in scale to those incurred in Europe in the 1970s

Example of 2 European steel producers loss per tonne of steel ($/t)

CISA members’ net profit composition (USD/tonne)
Davignon II plan implemented in Europe reduced capacity by 20%, improved utilisation rate by 10 percentage points and returned the industry to profit.

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<thead>
<tr>
<th>What policies?</th>
<th>What was achieved?</th>
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<tr>
<td>1977-1980 Davignon I plan</td>
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<tr>
<td>• No new capacity</td>
<td>• No capacity reduction</td>
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<tr>
<td>• State aid proposing capacity cuts supporting redundancies</td>
<td>• Reduction of manpower by ca. 120k (ca. 15%) over 3 years</td>
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<td>• Limited authority of European commission over national subsidies and aids</td>
<td>• Improvement of productivity</td>
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<td>1980-1985 Davignon II plan</td>
<td>• Capacity reduction of ca. 40mt (20%) within 5 years</td>
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<td>• Clear targets of capacity cuts at plant level</td>
<td>• Reduction of manpower by ca. 200k (ca. 30%) over 6 years</td>
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<td>• Well designed instruments to implement plan</td>
<td>• Improvement of industry utilisation rate by almost 10%, despite declining demand</td>
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<td>• In total ECU38 billion state aid</td>
<td>• Return of the industry to profitability</td>
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<td>- Ca. ECU23 billion for debt restructuring</td>
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<td>- Ca. ECU 2 billion for capacity cuts (redeployment/redundancies)</td>
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<td>• Legal framework for state aid to define and control the allocating of funding</td>
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<td>• Authority of European commission over national governments</td>
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Chinese government policy is directionally correct, but to be successful it needs clear systems/instruments and authority and should arguably target deeper reductions.

### Key policies

#### Europe – Davignon plan II

- **Production quota**
  - Mandatory production quotas applied to 4 cat. steel products (80% total steel outputs) for 3 years until June 1983
  - Strict control system and fines imposed by Europe Court of Justice

- **Compulsory minimum prices** according to the sensitivity of the products to define what prices increase were necessary
  - Regulated by law with fines imposed by Europe Court of Justice

- **Labour reduction**
  - Reduction of ca. 200k people (ca. 33%), including Davignon I of ca. 320k (ca. 45%)
  - Of ca. ECU38 billion total state aid ca. ECU2 billion (ca. 5%) for redundancies/redeployment (ca. ECU10000 per person)

- **Capacity cuts**
  - Capacity reduction of ca. 40mt (20%) within 5 years
  - Financial aid of ca. ECU23 billion (12 times of aid of redeployment)
  - Legal power over national aids and subsidies decision
  - Precise business plan required proving long term financial viability

#### China – government policies

- No government plan to impose production quotas
  - Voluntary production cuts as response to low profit margins resulted in temporary market stabilisation in the past

- Targeted reduction of ca. 500k people (ca. 14%)
  - In total ca. RMB53 billion required (ca. RMB105000 per person) for 150mt cut, with 2/3 from Central Government (ca. RMB35 billion which reflects ca. 1/3 of total fund of RMB100bn)

- Targeted capacity reduction of 100-150mt (9-14%) within 5 years – is this sufficient?

- Required estimated debt restructuring of RMB270 billion (5 times of aid of redeployment)
  - Central government has given clear high level target
  - Instruments and control system have to be put in place
There is a real risk that capacity reduction will be insufficient and/or too slow; this is what happened in Europe in the 1970s.

**W. Europe* - production, capacity and utilisation rate (million tonnes, %)**

**China - production, capacity and utilisation rate (million tonnes, %)**

*EU 9 countries include Germany, UK, France, Italy, Ireland, Belgium, Denmark, Luxembourg, Netherlands.*