Doubt cast on drive to cut steel capacity

Local governments' fears over loss of growth momentum, tax revenues and jobs likely to constrain the clampdown amid dwindling demand

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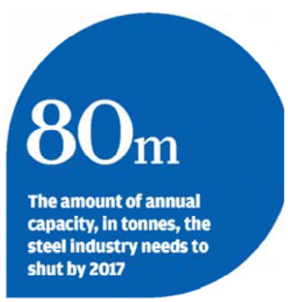
Beijing's latest drive to press local governments to cut excess capacity in the steel sector by administrative means is unlikely to turn around the industry's low profitability an time soon despite its ambitious targets.

This was because local governments' fear of losing economic growth momentum, tax revenues and employment would continue to constrain any serious effort to shut outdated capacity, analysts said, especially as the predominantly state-owned sector faced slow demand growth for years to come.



"Using administrative measures to tackle an industry facing a competitive market is not effective," said Yuan Gangming, an economics researcher with the Chinese Academy of Social Sciences. "To fundamentally resolve overcapacity, we need to carry out state-owned enterprise reform relentlessly and let the market decide which firm will stay and which will die."

National Development and Reform Commission deputy director Hu Zucai told a video conference with local government and steel industry leaders early this month that they must execute a State Council circular last month on phasing out outdated capacity.

The circular required the industry to shutter 80 million tonnes of annual production capacity in the five years to 2017.

It also ordered local governments to shut more than 40 million tonnes of capacity by next year, a year ahead of the original plan.

A supplementary target of 15 million tonnes of plant closure has been mandated for 2015.

"Some local governments have been focusing too much on chasing after speed of development and investment by supplying tax exemptions, low-cost land and other resources," the NDRC said. "This promoted redundant investment and capacity expansion."

Poor policymaking, planning, industry standards and environmental protection regulations had created barriers for the retirement of outdated capacities, it added.

Local officials have been asked to stop approving new projects and "clean up" those that have been built or have begun construction without proper approvals on land use, pollution discharge and compliance with Beijing's industry development directions.

Local authorities are supposed to starve them of bank loans, slap them with higher water and power prices, and push for mergers and acquisitions to enhance industry concentration and competitiveness.

The country had 976 million tonnes of crude steel production capacity at the end of last year, according to the China Iron and Steel Association. About 44 million tonnes of capacity has been planned or is under construction this year.

With just 717 million tonnes of output last year, capacity utilisation stood at 73.5 per cent.

This compared with 78.8 per cent in the global steel industry, of which the mainland accounted for 46.3 per cent of output, World Steel Association figures showed. This implies mainland utilisation is about 10 percentage points short of the non-mainland utilisation rate of 83.4 per cent.

The mainland's 86 largest steel mills posted a total net profit of just 1.58 billion yuan (HK$2 billion) last year, down 98.2 per cent from 2011. In the first half of this year, net profit was 2.27 billion yuan, of which 1.5 billion yuan was gains from a change in accounting policies by extending the estimated life of fixed assets to reduce depreciation expenses, the China Iron and Steel Association said.

The first-half profit represents a net margin of 0.13 per cent, compared with 5.4 per cent for the country's entire manufacturing sector.

Despite a marked improvement to 8.1 billion yuan in total net profit in the two months to August, Citi's analysts noted the industry's output and product prices had weakened in recent weeks, with the weakest players sliding into losses again.

What is more worrying is that steel demand growth in the country slowed to 3 per cent last year from more than 10 per cent in most of the 10 years to 2011, and it was expected to stay low until the end of this decade, analysts said.

"With so many partially constructed or idled residential blocks and social housing, much of the steel demand has been front-loaded," American brokerage Sanford Bernstein's analysts said in a research report. "It is difficult to imagine urbanisation being a significant boost to steel demand, beyond what is already baked in.

"The idea that building out the west could replace the infrastructure and construction boom experienced in the eastern coastal cities and provide the next demand catalyst for steel, cement and power for the coming decade was misconceived."

They projected steel demand would rise at an average annual rate of 3 to 5 per cent until 2020, when 60 per cent of the population would live in urban areas.

Analysts said the latest drive by the NDRC to use administrative means to push local governments to shutter excess capacity and consolidate the industry was not that different from tactics used in previous crackdowns.

Before this year, the NDRC, the Ministry of Industry and Information and Technology and the State Council had issued five circulars - in 2005, 2006, 2009, 2010 and 2011 - ordering the elimination of outdated steel capacity, according to Moody's Investors Service. Yet overcapacity has not been reduced.

Moody's analyst Zou Jiming said in a report that the latest drive should be more effective than past efforts since the NDRC had said the effectiveness of local officials' execution of measures to cut industry overcapacity would form part of their performance appraisal.

Still, while slowing demand, persistent low industry profitability and Beijing's resolve to correct the overcapacity problem should force a change, analysts expect progress to be slow.

Xu Xiangchun, the chief analyst at industry consultancy Mysteel, said whether the latest clampdown would yield better results would depend on the relative weight in local government officials' performance appraisals given to reducing redundant industry capacity, controlling pollution and promoting economic growth.

It is also uncertain how the targeted reduction of 80 million tonnes of capacity will be allocated among old and new plants, and among state-owned and private steel mills.

Hebei province, the country's largest steel-producing region, will shoulder the largest burden of 60 million tonnes, according to a provincial government announcement.

This would result in the mothballing of more than 1.5 trillion yuan of fixed-asset investments and affect the livelihoods of 150,000 workers, Xu said.

He said he expected private firms to be hit the hardest since they had added the most capacity in Hebei over the past few years and had flouted environmental protection and land-use regulations more than state-owned firms.

"It would be very tough for the Hebei government to meet its target since it will result in job losses, debt repayment defaults and the write-off of bad loans from banks," he said.

"How to come up with replacement economic activities to absorb the redundant staff and plug the tax revenue gap is the biggest question."

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