



State-Sponsored Overcapacity: The Looming Crisis In The Global Steel Industry

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The global steel industry is currently experiencing unprecedented levels of overcapacity, which are severely distorting the global market and threatening the continued viability of steel producers worldwide. While this crisis has recently become more pronounced, it is not a new problem.

OVERCAPACITY AND its underlying causes – primarily government intervention and market-distorting practices – have long plagued the global steel industry. For decades, governments have created and maintained substantial steel capacity in their countries, often far in excess of demand. The result has been persistent global steel overcapacity, and significant adverse effects stemming from this supply-demand imbalance.

Despite clear lessons from prior periods of overcapacity, including the 1997-2001 U.S. steel import crisis, many in the global steel industry have failed to address the underlying problems, resulting in massive overcapacity – estimated at more than 500 million metric tons worldwide and growing. This huge capacity growth has not been driven by market forces, but rather by increasing government ownership and intervention in the global steel industry.

History Repeated

For decades, global steel producers have suffered from overcapacity in the industry, largely caused by government subsidization and other market-distorting practices. While the adverse effects of overcapacity are less visible in boom times, problems associated with this market imbalance become especially pronounced when the business cycle dips and demand fails to keep pace with capacity increases. In the U.S. market, the global imbalance has led to a recurring cycle of low-priced import surges and deteriorating industry conditions, followed by periods of increased trade friction.

For example, from 1997-2001, the U.S. steel market experienced an import crisis, largely due to significant overcapacity

worldwide. The U.S. market was flooded with unfairly traded steel imports, and U.S. producers suffered drastic losses, with six manufacturers forced into bankruptcy. Now, while the immediate economic circumstances differ, the industry again finds itself in the midst of a crisis, as many around the world failed to effectively address overcapacity and long-term market distortions identified more than a decade ago.

The Current Crisis

Since 2000, the global steel industry has added nearly one billion tons in capacity, surpassing demand growth during the period by nearly 300 million tons. As a result, according to the OECD, there were 542 million metric tons of excess capacity in the steel industry as of 2012, including up to 300 million tons in China, 80 million tons in the EU, and nearly 40 million tons in CIS/Russia. Largely as a result of this overcapacity, U.S. steel imports rose by 40 percent from 2010-2012, resulting in declining prices and profitability for U.S. producers.

Capacity Growth Has Not Been Market-Based

The overcapacity crisis is largely a result of non-market-based forces. While in a competitive, market-based industry, production and ultimately capacity follow market signals, recent growth in steel capacity has not tracked demand or profitability in the industry, resulting in the current crisis. In fact, while in the previous decade, global demand for steel grew by about five percent per year, apparent global steel usage in 2012 grew by only 1.2 percent – the slowest rate since 2009. And demand growth rates are expected to remain lower in the near future.

In particular, as reflected by the declining capacity utilization rates of Chinese

steel producers, rates of demand growth in China have slowed considerably, while capacity continues to increase rapidly. Chinese steel demand grew by only approximately two percent in 2012 and is expected to increase by similar rates in 2013 and 2014 – in stark contrast to the major capacity increases in the country. These capacity increases are similarly not tied to profitability, with the vast majority of global capacity growth since 2000 occurring in China, which has the least profitable steel industry in the world.

Overcapacity as a Result of Government Intervention

Rather than market-based growth, steel capacity continues to grow largely due to government intervention. Many governments significantly subsidize the growth of their steel industries – including through government ownership, low-interest loans, grants and low-priced inputs – resulting in rapid and enormous capacity increases in many countries, and causing oversupply globally as well as market distortions.

Political intervention is also a key barrier to permanent capacity closures in the industry. Governments often prevent mill closure to maintain employment levels and for other non-commercial purposes. While in a purely market-based system, the power of the market alleviates excess capacity, by forcing inefficient producers that incur losses to leave the market, government intervention artificially prevents this self-correction. In the steel industry, government impediments to capacity clo-

sure, combined with legitimate market-based barriers to exit, have led to the accumulation of persistent overcapacity.

China provides the most striking example. The unprecedented growth in Chinese capacity largely results from massive government ownership and control over the steel industry. According to the OECD, China's government has ownership interests in 18 of the 20 largest Chinese steel producers. The Chinese government also maintains a high degree of decision-making authority over the steel industry and intervenes extensively in individual companies' operations.

The Chinese government's significant involvement in its steel industry has contributed to enormous increases in new capacity and prevented the closure of inefficient capacity. The government for decades has directly subsidized its steel industry through grants, preferential loans, debt-for-equity swaps, tax refunds, and other preferential policies, as well as various forms of indirect support, such as restrictions on foreign investment. China's government also intervenes to prevent the closure of capacity. Many older, low-technology Chinese mills, which would likely close in a purely market-based environment, have been supported by local governments and continue to operate, intensifying global oversupply.

Turkey is another prime example. The Turkish industry has grown rapidly, from the 17th largest steel-producing country in 2000 to the 8th largest by 2012, and the 7th largest net exporter of



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GLOBAL STEEL

Increases in global capacity over the past decade have largely been led by the explosive growth of the Chinese steel industry. China, which now accounts for approximately 46 percent of world steel output, added a massive 750 million metric tons of steelmaking capacity from 2000 to 2012 (making it responsible for more than two-thirds of the total global increase in capacity during that period). Chinese capacity and production, unlike in the rest of the world, continued to grow steadily even during the 2008-2009 global economic recession. As a result, the China Iron and Steel Association estimates its surplus at close to 300 million metric tons.

steel. Such dramatic growth was facilitated by significant government subsidies, including low-interest development bank loans, export credits and insurance and tax benefits.

Similarly, the Indian government has fostered its steel industry's rapid expansion. The government owns at least 80 percent of the Steel Authority of India Ltd., India's largest steel producer.

Beyond ownership, India's government has historically intervened in its steel market by promoting investments and propping up struggling enterprises with loans, loan guarantees, debt write-offs, and tax breaks, in addition to imposing import duties, licensing requirements, and raw material export restrictions to protect domestic producers.

Governments in other countries are fol-

lowing suit. Companies in Vietnam, Argentina, Ecuador, Peru and Bolivia, all backed in some way by governments, are planning new mills. The following governments also own significant shares of large steel companies in their countries, thereby playing a role in increased production in these countries: Indonesia (PT Krakatau Steel), Libya (Libyan Iron and Steel Company), Venezuela (Siderúrgica



del Orinoco and Siderúrgica del Turbio SA), Pakistan (Pakistan Steel Mills Corporation), Saudi Arabia (Saudi Basic Industries Corporation), and the United Arab Emirates (Emirate Steel Industries PJSC). Indeed, the OECD reports that 17 of the largest 50 steel companies in the world are state-owned.

Even in countries with historically market-based economies, governments

are intervening in the steel sector. Some European governments have intervened to delay or prevent plant shutdowns, to avoid social and economic consequences. For example, in Italy, the government recently prevented the closure of Ilva SpA's plant, which produced 30 percent of Italian 2012 steel output, out of concern that closure would be a shock for the country's economy. And

the French government recently threatened to nationalize two ArcelorMittal blast furnaces when the company announced it would mothball them due to chronic overcapacity.

These examples demonstrate that growing overcapacity in the global steel market continues to be due in large part to government subsidies and intervention in steel industries around the world.

Even more so than in previous periods, government subsidies continue to create massive steel capacity worldwide and prevent much-needed capacity closures and reductions in response to oversupply and weakening demand conditions.

Solutions to the Global Overcapacity Crisis

To remedy the current crisis, the major steel-producing countries should remove government ownership and control, as well as any other government involvement, from the steel industry. This includes: eliminating government subsidies and other assistance (with the only potential exception being for certain assistance necessary to facilitate the permanent closure of inefficient capacity); eliminating government practices that prevent or forestall market-mandated adjustments, including those that impose barriers to exit the industry; removing government industrial planning and decision-making; removing export restrictions on critical raw materials and other government intervention in raw materials markets; and removing import tariffs and trade-distorting non-tariff barriers on steel products.

Major steel-producing countries should also remove other practices that cause market distortions and take measures to ensure a market-based, competitive home market. For example, countries should properly enforce antitrust rules, and remove import barriers that insulate domestic producers from competition. There is no justification for countries with developed steel industries, such as

Brazil, India, Russia and Turkey, to maintain import barriers on steel products or impose export restrictions on raw materials, which artificially reduce costs and inflate the export competitiveness of domestic producers, leading to surplus capacity and trade distortions. In addition, industries with significant excess capacity should undergo market-based restructuring to eliminate inefficient capacity, and barriers to consolidation should be removed, as they were in the United States in the 2000s.

The 1997-2001 crisis, and others like it, demonstrates that the U.S. market can be adversely affected by overcapacity and market-distorting practices that occur elsewhere. Even after the U.S. industry took the difficult steps to restructure, it is not immune from the adverse effects of imbalances and distortions around the globe. Thus, overcapacity and other market distortions will not be remedied unless there is cooperation from all major steel-producing countries. China in particular must deal with its state-sponsored overcapacity for any solution to be effective.

If the long-term issues associated with overcapacity and other market-distortions are not comprehensively addressed, the adverse effects stemming from these imbalances, including unfair trade practices and resulting trade friction, will undoubtedly recur. By taking meaningful, though often difficult, steps now, governments can help reduce the unprecedented overcapacity and avoid the cycle of import surges and trade actions that have characterized steel trade for decades. ●

U.S. Steel Import Crisis

During the 1997-2001 U.S. steel import crisis, excess capacity on the other side of the globe devastated the U.S. market. Over six months in 1998, the U.S. market experienced record levels of unfairly traded imports, primarily from Russia, Japan, Korea and Brazil. U.S. steel producers suffered significant losses, with six companies going bankrupt, and laid off thousands of workers, despite robust demand.

The Department of Commerce concluded that growing overcapacity – fueled by government subsidies and intervention – played a major role in the crisis. Government subsidies created massive capacity worldwide, and government intervention prevented capacity reductions in response to deteriorating demand. This government support resulted in significant global overcapacity in the period preceding the 1997-2001 crisis. Millions of tons of steel had to be diverted to overseas markets, including the United States, with devastating consequences for U.S. steel producers.