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A NORTH AMERICAN PERSPECTIVE ON GLOBAL STEEL INDUSTRY DEVELOPMENTS

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GOVERNMENT SUPPORT FOR THE CHINESE AND INDIAN STEEL INDUSTRY: THE PERILS OF OVEREXPANSION

Introduction

1. Thank you for giving me this opportunity to discuss an issue of enormous importance – the role of government aid in the creation of excess capacity – with the leaders of the global steel industry. I am appearing today on behalf of the five major trade associations representing the North American steel industry. The North American industry has been concerned for some time about the overexpansion of global capacity, and especially with the role that state aid may be playing in the process. Today I will focus on the situation in two of the world's greatest steel producers, China and India.

2. Governments around the world have frequently provided special assistance to their steel industries. The result has all too often been the creation of capacity in excess of real long-term needs. Currently, both China and India are planning major expansions of their steel industries, expansions that will be made possible in large part through state support. We are concerned that the governments and steel industries of China and India may be repeating the mistakes of other countries, and building excess capacity in response to government policies rather than the requirements of the market. We examine the role of government in the Chinese and Indian steel industries in detail in a separate paper we have submitted to the conference; today I will be discussing some of our main points and conclusions.

3. Overcapacity and overproduction inevitably result in falling prices and disappearing profit margins. Unfortunately, these effects are not limited to the countries in which the overcapacity was built. Because steel is a globally traded commodity, excess production in one country can result in mill closures and bankruptcies in another. For these reasons, overcapacity in China and India could have a direct impact on the North American steel industry.

4. In 2005 China was the world's largest steel producer, and India the seventh-largest. Between 2000 and 2005, Chinese production increased by 176 percent, and Indian production by 45 percent. Both countries have recently added very large amounts of production capacity, and have plans to add more. While steel consumption has increased substantially in both countries, growth in capacity has outstripped growth in consumption. In both countries, government direction, subsidization, and indirect support have played a central role in the expansion of capacity. This raises the concern that capacity in these two countries may be expanding to meet government goals, rather than the needs of the market, and what the impact of such a development might be on the rest of the world steel industry.

The Chinese Steel Industry

5. The dramatic expansion of the Chinese steel industry between 2000 and 2005 reflected a conscious decision by the Chinese government to funnel resources into the steel industry. The Chinese steel industry continues to be primarily state-owned, and state-owned steel producers often receive special benefits from the government. Some of the ways in which the Chinese government has provided resources to the Chinese steel industry include:

6. *Transfers of ownership interests on terms inconsistent with commercial considerations*. Because the Chinese government owns most steel companies, it can subsidize companies by transferring ownership of shares or facilities from one company to another at below-market or even at no cost. For example, in January 2005, the Government of Hubei Province transferred a 51 percent stake in Ercheng Iron & Steel, a local steel producer with a production capacity of 3 million tons per year, to another state-owned producer, Wuhan Iron and Steel, at no cost.[1] Ercheng had crude steel output of 3 million metric tons, and profit of 20 million RMB in 2004.[2]

7. *Conversion of debt to equity in steel companies*. State-owned banks lend money at below-market rates to steel producers; then, when the borrower is unable to pay back even these subsidized loans, the bank converts the debt into equity in the company. Since 2000, China's iron and steel companies have benefited from debt-to-equity swaps worth at least USD 8.4 billion, as part of the government's plan to restructure and consolidate the steel industry.[3] Two of China's largest steel producers, Shanghai Baosteel and Anshan, both benefited from this process.[4]

8. *Preferential loans and directed credit.* The Chinese government owns all of the major banks in China - the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Agricultural Bank of China. Traditionally, these banks have made loans based on political directives from the central or provincial governments, not creditworthiness or other market-based factors. Chinese steel companies have benefited significantly from subsidized loans. For example, in 2005, China Development Bank, a state-owned bank, agreed to provide Anshan Steel Group (now Anben) with RMB 10 billion (US 1.2 billion) in subsidized loans.[5] The same year, Handan Iron & Steel Group received interest-subsidized loans from the government worth RMB 2.4 billion (USD 300 million) to fund a 1.3 million-ton cold rolled steel sheet project.[6]

9. *Benefits for export performance*. The Chinese government has provided extensive benefits, primarily in the form of tax credits, to steel producers that export a substantial portion of their production. These benefits are not necessarily directed specifically to steel production, but are rather available to producers with foreign investment[7] or who are located in certain areas of the country.[8]

10. The Chinese government also provides a rebate of value added taxes of 11 percent on steel exports.[9] These rebates are permissible constitute a method of encouraging steel exports, as the Chinese

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1 Citigroup Global Markets, China Steel Industry: Capacity Continues to Grow, So Does Surplus, Feb. 21, 2006, at 28, 69.

2 Id.

3 See Letter to Gloria Blue from American Iron and Steel Institute re: China's Compliance with its WTO Commitments, at 5 (Sept. 6, 2005); China's Iron/Steel Industry to See M&A Activity, Asia Times Online, Aug. 24, 2005.

4 Organization for Economic Cooperation and Development, Reforming China's Enterprises 78 (2000).

5 Xinhuanet (September 26, 2005), available at http://finance.sina.com.cn/stock/t/20050926/0829328489.shtml.

6 See Stockstar.com (September 21, 2005), available at http://resource.stockstar.com/info2005/darticle.asp?id=SS,20050921,30269085&column=.

7 See People's Republic of China, Subsidies: New and Full Notification Pursuant to Article XVI:1of the GATT 1994 and Article 25 of the SCM Agreement, G/SCM/N/123/CHN ("China Subsidies Notification") at 2-4. As discussed below, however, the Chinese government limits foreign ownership in the steel industry to a minority share, and generally requires the transfer of technology as a condition of investment.

8 See id. at 11-18.

9 Current Situation of the Chinese Steel Industry at 8.

government itself has admitted.[10] Recent reports state that "China will probably scrap tax rebates on all steel products in the second half {of 2006} to discourage exports" of steel.[11]

11. *Currency manipulation*. The refusal of the Chinese government to allow the RMB to float freely has been a major source of friction between China and its trade partners. By some estimates, China's continued linkage of the RMB to the U.S. dollar provides Chinese steel exports with an effective subsidy of 27 to 40 percent, and imposes an effective tax on steel imports of a similar magnitude.

Expansion Plans for the Chinese Industry

12. The Chinese government's steel policy explicitly calls for continued support for the expansion and modernization of the steel industry. Projects either under construction or in the planning stage would add another 150 million tons of capacity. At the same time, the Chinese government has realized that the industry in China already has excess capacity, as it is planning to close 55 million tons of capacity in older, smaller mills. If it carries out all of these plans, Chinese capacity will still rise from its current level of 414 million tons per year to around 509 million tons over the next few years.

The Indian Steel Industry

13. The Indian steel industry is primarily privately owned, although the largest producer, SAIL, is state owned. Significantly, SAIL by itself accounts for over 35 percent of Indian steel production. Since 1990, the Indian government has significantly reduced regulation of the steel industry, and no longer directly controls investment and prices. Government support was essential to the survival of SAIL during the last decade, though, as it provided a rescue package worth some USD 2.2 billion. The Indian government continues to provide benefits to steel producers through a number of programs.

14. Indian steel producers receive a range of export incentives, including excessive remissions of taxes on imports of raw materials and machinery; licenses to import raw materials duty free when the materials are used for export production; and exemptions from income tax on export income. Both the United States and Canada have found many of these incentives to constitute countervailable subsidies. The Indian government is also targeting investment in the infrastructure needed for exports, such as port facilities.

15. India also provides steel producers export credit on favorable terms. The Reserve Bank of India has directed commercial banks to provide export credit both at pre- and post-shipment stages.[12] Pre-shipment credit, or packaging credit, is granted to exporters for purchase of raw materials of the finished product upon the presentation of confirmed export orders or letters of credit.[13] With post-shipment credit, the credit is offered to exporters against either the shipping bill or drawback claims.[14] The Steel Development Fund provides preferential loans to industry members. .

16. The Indian federal government, and those of certain states, also control prices for iron ore indirectly. India has some of the largest iron ore reserves in the world. The Indian government has granted SAIL and Tata the exclusive right to use the production from selected mines. This gives them a huge cost advantage; as of December 2005, the cost of extraction of iron ore for SAIL and Tata Steel was between

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10 See Current Situation of the Chinese Steel Industry at 8.

11 Shanghai Daily (April 25, 2006).

12 Id.

13 Id.

14 Id.

Rs 250 and 325 per metric ton, while the market price for iron ore was approximately Rs 2,000 per metric ton.[15] Even India's Ministry of Mines admits that captive mining by steel producers results in a huge subsidy to them.[16] The Indian national government also restricts exports of high-grade iron ore, while several state governments, including Orissa, prohibit steel producers from exporting iron ore from the state.[17] This effectively requires that the ore be used in the state, which has the inevitable result of driving the cost of iron ore for domestic steel producers down.

Expansion Plans for the Indian Industry

17. The Indian government plans for Indian steel capacity to more than double by 2019, to reach 100 million tons per year. At least one participant in the industry predicts that the industry will in fact reach 200 million tons in capacity by 2020. The Indian government intends to assist the expansion process by providing the Indian industry with additional export incentives, and even buyback provisions.[18] Individual states, especially Orissa, have extremely ambitious plans to leverage government support into an enormously expanded industry.

18. While the government expects the Indian industry to increase capacity by 20 percent per year, domestic demand for steel in India is expected to grow by only 8-10 percent per year.[19] To use all of the planned capacity, Indian producers will have to increase their exports enormously. India already exports approximately 15 percent of its steel production; by 2010, this figure is expected to rise to 45 percent, or 35 million metric tons per year.[20]

19. When the Chinese steel industry overbuilt, it was able to slough off with comparative ease a large portion of the cost to the state-owned banks and asset management companies. India has no such option. If the Indian steel producers encounter financial hardship as a result of excess capacity, the result is more likely to be bankruptcies and mill closures, as well as pressure for direct government bailouts (like that of SAIL) to avoid hardship on the workers, communities and local financial institutions.

The Consequences of Overcapacity

20. The construction of excess capacity in China and India will cost both countries billions of dollars in scarce capital. It will also have a negative effect on producers in other countries. As the NAFTA steel industry explained in a paper submitted to the OECD in 2005, the construction of excess capacity "will impose costs on all world steel producers by driving up the prices of inputs such as scrap, iron ore, coke, and energy."[21] Overexpansion of the Chinese steel industry has already had some of these effects, as high Chinese demand for scrap and coke drove world prices for these key inputs to record levels in 2004 and 2005.

21. Overcapacity will of course ultimately have an impact on steel prices as well. Steel is a cyclical industry, and producers depend on profits during the relatively short boom times to tide them over during the inevitable bust. The global steel industry has experienced such a boom over the last three years,

15 Ministry Opposes Captive Iron Ore Mining by Steel Producers, Business Line, December 26, 2005.

16 Id.

17 THE INDIAN STEEL INDUSTRY, supra note 54, at 35.

18 National Steel Policy at 4.

19 The Indian Steel Industry at 28.

20 Id.

21 Organization for Economic Cooperation and Development, Capacity Expansion in the Global Steel Industry 2 (2005).

although prices have already begun to decline from their highs in 2004. The construction of excess capacity in China and India will exacerbate the situation. This can lead to the well-known “death spiral,” in which producers race to cut prices while maintaining production.

22. The construction of excess capacity in China and India will cost both countries billions of dollars in scarce capital. Overexpansion of the Chinese steel industry has already had negative effects on producers in the rest of the world; overexpansion of the Indian industry will only exacerbate the situation. Steel producers in both the developed and developing countries, including Brazil, have expressed concern over the building of excess capacity in these countries. Elimination of state support for the steel industry by China, India, and all other developing and developed countries is likely to limit excess capacity, and is more likely to result in a stable and healthy global steel industry.

THE NEED FOR AN ONGOING OECD FOCUS ON STEEL

Presented by Terrence D. Straub

Senior Vice President – Public Policy & Governmental Affairs

23. It is a pleasure to be here and have the opportunity to address this distinguished gathering. I am going to be discussing a topic that is certainly of keen interest to the North American steel industry and, I think it is fair to say, of general and significant interest to those here today -- namely the policy implications flowing from concerns over state-supported capacity growth, particularly in terms of the ongoing work of the OECD Steel Committee and the High Level Group on Steel. The remarks I will give represent the views of the five major steel association of North America.

24. The discussion we have just heard relating to state-supported capacity growth in China and India is of course reflective of the wider concerns that have preoccupied industry participants and observers for years. Indeed, the persistence of subsidies in the global steel industry, and the seemingly ineradicable problem of excess capacity and market distortions flowing from government support, undoubtedly constitute the most significant area of policy concern confronting the industry now and for decades past.

25. It is sometimes observed that, "Everyone complains about the weather, but no one ever does anything about it." The more pessimistic among us might say the same is true of state supported capacity in the steel industry. The truth is, however, that the last few years have seen a level of serious engagement, and thoughtful dialogue, on the issue that goes well beyond the finger-pointing of the past, and offers some hope that global players may finally be coming to the realization that something needs to change.

26. The work of the High Level Group on Steel has of course centered on the issues of subsidies and overcapacity, while also prompting serious dialogue on other basic issues affecting steel producers and world markets. The failure to reach consensus on a steel subsidies agreement (SSA) was a disappointment, but the focus these discussions brought to the problem of trade-distorting aid -- a focus that has in many ways remained even as market conditions have rebounded -- was in itself a significant achievement and a foundation for future consideration of the issues involved.

27. If there is a single message we hope will come out of this discussion today it is this: that the failure to reach consensus in the SSA talks cannot and must not result in a loss of resolve to tackle the fundamental issues facing this industry globally, or a diminishment in the attention paid by policy makers to the industry's problems. We all know the problems have not gone away, and that we are nothing more than a downturn away from seeing their effects front and center once again.

28. The document circulated by Mr. Schlögl, Chairman of the High Level Group, regarding the future work of the OECD on steel reflects a thoughtful understanding of the need to keep an appropriate focus on the challenges confronting the industry, as well the need for a meaningful forum to address them. Indeed, if we are to avoid the pitfalls of the past, we need to enhance the level of dialogue and the sophistication of our approach. And that should be the touchstone of our thinking in terms of the OECD's work going forward.

29. In this regard, the question is not whether we need to continue a process where government officials and industry can engage in a meaningful and substantive way on the broader policy issues confronting the global steel sector. Rather, the question is what forum can best further this goal and invigorate it.

30. North American governments have taken the view, which the industry shares, that the OECD Steel Committee itself should serve as the primary locus for future work on the policy issues affecting steel, and that the work of the High Level Group should be largely reoriented into that of an expanded Steel Committee agenda in the near term. To the extent consensus comes within reach on one or more of the core policy issues considered by the Committee, the High Level Process could and likely should be reengaged to explore avenues to effectuate that consensus -- whether in terms of new subsidy disciplines or other policy action. But for now, we believe a single forum, with the resources and focus to succeed, should be our principal objective.

31. There are a number of factors that argue in support of the Steel Committee as the logical candidate to serve in that role.

- First, the Steel Committee offers a proven and ready site for such work. The Committee has long served as the only international forum for government-industry dialogue on steel policy issues, and has a structure in place suitable for future engagement.

- Second, the Committee has in the past served as a forum for discussion of the core policy issues identified in Mr. Schlogl's discussion paper -- namely steel-specific trade issues, structural adjustment, the situation in developing economies, and environmental challenges.

- Third, the need to maximize the impact of available resources argues to consolidate efforts in a single forum, at least initially -- avoiding redundancy of effort and allowing a streamlined, efficient and consistent focus.

- Fourth, the ongoing outreach efforts of the Steel Committee in terms of non-OECD members can and should be continued to encourage the broadest participation in future substantive dialogue.

- Finally, and most importantly, the Steel Committee has the expertise, resources and experience to facilitate meaningful work on the policy issues confronting the industry.

32. If the Steel Committee is to be tasked with an enhanced role to further and build upon the progress made by the High Level Group -- as we believe it should -- its agenda and budget must reflect the greater demands that will be placed upon it. We certainly agree with and support the elements of the proposed 2007/08 OECD work program, including studies and reports on world market and industry developments, capacity review, raw material issues, and steel trade -- as well as reports and workshops relating to developments in non-Member economies. <u>But we believe the agenda for the Committee should be substantially broadened beyond statistical reports and technical issues, to include serious engagement and discussion on the many challenging policy issues impacting the global steel industry.</u>

33. These issues should no doubt include those highlighted by Mr. Schlögl and others, including most prominently consideration of trade and government support measures of steel industries around the world, the growth of excess capacity, and other trade distortions affecting steel producers globally. The agenda should include real engagement on potential policy tools needed to impact these problems. The same is true of other major policy areas confronting steel, including environmental issues of common concern, energy policy, raw materials issues, and the rapid growth of steel production in developing economies.

34. Any hope of conducting serious and productive work in these areas will obviously require a budget sufficient for the task -- and not merely resources geared to a technical and statistical role. The industry globally has a common interest in making clear the need for governments to insist on appropriate

funding to further the core objectives originally laid out for the High Level Process, as now being integrated with the traditional work of the Steel Committee.

35. It is most critical right now to retain and build on the growing recognition of the need for market outcomes in the industry, and the imperative to eliminate state-support and subsidies in the steel sector. As the Steel Committee receives renewed interest and energy, it is well to keep in mind that we simply do not have any time to lose in terms of dealing the fundamental problem of subsidized capacity growth.

36. The Steel Committee should explore innovative ways to keep attention on the problem and develop new tools to confront it. But we must also not lose sight of the need to maintain and enhance the effectiveness of the tools we already have -- and that too should be at the forefront of the Committee's concerns. In this regard, traditional fair trade remedies have in truth proven the only effective policy means to discipline trade-distorting practices, and to disincentivize the creation of unwarranted, excess capacity. So long as countries can essentially "export" their own problems in terms of excess capacity, there is little hope to garner the will on the part of steel-producing countries to meaningfully address the problem.

37. While the use of anti-dumping and anti-subsidy remedies -- along with direct WTO remedies -- has, to be sure, rankled those impacted by them, it is important to consider that they benefit all global producers to the extent that they force countries to confront the problems within their own industries. If these disciplines are weakened or eviscerated internationally, it will only mean that the marketplace will be ceded to those who can game the system the best and enlist their governments to help fight the battle in terms of subsidies and the inappropriate financial support of national industries. That will truly be a race to the bottom, a legitimate death spiral for the many, and a hollow victory for the few who remain.

38. We are confident that a reinvigorated Steel Committee can serve as the right forum at the right time to make a difference. The steel crisis and the High Level Process helped to create an intellectual recognition of the fundamental problems facing the industry, and to begin the process of exploring how they can be meaningfully confronted and addressed at the policy level. To simply give up on that hope now would be a terrible mistake -- one that policy makers and industry participants would no doubt live to regret. Instead, we should build on the progress made, be realistic in our expectations, but strive to make the Steel Committee a forum that promises real results over time.