Beijing Steels Stands for an Iron Ore Battle

There is no more important industry to Australia than the Chinese steel sector. Australian miners shipped $50 billion of iron ore to China last year, making it by far the largest export earner for this country.

So, what happens in the Chinese steel sector matters a great deal for Australia. The industry is suffering from an intractable problem of excess capacity.

In 2014, China produced 823 million tonnes of steel, about 50 per cent of the world's total output. To put that into historical perspective, only the US, Japan and the former Soviet Union have ever managed to produce more than 100 million tonnes of steel a year at the peak of their production they never exceeded 200 million tonnes a year.

One of major policy challenges for Beijing is to reduce the country's excess capacity. To say the task is challenging would be a huge understatement. Though the basic law of supply and demand applies in China, other factors such as local protectionism, environmental degradation and tension between Beijing and local governments will also determine the future of the industry.

Zhang Guobao, the former deputy head of the National Reform and Development Commission and a key decision-maker in the country's steel industry, recently highlighted the difficulty of restructuring the sector in a lengthy piece on Caijing magazine, a respected business publication.

In his article, he drew attention to the forces of local protectionism in reducing excess capacity and used the industrial restructuring in Guangzhou as an example. Guangdong is the manufacturing hub of China with strong demand for steel, but it has to source 80 per cent of its steel from outside the province. Therefore makes it logical sense to expand the steel production in Guangdong.

However, the catch is that China already suffers from a massive overcapacity problem. So for Guangdong to expand its steel production, it means someone else has to cut back on their production, which is about as easy as climbing Mount Everest.

Beijing wants Shanghai-based Baosteel, the most modern and efficient steelmaker, to build a large steel mill in Guangdong. This project is only possible if three provincial producers agree to be restructured or even closed down. The move was met with fierce opposition from local officials, who rely on provincial steel producers for tax revenue and job creation.

It was only agreed that these provincial steel mills be restructured after lengthy negotiations and Baosteel's undertaking to pay a large sum of money to resettle workers. In the end, the provincial government agreed to shut down 10 million tonnes of production capacity in order for the Baosteel project to go ahead.

While Guangdong finally agreed to an industrial restructuring package, the neighbouring Guangxi province, a poor and underdeveloped region, also asked Beijing to expand its steel industry. The Guangxi provincial government argues it is a poor region with a lot of ethnic minorities. More importantly, it also emphasises the province's important role as a supporting base for China's military action in Vietnam and argues that it deserves a reward for that effort.

As the decision-maker, Zhang recalled that it is very difficult for Beijing just to approve Guangdong's new project. “It is hard to say no to any of these two projects and the decision-making is even harder considering the country is suffering the problem of excess capacity,” he wrote.

Zhang, the former head of China's energy administration, asked WuSteel, one of the largest state-owned mills from central China, to restructure Guangxi's steel industry. As part of the restructuring deal, WuSteel needs to cut back its production in its home province of Hubei. Just like in Guangdong, it is difficult for local governments to agree to steel industry production cuts.

“Industrial restructuring and structural changes sound easy, but it is extremely hard to implement,” he says. The chief difficulty stems from local governments' concerns for jobs. He cites example of Baosteel's restructuring of Shanghai Steel, which involved the herculean task of resettling 200,000 workers.

Baosteel had to create a lot of specialist subsidiaries, manufacturing anything from stainless steel to threads for blinds, to absorb 200,000 workers. From time to time, Beijing had to use the pretext of hosting major international events to move or close down inefficient and polluting steel mills. For example, Huangzhou Steel, which is based in the picturesque and prosperous Huangzhou, could only be shut down due to fact the city is hosting the G20 meeting next year.

Similarly, Capital Steel could only be moved and restructured thanks to the 2008 Summer Olympic Games. China's steel production centres are dotted around major cities, a Maoist legacy that no longer makes any sense as the country relies on seaborne iron ore to feed its blast furnaces. But Beijing finds it difficult to persuade local governments to give up their industries.

It seems local protectionism is Australian miners' best friend. If Beijing could have its way and shut down a lot of the country's excess capacity, it could have a devastating impact on our iron ore industry.