Crude steel production increased from 495 million metric tons in 2007 to 832 million mt a decade later.
The removal of China’s two-term limit on presidential tenures during the National People’s Congress in March this year was well signposted. No evident successor to President Xi Jinping had been anointed at the 19th Party Congress the previous October, where party cadres gathered to endorse him for another five years. New members elected to the Community Party’s inner sanctum—the seven-person Politburo Standing Committee—were widely viewed as Xi supporters.

What it means is that Xi’s vision for China and his economic policies are unlikely to be altered by a new leader or leadership team in five years’ time—and possibly well beyond. President Xi is in for the long haul, along with his policies, and companies dealing with China or competing in international energy and resources markets need to understand the implications.

Chief among these policies is the Chinese government’s supply-side reform agenda. This has seen Beijing removing systemic risk, cutting excess capacity and deleveraging polluting industries—notably steel, coal, aluminum, petrochemicals and cement—that grew bloated on the shoulders of China’s rapid economic development and urbanization over the past couple of decades.

In Xi’s 3.5 hour speech at the 19th Party Congress, ‘Furthering supply-side structural reform’ was point number one in the section on China’s ongoing economic development. “We will continue efforts to cut overcapacity, reduce excess inventory, deleverage, lower costs and strengthen areas of weakness, and work to achieve a dynamic balance between supply and demand by improving the allocation of available resources and increasing high-quality supply,” he told party members.
In terms of overcapacity, steel has been a major culprit. Crude steel production increased from 495 million metric tons in 2007 to 832 million mt a decade later. To put this into context, the 337 million additional tons of production added over the period is more than the combined output of Japan, India and the United States, the second, third and fourth largest global producers respectively. Much of the new steel capacity was poor quality, destined for the tens of millions of no-frills apartments China was quickly building. The previous Chinese administration’s stimulus programs—particularly the huge cash injections during the global financial crisis of 2008-2009—pulled forward the pipeline of infrastructure projects, put cheap credit into the hands of property developers, and incentivized new and established steelmakers and associated industries to build capacity.

Since taking over in late 2012, the current leadership’s economic focus has been on unwinding the excesses of this period and putting the country back on a more even and sustainable keel. Over the next five years, global markets can expect this policy to be pursued with gusto.
Quality over quantity

In many respects, the supply-side reform agenda can be viewed as a clearing of the decks, a readying of the foundations for the next stage of China’s economic development. Earlier in the Xi tenure, the government spoke of the “new normal” of slower, steadier and sustainable economic growth. Setting ambitious GDP targets was no longer so relevant and many economists outside of China questioned them anyhow. Now, the phrase often heard is “quality over quantity.” China believes it has taken enormous strides in its industrial de-capacity program. The focus now is on lifting the overall quality of industrial output, and enabling the country to compete on an even footing with international competitors such as Japan and the US.

“We will work faster to build China into a manufacturer of quality. … We will support traditional industries in upgrading themselves. … We will move Chinese industries up to the medium-high end of the global value chain,” President Xi told the Congress last October.

Under the supply-side reform agenda, China pledged to remove 100 million-150 million mt/year of crude steel capacity during the current 13th Five-Year Plan period of 2016-2020. Over the same period, the country planned to close some 500 million mt of coal production capacity, which had grown to more than 2 billion mt/year. In the case of steel, the mandated closures equate to roughly one-tenth of China’s overall capacity. China is likely to achieve the upper end of the target this year.

Further, an additional 140 million mt/year of unlicensed, low quality induction furnace capacity was surprisingly and quickly closed down last year. This provided market share opportunities for domestic steelmakers, resulted in a marked reduction in exports, and helped support global steel and raw materials prices.

Though a big chunk of capacity has been removed, steel and aluminum production increased last year as more efficient producers lifted their operating rates. Aluminum production for 2017 rose 1.6% on year to 32.27 million mt, while crude steel output increased by 5.7% to 831.7 million mt.

Ongoing monitoring

But there was more to come. In an attempt to meet stringent environmental targets, the government ordered steelmakers in the most polluting provinces and cities in northeastern China to lower their utilization rates—and therefore emissions—to an average of 50% during the winter heating season of mid-November to mid-March. In some cases, restricted output has been extended beyond the March deadline, and is effectively in place for the full year.

As part of the winter heating season cuts, major aluminum producers China Hongqiao Group and Xinfu Group were told to cut their production by 2 million mt and 2.6 million mt, respectively, over the
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period. Question marks remain over the efficacy of the winter curtailments as the net impact was not as pronounced as expected. Further, in the case of aluminum output, new smelting capacities brought on in 2017—such as Aluminum Corp of China’s new facility in Inner Mongolia—exceeded the cuts. Steel, too, is seeing an upswing in new electric-arc furnace capacity, which is deemed to be less polluting than traditional iron ore and coal fed blast furnaces.

Constantly monitoring and adjusting utilization rates and production levels to ensure environmental targets are being met appears to be a policy that is here to stay. Often the moves can be sudden and create enormous ripples—both beneficial and negative—in international markets, impacting prices in a big way. This was clearly seen in 2016 when the number of working days at China’s coal mines was reduced to 276 from 330. Suddenly, international buyers of coal feared China would lift imports, leaving less available material for them. The production scale-back was the major contributor to export prices of high quality Australian metallurgical coal soaring beyond $300/mt FOB, while thermal coal export prices reached $89/mt FOB by the end of 2016. Met coal exporters were happy, but the higher prices put tremendous pressure on steelmaker margins. Some Indian producers were forced to temporarily halt operations at some of their facilities.
The move to higher quality output means China will increasingly require higher quality inputs.”

Paul Bartholomew

until the steelmaking spreads were more conducive. So while China is trying to remove risk from its industrial landscape, that risk can be passed on, most notably in the form of price volatility. It is one of the reasons that commodity price hedging through derivatives has been a major growth area in recent years.

The move to higher quality output means China will increasingly require higher quality inputs. In the case of iron ore, the spread between low- and high-grade material has blown out with 58% Fe material receiving discounts of up to 40% against the S&P Global Platts 62% Fe benchmark.

What has become clear is that the days of paying lip-service to improving the environment in China are over. Previously, the environment came a distant second to economic growth, and provincial governments were often more concerned about achieving their revenue targets than providing clean air for their inhabitants. This scenario was a major contributor to the excess capacity and waste seen across so many industries. Further, provinces did not always heed the missives and instructions coming out of Beijing. Now, however, they are being put under pressure to meet PM2.5 targets, and industrial activity, such as steel production, is being wound back until these targets are met. Steel mills and aluminum smelters are now subject to regular environmental inspections, and simply turning equipment back on the moment the inspectors have departed the premises is less of an option.