Supply-side reform: less is more

More successful than many had imagined, China's supply-side reforms should produce leaner, more competitive steel and coal industries.

- Industry restructuring prompts new steel expansion plans
- Coal use dependent on economic growth
- Construction slowdown key risk for steel demand

China’s supply-side structural reforms have been a major part of the 13th Five-Year Plan 2016-2020. Aimed at optimizing supply of products and services and thus improving productivity, the policy has had more success than many might have imagined in helping to ameliorate the excesses and tackle the problems brought about by China’s investment-dependent development model.

This was exacerbated by the huge fiscal stimulus of 2008-2009, which showered the economy with cheap credit; from steelmakers to infrastructure projects to real estate developers, if a project needed capital it got it.

This resulted in a glut of unwanted fixed assets — excess industrial capacity and empty apartments — and on the other side of the balance sheet a huge build up in debt which threatened economic growth.

FLOOR SPACE STARTED, COMPLETED AND SOLD

Source: National Bureau of Statistics
Against this backdrop the supply-side reforms have reduced excess housing inventory, especially in smaller cities, and removed old, inefficient capacity in the steel and coal industries, which have been the particular focus of government attention.

This has helped improve industrial profitability, lower costs and improve industrial structure, but it would be a mistake to think this means that the coal and steel industries have been cut down to size. If anything, it has made them stronger.

Out with the old …

China’s steel sector has been plagued by overcapacity for years. Over 2007-2017, official statistics suggest steel production grew by more than 340 million mt, more than the combined output of Japan, India and the United States.

Much of this was commodity steel, the raw material needed to build those infrastructure projects and apartments that would end up being a drag on the national balance sheet.

Oversupply in the Chinese steel industry can clearly be seen from the export statistics. Over 2008–2012, when domestic demand was rising, fueled by the stimulus package, China’s exports were under 60 million mt/year.

However, as consumption peaked in 2013 and started to fall thereafter, exports rose, spiking at 112 million mt in 2015, dragging down steel prices across the globe and causing trade friction with major trading partners.

China targeted the removal of 100-150 million mt/year of crude steel capacity during the 13th Five-Year Plan, equivalent to roughly one-tenth of overall capacity.

However, it was the closure of a huge number of unlicensed induction furnaces (IF) in 2016-2017 that really changed the fortunes of the industry.

It is hard to pin down with accuracy how much steel China’s IFs produced; small in scale, relying on scrap to produce low grade construction products, they were very inefficient, and operated in the shadows.

Usually unlicensed, and often avoiding taxes, at their height they might have produced anywhere between 40 million and 80 million mt/year.

Over an eight-month period the government shuttered an estimated 140 million mt/year of IF capacity. This saw steel prices rise, especially for commodity construction products.

The beneficiaries were conventional steelmakers which saw utilization and margins increase, as well as mining companies who saw rising demand for iron ore and coal as the scrap-based IFs exited the market.

… and in with the new

Perversely, the improved profitability and stronger balance sheets resulting from the capacity eliminations have incentivized mills to embark on a new round of capacity expansions. Around 50 million mt of new electric arc furnace (EAF) capacity was approved in 2017 and another 20 million mt is likely to be approved this year.
Construction – China’s economic bellwether

China’s multi-decade process of urbanization coupled with housing market liberalization at the end of the 1990s precipitated a huge real estate boom. Rather than slowing during the 2008-2009 financial crisis, it picked up speed on the back of Beijing’s massive stimulus package.

Real estate is in many respects a bellwether for the Chinese economy. It is a huge driver of demand for infrastructure, which requires cement, plastics and metals, especially steel – and of course energy, not to mention the goods that will fill new apartments and the services they require.

Moreover, because China’s banking sector is state controlled, and the banks are the primary source of credit, it is a sector over which the government can exert influence. However, it is also one that can sometimes take on a life of its own in defiance of central government control.

Taming the beast

China’s real estate investment grew from under 6% of GDP in 2000 to a peak of 15% in 2014, with residential housing investment accounting for two thirds of the total. The IMF estimates that around a quarter of China’s GDP and a quarter of all loans sitting on bank balance sheets are related to real estate. Land sales are also an important source of revenue for local governments.

The post-financial crisis credit boom saw a huge increase in real estate construction starts across the country, far in excess of sales, while completions continued to grow more or less on trend with rates seen since the early 2000s. However, such was demand that rising prices led to public disquiet in 2011-2012 and again in 2014-2015.

The government tightened credit and enacted administrative measures, for example restricting the purchase of multiple properties, in an effort to cool the sector. This resulted in prices falling and sales volumes slowing, but it didn’t stop the rise in unsold housing inventory, especially in smaller third and fourth-tier cities, which had built up over 2011-2015.

Since 2015, the government has made progress in reducing the excess. In smaller cities, the government has shifted the focus of social housing programs from construction to the purchase of existing unsold properties built by developers. Beijing has taken measures to strengthen supervision of financial activities, including non-bank lending, which is likely to constrain credit to the sector.

However, if real estate sales fall significantly, the level of outstanding debt and the collapse in demand in associated sectors poses a significant risk to the economy.

Urbanization will continue, but with nearly 60% of China’s population now classified as urban, and the number of people living in rural poverty down from nearly 300 million in 2005 to 30 million by the end of last year, it is not a process that can sustain indefinitely the vigor of the past.

Outside China, the fear for steelmakers is that the Chinese property market will collapse, forcing Chinese mills and traders to export excess steel, bringing down international steel and raw materials prices. A collapse may not be on the cards, but a return to the growth levels seen over the last two decades is very unlikely.
Like IFs, EAFs use electricity and scrap rather than coal and iron ore to make steel. But they are much more efficient, using less electricity per ton, and can produce higher quality products.

Although there may be a reduction in overall net capacity, the true legacy of China’s supply-side reforms is likely to be a more efficient, competitive and productive steel industry, capable of making higher quality products.

Coal rationalization

The problems affecting the coal industry are if anything more acute than the steel sector. Seaborne coal prices are formed largely off the back of southeast coast Chinese coal trade, affecting markets worldwide, but because there is little negative spillover in terms of trade frictions, the sector makes fewer waves outside China.

In 2017, China had around 4,000 coal mines, with total capacity of 3.41 billion mt. With only a few large state-owned players, this led to structural oversupply and declining corporate profits. With coal providing around 60% of China’s total energy needs, the sector is a systemic risk to the whole economy.

Similar to the steel sector, the government embarked on a program of capacity reductions and state-sponsored vertical integration.

Around a year and a half after a policy document outlined plans to integrate coal miners and electricity generation companies to better match supply with demand, the government approved the merger of state-owned Shenhua Group Corp., the country’s largest coal miner, with China Guodian Corp., one of its largest power companies. The combined entity will likely be the world’s largest utility.

Meanwhile, as of this year the government claims to have cut 800 million mt/year of production capacity, achieved by closing smaller, privately-owned mines, especially those with poor safety records and environmental standards.

As well as closing mines, the government also strictly controlled production, allowing mines to operate for no more than 276 working days a year, a huge reduction from their normal 330 days.

This policy saw China increasingly short of coal, driving up prices and imports by as much as 50%. The effects rippled across the global coal market, giving a boost to the fortunes of an industry many had thought in terminal decline.

By the middle of winter, the time of peak coal demand, prices had risen so much that the government was forced to relax operating restrictions, which saw prices ease, but still remain elevated, compared with the lows of 2014 and 2015, hugely improving the sector’s profitability.

The government will probably exceed its target of eliminating 800 million mt/year of inefficient coal mining capacity, and it will stop approving new mines which produce inferior quality, high sulfur, high ash coal, but Beijing’s plans also envisage adding around 500 million mt/year of advanced coal mining capacity by 2020.

The supply-side reforms are just as much about improving industry structure and the quality of the coal produced than reducing coal use — at least in the short term.

China will be hugely reliant on coal for years to come and its ability to reduce coal use is heavily dependent on the rate of economic growth. As in 2017, faster growth means a return to higher coal use, despite the construction of huge renewables capacity and the restructuring of the economy away from industry to services.