STATEMENT OF ALAN H. PRICE

ON BEHALF OF THE AMERICAN IRON AND STEEL INSTITUTE AND THE STEEL MANUFACTURERS ASSOCIATION

GOVERNMENT SUBSIDIZATION OF THE CHINESE STEEL INDUSTRY AND ITS CONSEQUENCES

BEFORE THE U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

CHINA'S WORLD TRADE ORGANIZATION COMPLIANCE: INDUSTRIAL SUBSIDIES AND THE IMPACT ON U.S. AND WORLD MARKETS

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China's compliance with the obligations it assumed upon its accession to the World Trade Organization has been seriously deficient. Nowhere is this more obvious than if one examines the Chinese government's support of the steel industry in China. The American Iron and Steel Institute (AISI) and the Steel Manufacturers Association (SMA) have identified a number of ways in which the Chinese government has provided the Chinese steel industry with comprehensive support. Through a combination of direct subsidies, including prohibited export subsidies, indirect subsidies such as the direction of credit, and, above all, manipulation of the value of the Chinese RMB, the Chinese government has enabled and indeed required the Chinese steel industry to expand to a size far beyond anything the market would have built. These actions by the Chinese government are having profound consequences for both steel producers and downstream users of steel in other countries. The headlong expansion of the Chinese steel industry is also having a negative impact on the global environment.

The Chinese Steel Industry Has Expanded Enormously in Five Years

To understand the full scale of China's subsidization of its steel industry, it is necessary only to review a few statistics. In 2000, China produced 126 million tons of steel, about 20 million tons more than the next largest producer, Japan. In 2005, China made 348 million tons of steel, an increase of 175 percent in only five years. This was more steel than the next three largest producers combined. Over this period, China moved from a net importer to a net exporter of steel.

How was such a dramatic and indeed unprecedented expansion of capacity possible? The short answer is that the Chinese government made a conscious decision to funnel tremendous resources into the steel industry. It did so in violation of both its WTO commitments and the logic of the market.

The Chinese steel industry continues to be primarily state-owned. Although minority positions in some of the larger producers are privately owned, the Chinese government holds a majority interest in *every* major Chinese steel producer. The structure of the Chinese steel industry reflects the pervasive influence of the Chinese government. The Chinese industry is extremely fragmented. There are approximately 800 steel mills in China. This fragmentation reflects the active intervention of the Chinese government at all levels – national, provincial, and local – in

the steel industry. Every province and every region seemingly wants its own steel mill, and is willing to provide lavish benefits to build or keep its steel industry.

The Chinese Government Provides a Range of Subsidies to the Steel Industry

The ways in which the Chinese government has subsidized the steel industry are manifold and ingenious. AISI and SMA are preparing a report that examines these subsidies in great detail. The following are just a few examples of the various direct subsidies the Chinese government has provided the steel industry.

- *Transfers of ownership*. 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 – even though Ercheng had been profitable.

- *Cash grants*. The Chinese government has admitted that it continues to provide direct grants to steel producers that incur losses, even though it had promised in its WTO accession agreement not to do so.

- *Debt-for-equity swaps*. This is an extremely common way in which the Chinese government funds the steel industry. 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. In 2000 alone, the Chinese government converted more than $7 billion in direct government financing into equity in 37 different Chinese steel companies. The *Asia Times Online* reports that, in the years leading up to 2005, China's iron and steel companies benefited from debt-to-equity swaps worth 11.19 billion yuan as part of the government's plan to restructure and consolidate the steel industry.

- *Debt forgiveness and inaction regarding non-performing loans*. Closely related to debt-for-equity swaps is the frequent forgiveness of loans to steel producers by Chinese government bodies. One of the most prominent was the write-off by the Heilongjiang provincial government of $4.4 billion worth of non-performing loans owed by state-owned industrial enterprises, including local steel producers. Just as significant, though less obvious, is the failure of government bodies to force borrowers to pay non-performing loans. As much as $800 billion worth of state-owned banks' loans are non-performing.

- *Benefits for export performance*. The Chinese government provides extensive benefits to steel producers that export a substantial portion of their production, primarily in the form of tax credits, but also through direct grants. On their face, these benefits would appear to be subsidies contingent on export performance, which are explicitly prohibited by the WTO agreement on Subsidies.

- *Energy and raw material grants.* The Chinese government has provided grants to fund the purchase of energy and raw materials, either in the form of money or in kind, to steel producers, including the provision of coking coal and iron ore to Shougang Steel by the Shanxi provincial government in exchange for Shougang's assistance in the ongoing restructuring and upgrading of the steel industry.

- *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. These four banks alone account for over 60 percent of all loans. The government frequently directs the banks to make loans to individual steel companies on non-commercial terms.

- *Control over raw material prices and exports*. The Chinese government has imposed export restrictions or high export taxes on key steelmaking raw materials such as coke and steel scrap, restrictions that have the effect of reducing domestic prices for these inputs below world market levels. The Chinese government has also threatened to use import licensing schemes to control the price of imported iron ore.

- *Import barriers*. High tariff rates and other barriers protect the Chinese steel industry from competition from imports.

- *Barriers to foreign investment*. Chinese law prohibits foreign companies from owning majority stakes in Chinese steel companies and requires that foreign investors possess proprietary technology or intellectual property in the processing of steel. While this might appear likely to prevent the expansion of capacity, its major effect is to prevent that rationalization of capacity through the purchase and consolidation of Chinese steel companies by foreign investors.

- *Currency manipulation*. By keeping the value of the Chinese RMB artificially low, the Chinese government effectively subsidized Chinese steel exports, while making imports more expensive.

Some of these subsidies, such as tax benefits based on export performance, are clearly prohibited subsidies under the WTO Subsidies Agreement. Others, such as the provision of subsidies to loss-making state owned steel companies, violate the obligations China assumed under its WTO accession agreement. The net effect of these subsidies has been to drive the expansion of the Chinese steel industry to levels far beyond anything the market would have created.

The New Steel Policy Is a Prescription for More Subsidies

Nor can there be any doubt that the Chinese government fully intends to continue on this course of extensive control over the steel industry. In July 2005, the National Development and Reform Commission ("NDRC") issued China's new Steel and Iron Industry Development Policy ("Steel Policy"). The Steel Policy outlines a comprehensive policy for the continued expansion and modernization of the Chinese steel industry. The policy prescribes continued government involvement in all aspects of the management of China's steel industry, including resource and equipment utilization, regional concentration of output, quality improvements, technological in-

novation, investment management, and consolidation. Article 20, for example, provides for the strategic reorganization of China's largest steel producers to create an industrial structure with two 30 million-ton steel groups and several 10 million-ton level steel groups by 2010. The policy further prescribes the number and size of steel producers, where they will be located, the types of products that are allowed to be produced, and even minute details relating to the technology that will be used (e.g., size and composition of blast furnaces).

The Steel Policy mandates direct government subsidization of the steel industry. For example, Article 16 specifically provides for government support in the form of "tax refunds, discounted interest rates, funds for research and other policy support for major iron and steel project utilizing newly developed domestic equipment." The policy also calls for indirect support, by among other things, restricting foreign investment, discriminating against foreign equipment and technology, and by providing various export credits. In short, the Steel Policy is a perfect example of the Chinese government's resolution to assert comprehensive control over the steel industry, arrogating to itself decisions that the entire WTO framework assumes should be made by the market.

China's Subsidization of the Steel Industry Is Having Negative Global Consequences

China's massive subsidization of its steel industry is having consequences that are truly global. By expanding its steel industry by government fiat, rather than in response to the demands of the market, China has skewed the entire world market in steel and in the inputs used to make steel. In doing so, it has directly injured both foreign steel producers and steel consuming industries in other countries.

The expansion of China's steel industry has come at the expense of foreign producers. China's explosive growth between 2000 and the present required massive amounts of steel, and indeed, during much of this period China was the world's leading steel importer. By building up its steel industry to artificial levels, though, China deprived steel producers in other countries of valuable sales. This is significant, because steel is a highly cyclical industry; producers depend upon high production and prices in good times to help them weather the inevitable downturn.

Not surprisingly, the rapid expansion of steelmaking capacity in China led first to the replacement of imports, and then to a boom in exports. In product line after product line, from wire rod and seamless tubular products to rebar, and flat rolled products, Chinese exports have flooded world markets, driving down prices.

The Chinese steel producers have initially targeted their neighbors. Large quantities of Chinese steel are forcing their way into the Australian, Japanese and Korean markets, among others. This in turn encourages the producers in those countries to seek other markets for their production – and the United States is the largest and most open of these markets. The United States has experienced massive increases in imports from these countries.

The world in many ways constitutes an integrated market for steel. Through a dramatic expansion in capacity fueled largely by subsidies and government-directed lending, the Chinese steel industry is destabilizing that market. It is only a matter of time before the effects of the Chinese

expansion become obvious in the U.S. market, to the detriment of U.S. steel producers and U.S. steel consumers.

The dramatic expansion of the Chinese steel industry has had another, equally direct impact on steel producers elsewhere. The Chinese government has driven demand for steel in China to artificially high levels through various policies and subsidies to other steel consuming industries. As production in China skyrocketed to respond to this artificial demand, the Chinese steel industry's demand for iron ore, scrap, coke, and other inputs into steelmaking also skyrocketed. Among other consequences, this was a major cause of the precipitous increase in prices for steel scrap in the United States, which remain at near-record levels. China is the world's largest coke producer; export restrictions on coke in 2004 had a similar impact, driving prices outside of China to levels twice as high as prices inside China. China's insatiable demand for shipping for iron ore, scrap, and steel exports also caused a rise in shipping prices. All of these events harmed steel producers in the United States and other countries.

Foreign steel producers are not the only ones harmed by the subsidized expansion of the Chinese steel industry. Foreign steel consumers have also been injured. The expansion of the steel industry is only part of the Chinese government's plan for the development of the Chinese economy; the Chinese government is also encouraging the development of manufacturing industries that use steel. Manufacturers of products that are steel-intensive, such as automotive parts and appliances, are seeing increasing competition from Chinese producers who have access to subsidized domestic steel. Subsidized steel is going to manufacture components in China that ultimately end up in the United States and replace American steel. Indeed, American consumers report that they can import finished parts cheaper from China than they can buy the steel here. At the same time that U.S. steel producers are seeing increased imports caused, directly and indirectly, by increased Chinese production, we are also seeing many of our domestic customers move production to China, or go out of business altogether.

The Chinese Steel Industry Is a Major Polluter

The subsidized maintenance of many small, old and inefficient steel facilities in China have had another, truly global effect – pollution. Although China has relatively strict environmental laws on the books, it often does not adequately enforce them. All too often, many older Chinese plants, including in the steel industry, do not employ even the most basic pollution control measures. It has been calculated that China is responsible for 25 percent of worldwide emissions of particulates, and that the Chinese steel industry discharges far more greenhouse gases than the U.S. industry per ton of steel produced.

Concluding Thoughts

China is a major economic power. Under true market conditions, China would undoubtedly have a large and diverse steel industry. It would not have a steel industry that has grown to account for a staggering 31 percent of total world steel production. The Chinese steel industry in its current form is the creation of the Chinese government. It has benefited from massive direct and indirect subsidies, many of which violate the WTO's Subsidies Agreement, China's obligations under its WTO accession agreement, or both. The Chinese government has adopted an official policy that requires it to continue to provide the steel industry with massive subsidies.

The consequences of these actions have been profound. The growth of the Chinese steel industry has been at the expense of its international competitors. The Chinese steel industry's expansion is simply one component of an overall strategy that has resulted in the displacement of production in dozens of industries from the United States to China, at the cost of hundreds of thousands, if not millions, of American jobs. Because the Chinese steel industry is a major emitter of pollutants and greenhouse gases, the long-term impacts may be even more severe. The economic stability and security of the United States demand that the Chinese government end its policy of subsidization of the Chinese steel industry.