

China steel demand nears peak, and so does iron ore import

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- THE AUSTRALIAN
- 12:00AM AUGUST 4, 2016

China's steel industry — producing half the world's output — comprises a mass of contradictions, guaranteeing Australian iron ore analysts reasonably secure employment.

But some trends are starting to look inexorable. They point to sustained but not significantly increased ore demand over the medium to long term.

For instance, leading Chinese economists Liu Haimin and Song Ligang, writing in the latest annual *China Update*, published a few days ago by the Australian National University, believe that the country's steel production may have peaked already — give or take a few fluctuations such as those we are seeing this year.

Production soared by an astonishing six times from 2000 to 2015, to 804 million tonnes. But almost half of the enterprises in the steel industry lost money last year.

Can they find productivity increases, input cost reductions or escalating demand to turn that around? One of the most experienced hands in this sector, operating successfully in both Australia and China, is Melbourne-based lawyer Robin Chambers who forecast five years ago — with weighty support from Chinese steel veteran Jiao Yushu — that “peak steel” would plateau at around 800 million tonnes.

Of course, not a quantity to be sniffed at. That generated demand last year for \$39 billion of ore imports from Australia, and \$6bn of coal. Most of the coal bought by China is used in steelmaking, for which despite the apparently widespread detestation of the mineral in Australia, it is hard to find alternatives.

But the arguments for a significant increase in steel production in China are looking thin. Back to steel later. What of iron ore?

As the ore price began to fall with increased supply, especially from the Big Three — Brazil's Vale, BHP Billiton and Rio Tinto — the established

domestic Chinese mines, with high costs and decreasing ore quality, have found it hard to survive.

A decade ago, China's mines provided about half the ore its steel mills needed. Today, they supply just below 20 per cent — though to a much larger industry. So there is only modest scope for Vale, BHP and Rio to grow their market by replacing domestic production as smaller mines close.

Twenty Chinese miners a few days ago issued a joint statement calling for an anti-dumping investigation into ore imported from the big three, in a mirror image of anti-dumping measures imposed on Chinese steel exports around the world. But Rio and BHP can deliver ore to their ports for just \$US13 a tonne, so they retain a healthy capacity to profit from even lower prices.

The Beijing-based GavekalDragonomics economist Rosealea Yao says that “iron ore imports cannot sustain their current growth rates”, with only another 150 million tonnes at the most of Chinese demand to be captured, even if imports are to reach 95 per cent and even if iron ore use can be sustained at around 1 billion tonnes per year. “The remaining large Chinese producers will be much more difficult to dislodge,” Yao points out.

“So while iron ore imports likely have a strong several months ahead of them, they are getting close to their peak as well”.

Of course, for some in the market, “several months” is a very long time indeed, and they will settle for that. But beyond that, the case for sustained steel growth rests heavily on continued government desire and capacity to maintain its massive stimulus spending, expanding corporate credit beyond even the current debt crisis levels — and risking a surge in corruption, since there is little evidence that the funding is finding its way into productive ventures.

The latest production data for steel indicates output is still growing, up 9.2 per cent in the second quarter, despite the government's pledges to rationalise the industry.

Vale, the world's biggest producer, cheered that demand was still growing, “boosted by the credit easing”, and “encouraging worldwide production”.

Prices have thus turned around from \$US37 a tonne last December to about \$US59 a tonne. But this is on the back of funding being funnelled through inefficient and mostly loss-making state-owned enterprises. Private fixed asset investment grew just 2.8 per cent in the first half of 2016.

China targeted a 45 million tonne reduction in steelmaking capacity this year, and 140 million tonnes by 2020 — but only succeeded in cutting 13 million tonnes in the first half, out of a total capacity of about 1.1 billion tonnes.

The government wants to create bigger state-owned national champions in many strategic economic sectors, including steel. It is pressing Baosteel, the modern, second largest producer, to merge with Wuhan Steel, the sixth largest, which operates older and less efficient mills, and Hebei Iron and Steel, the number one, to merge with Shougang Steel.

But Beijing is reluctant to force closures and the resulting redundancies. If this proves necessary in order to gain any productivity improvement, it seems it would, in this and other instances, burden the more efficient operator — say, Baosteel — with massive new pension and other welfare costs to prevent social aggravation.

Exports, of course, provide a potential driver for steel growth for China. The global economy is not itself expanding healthily, but China still has room to displace other, perhaps less efficient, producers — as long as the current - resistance illustrated by anti-dumping measures does not become entrenched.

Such demand growth is being balanced, for now, by capacity reduction due to temporary factors — including devastating flooding, and tougher inspections by the Environment Ministry, checking on emissions and forcing some production cutbacks.

Overall, the picture is one of the government continuing to push vast quantities of cash into construction via provincial investment vehicles, thus maintaining demand growth to a degree. But this tactic is unsustainable, and indeed contradicts Beijing's own longer-term goals to restructure the economy.

Yao describes 2015 as “the year of peak everything” in terms of true as opposed to confected demand, for steel, cement and coal. China's usage last year roughly paralleled Japan's, as it peaked at about the same income level. And that's the picture that matters, beyond short-term stock churning.