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To

U.S.-China Economic and Security Review Commission

Regarding the Extent of the Government's Control of China's Economy, and its Impact on the United States

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American
Iron and Steel
Institute

Good morning. I am Barry Solarz, Senior Vice President for Trade and Economic Policy at the American Iron and Steel Institute (AISI). I appreciate the opportunity to be here today on behalf of our U.S. member companies, who together account for approximately 75 percent of annual raw steel production in the United States.

The topic of subsidies and state support of industrial capacity in China is of critical concern to domestic steelmakers and all American manufacturers. While my testimony will address the specific questions the Commission is focused on at today's hearing (China's use of central planning and state-owned enterprises to develop its economy), I plan to emphasize in particular the effects of massive government subsidies and a severely undervalued currency. These factors have combined to fuel an uncontrolled explosion of Chinese steel capacity far in excess of China's domestic demand, which in turn have led an unprecedented surge of exports of steel and steel-containing products to the United States and other world markets.

1. *How are U.S. firms affected by the Chinese central government's moves to consolidate control of "strategic" and "heavyweight" industries? Will U.S. companies be able to compete with Chinese state-owned companies that are able to tap government resources – including tax abatements, discounted land purchases, low-rate financing, and other subsidies?*

With regard to the Commission's first question, the Chinese central government is not "consolidating" control of its steel industry. Steel in China has been government-owned and controlled for decades. In fact, thanks to subsidies and other non-market forces, the Chinese steel sector has now grown so large and so fragmented, that even the central government is finding it difficult to implement some of the major aspects of its steel policies in the provinces and localities far from Beijing.

To cite three examples of how the Chinese steel sector is not operating as a market economy: (1) millions of tons of obsolete and heavily polluting steel capacity in China has not been eliminated; (2) steel capacity and production in China are continuing to expand geometrically in the face of domestic oversupply conditions; and (3) contrary to what has occurred in the Americas and in Europe, steel industry consolidation in China has yet to occur.

Accordingly, the steel sector has become a "poster child" for what is wrong in the U.S.-China trade relationship. However, the key point here is not about steel alone. No U.S. industry (regardless of how competitive) can compete against the government of China, and that is what we and many of our domestic customers are being asked to do.

The bad old days, when a significant percentage of the world's steel capacity was owned and controlled by government, are back – thanks to the massive buildup of

Chinese steel capacity, which today is roughly one-third of total world capacity. Nine out of ten of China's largest steel producers are majority-owned by the Chinese government, and state-owned enterprises account for nearly 60 percent of total Chinese steel production. However, the critical factor to keep in mind is not only that the Chinese government is continuing to own and control steelmaking in China – it is that Chinese steel companies, whether state-owned enterprises (SOEs) or not, are continuing to receive massive government subsidies.

In July 2005, China's National Development and Reform Commission adopted a new National Steel Policy to guide the industry for the next 15 years. This central government industrial policy calls for continuing subsidization of key steel projects, exports and technologies. At a previous hearing, we provided this Commission with a copy of our July 2006 report, "The China Syndrome." It shows that China has the world's most heavily subsidized steel industry and that Chinese government subsidies take many forms. They cover the waterfront -- from preferential loans and tax treatment, to subsidized raw material and energy inputs.

2. *What advantages do Chinese SOEs have over American firms and how do these advantages affect your industry? What are the elements that affect you the most?*

With regard to the Commission's second question, Chinese steel companies (whether state-owned or ostensibly private) face a number of competitive challenges, not the least of which are high input and energy costs. Contrary to popular opinion, Chinese steel companies are not low-cost producers. They do, however, have significant artificial competitive advantages in the form of government subsidies, an undervalued currency and government intervention in raw material markets, which is an issue of growing concern to steelmakers in many parts of the world.

Following publication of "The China Syndrome," U.S. steel producers have continued to research the issue of Chinese government subsidies, albeit hampered by the lack of transparency in the Chinese system. Last month, the Specialty Steel Industry of North America released a study on "Chinese Government Subsidies to the Specialty Steel Industry," which I would like to submit for the Commission's use and records.

In addition, just last week, AISI and four other major steel associations in North America presented a paper at an OECD Steel Committee meeting in Istanbul, Turkey, about the "Environmental Aspects of Global Trade in Steel." It notes that worldwide production of steel has increased by about 470 million metric tons over the last decade, with most of the expansion occurring in countries, especially China, that in general have greater amounts of inefficient steel production and weaker environmental regulation or enforcement. This lack of environmental enforcement is also a form of subsidy. I would like to submit this document for the Commission's use and records because -- with China already responsible for 50 percent of the global steel industry's total greenhouse emissions -- it is a stark reminder that the climate change challenge requires a global solution.

I will not discuss at length the issue of China's currency, but will submit for the Commission's use and records the testimony of the China Currency Coalition (CCC) at this week's Senate Banking Committee hearing. Among other points, this testimony stresses that: (1) China's accumulation of $1.3 trillion in foreign reserves is serving to meet its economic, social and military goals; (2) the continued undervaluation of the Chinese currency by 40 percent or more is harming U.S. manufacturing, employment and national security; and (3) the problem of currency misalignment (which is the result of protracted large-scale intervention by, or at the direction of, a governmental authority) should be a countervailable prohibited export subsidy under U.S. trade remedy law.

Meanwhile, the U.S. steel industry is being directly and adversely affected by a surge of Chinese imports. In 2006, China shipped over 5 million net tons (NT) of steel products to the United States, more than double the level of imports from China in 2005. By the end of last year, we were importing more steel from China than from any other country – including Canada. In fact, we were importing more steel from China than from all EU members combined.

Moving downstream, the U.S. pipe and tube sector was especially harmed by this surge, as imports from China in 2006 assumed a 28 percent share of the U.S. market. Because this dramatic increase resulted in a rash of plant closings in the United States -- and because this represents such a good case study of the "China model" of subsidization, overbuilding, exports and injury -- I will submit for the Commission's use and records a paper presented earlier this month by a representative from IPSCO, an AISI member company, entitled "Saying One Thing and Doing the Other."

Moving upstream, we see that the Chinese government is intervening increasingly in raw material markets. This is another form of subsidy that is both benefiting domestic steel producers in China (by keeping raw materials at home) and harming steel producers in the United States and in other regions (by limiting the availability of raw materials in world markets).

The old standby that China is sending us mainly lower-valued "long" steel products is becoming more of a myth each passing month. Government subsidies are allowing China to move up the steel value chain, with the production of increasing amounts of advanced steel products such as cold-rolled sheet, corrosion-resistant sheet and oil country tubular goods. These products are among the most valuable to the U.S. industry, and Chinese state policy explicitly targets these products for subsidization -- and for export. We can see this policy of "channeling" exports clearly in the recent Chinese government announcements of changes in border tax policy affecting steel exports. These policies, allegedly intended to slow the production and export of certain steel products, have specifically exempted pipe and tube and other high-value products.

The U.S. industry is very competitive with regard to high-value steel products. U.S. producers of corrosion-resistant steel increased their productivity by 78 percent between 2000 and 2006. On level terms, we can compete with steel producers anywhere, but we cannot compete against their governments – especially the government of China.

3. *Do the challenges you face from China's industrial policies apply only to your operations in China, or do they have consequences for you in other markets as well? Do they make it harder to invest in China? To export to China? To compete with Chinese exports in third country markets?*

With regard to the Commission's third question, both the U.S. government and domestic steel producers have complained that the National Steel Policy limits the ability of foreign companies to invest in Chinese steel companies (there is a 49 percent limitation on direct foreign investment). However, our main concern about China's industrial policies is the effect they are having on the U.S. steel market and our domestic customer base. We are also very concerned that, if the obsolete steel capacity in China is not eliminated and if the other fundamental problems in the Chinese steel sector remain unaddressed, there could be truly disastrous spillover effects in world markets.

Government support for the Chinese steel sector has clearly led to the addition of capacity that has nothing to do with market signals or supply and demand. With Chinese steel production exploding over the course of the last decade, a growing surge of Chinese steel has already impacted the global market. Between 2003 and 2006, we witnessed an historic shift of approximately 70 million tons in the net steel trade position of China, as it went from being a major net steel importer to a major net steel exporter to the world's number one steel exporting nation.

Chinese crude steel production more than quadrupled in the last 10 years, growing from an estimated 100 million MT in 1996 to approximately 420 million MT in 2006. This is the rough equivalent of building three entire American steel industries in one decade. China's production growth has far outpaced growth in the rest of the world. Its share of world steel production skyrocketed from an estimated one-eighth in 1996 to over one-third in 2006. This underscores the unprecedented nature and enormous magnitude of what China is doing in steel.

Moreover, the largest portion of China's steel production growth has occurred in just the last few years. Between 2003 and 2006, it is estimated that the increase alone in China's crude steel production was roughly equal to the total production of the United States in 2006. It is likely no coincidence that these are the years immediately following some of the largest reported Chinese government payouts to the steel industry. Though we are still working to understand the full implications of this absolutely unprecedented industrial expansion, one fact is clear: the Chinese market is not able to support the hundreds of millions of tons of production capacity added in the last few years, and this excess supply is already displacing steel from other countries to the United States, thereby significantly impacting the world market.

In addition, the Commission should keep in mind that Chinese government subsidies are also harming our steel industry, manufacturing base and economy through an increasing U.S. "indirect steel trade" deficit with China in downstream markets of steel-intensive products. In 2006, fully one-third of imports of downstream products made entirely of steel came from China. It matters little whether subsidized steel distorts the market as a coil of corrosion-resistant steel or as a shipload of "white goods." Neither the domestic steel producer nor its domestic manufacturing customer is going to be able to compete with the Chinese government's subsidies and mercantilist policies without the full and aggressive enforcement of U.S. trade laws.

4. *Are Chinese State-Owned Enterprises less willing than other firms in China to accept investment or joint ownership from foreign companies? Are the operations of joint ventures with SOEs less transparent to joint venture partners than would be the operations of joint ventures with non-SOEs?*

With regard to the Commission's fourth question, we have no firm evidence that, where there is direct government ownership, Chinese steel producers may be less willing to accept investment or joint ownership from foreign companies. There are many who see control moving increasingly to the provincial and local levels. What we do know is that China's National Steel Policy seeks to micromanage many aspects of future steel industry development -- including the number and size of major firms, the size of new plants, the location of such plants and even the minimum size of blast furnaces to be installed. In addition, it bans foreign companies from controlling Chinese steel companies.

In terms of transparency, AISI does not have direct commercial or investment experience in dealing with Chinese steel companies. Therefore, we are unable to advise the Commission on the clarity of their operations and financial dealings.

5. *Do you see the State Assets Supervision and Administration Commission (SASAC) designation of seven "strategic" sectors and five "heavyweight" sectors as a continuation of longstanding industrial policy in China or as a new development and a deviation from a path that otherwise would lead to a market-oriented economy?*

With regard to the Commission's fifth question, we view the designation of seven "strategic" industries and five "heavyweight" sectors as a continuation of longstanding industrial policy. China's five-year plans, which address virtually every aspect of the country's economy, have reportedly ordered governments at all levels to support the ongoing technological renovation of the Chinese steel industry.

Regarding the State Assets Supervision and Administration Commission (SASAC) and its direct role in the management and financial direction of SOEs, it can be argued that the formation of this body actually recentralized government control of state-owned enterprises. What is clear beyond any doubt is that, even without this development, China (and especially the Chinese steel sector) would not be a "market economy." Thus, if our country is to address effectively China's ongoing non-market behavior and its trade and market-distorting practices, the U.S. must use all available tools. This means: (1) treating China as a non-market economy under antidumping law; (2) applying countervailing duty law to China and other non-market economies; and (3) addressing Chinese currency misalignment under our anti-subsidy law.

6. *Has it become more or less difficult in the past several years to compete with state-owned enterprises? Do you discern a trend line in the future?*

With regard to the Commission's sixth question, it is always difficult to compete with non-market behavior and with subsidized foreign competitors (whether state-owned or private). We would like the Commission to know that the problems of Chinese government subsidies and Chinese excess capacity are worse than our government realizes.

Given the costly efforts of domestic steel producers to restructure, invest and enhance their global competitiveness, the last thing we want is a replay of the Asian crisis of the late 1990s, where overproduction abroad resulted in a flood of dumped and subsidized imports that put the entire American steel industry at risk. The threat then was vastly under-appreciated, especially by the Administration of that day. The signals were clear and the results predictable -- and not just in retrospect -- yet they went largely unheeded until almost too late. The American steel industry suffered deeply and unnecessarily as a result. That is why we believe the time to act is now, before the situation gets any worse.

The U.S.-China trade relationship is the single most important trading relationship for the United States in the 21st century, and we had better get it right. As our annual bilateral trade deficit with China approaches the politically unsustainable figure of a quarter of a trillion dollars, it is clear that we need a new policy model of dealing with China trade problems. AISI supports, as initial steps in the right direction, the recent U.S. government policy moves to apply countervailing duty law to imports from China and to pursue a WTO action against China's prohibited subsidies. However, there are additional concrete policy actions that we believe must be implemented this year to help avoid a worsening trade crisis. These include: (1) addressing Chinese currency misalignment; and (2) maintaining, strengthening and enforcing our vital trade remedy laws.

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Thank you for this opportunity to testify before the Commission today. I hope my remarks have provided some insight into the domestic steel industry's views on these important matters. AISI strongly supports the work of the U.S.-China Commission, and we consider your work to be an essential component of getting our China trade relationship "right." I look forward to our continued dialogue during the question and answer session.