



How China's Steel Mess Was Forged

by Joe Studwell



IS THE RIO Tinto case interesting? The question is a little churlish. For Rio employees Stern Hu, Liu Caikui, Ge Minqiang and Wang Yong, five weeks' detention—two days short of the statutory 37-day maximum—at the pleasure of the Shanghai branch (reputation particularly unpleasant) of China's State Security Bureau is almost certainly the most interesting thing that has ever happened to them. Since accusations tantamount to espionage were set aside in favor of more pedestrian charges of bribery and theft of trade secrets, and the Shanghai Public Security Bureau has taken charge of the case, it is hopefully a little less interesting.

The bigger question is what the Rio case and its essential context—China's handling of multibillion dollar iron ore imports—tells us about the state of the nation. There are two points, the first well known to almost everybody, the second a little less obvious and more interesting.

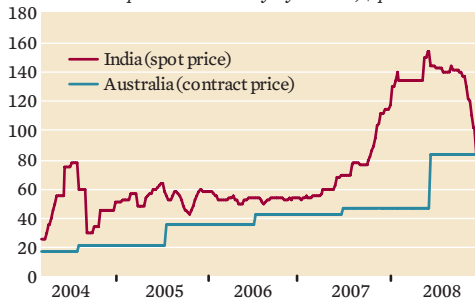
The first point is that the lamentable handling of the case—the resort to the state-security apparatus, the detention

without access to lawyers, the idiotic claim that China's steelmakers have overpaid for iron ore by more than \$100 billion—all point to a society where rule of law is neither keenly pursued nor necessary to narrow economic development.

China's developmental model is actually predicated on weak rule of law, and this is unlikely to change in the foreseeable future. To be fair to the Chinese state, it has never misled anyone about this. The country's constitution commits it to “socialist rule of law.” This is less like Anglo-Saxon rule of law than it is a restatement of the seminal socialist ideologue Georgi Plekhanov's dictum: “The supreme law is the welfare of the revolution.”

China's current revolution, of course, is its economic one. Throughout the development process, the country's leaders have used vague property rights and a biddable legal system to induce competitive forces that might otherwise have been absent.

∞ *Mr. Studwell's latest book is Asian Godfathers: Money and Power in Hong Kong and South-East Asia (Atlantic Monthly Press, 2007). He is currently writing a comparative history of development in Asia.*

BENCHMARKING BREAKS DOWN*Iron-ore prices on delivery by source, \$ per ton*

SOURCE: MACQUARIE RESEARCH

State sector managers, local politicians, private entrepreneurs and farmers have been driven to build businesses on the basis than that they *might* own the assets they work with. Ambiguity has been essential to China's transition away from almost complete public ownership. It is not the laws that have led investment, but the promise of growth and surplus.

The obvious point of contrast is the Russian voucher-privatization program of the early 1990s. There the legal situation was crystal clear. All entitled citizens owned a piece of the state's assets, embodied in the vouchers they were given. But in the absence of widely diffused information as to the value of the assets, the experiment was a disaster. A few well informed individuals with links to the banking system stepped in and bought up the vouchers at massive discounts to their long-term value. The result is an economy dominated by rentier billionaires who cruise the Mediterranean on outsize yachts and buy foreign soccer clubs instead of working in the developmental interests of their country. A pale imitation of this scenario exists in Southeast Asia.

China is not a law-led state and this has sometimes been a good thing in handling transitional property rights: It is hard to steal or expropriate assets with no clear legal identity, so state and private entrepreneurs have focused more on sweating the

assets they have access to, but not clear ownership of. Unfortunately, legal opacity and a general contempt for due process have huge knock-on effects for ordinary people, as the Rio Tinto employees learned. Much more ordinary people—none like Stern Hu with a Chinese ethnicity but an Australian passport—run up against the Chinese Leviathan and discover the same thing every day.

The first conclusion to be drawn from the Rio case is not—as some influential academics suggest—that a country like China has to have more rule of law in order to grow. This has been, and still is, palpably untrue. Nazi Germany and Stalin's Russia, after all, grew like topsy. Instead, the case for rule of law rests on a broader definition of development than just GDP growth.

Amartya Sen has observed that the debate about democracy's relationship to development is based on a false distinction—democracy is a part of development so the question of whether it is a condition is irrelevant—and the rule of law is no different. The right of habeas corpus, access to legal counsel, public court hearings, avoidance of prejudicial actions prior to cases—witness Chinese deputy foreign minister Liu Jieyu telling Australian television that the Rio Tinto employees would go down in an Australian court and ask yourself why a foreign minister is privy to the purported facts of the case—are all matters of institutional development that require no economic justification. China, to put it bluntly, is now economically a middle-income state but institutionally a backward one.

THE ABOVE IS the part of the Rio saga that anybody familiar with China can work out, and probably has worked out, for himself. The less explored part of the story is the extent to which the seaborne iron-ore trade that provides the backdrop to the Rio arrests is a microcosm of the problems and vagaries

of China's economic development model. Beyond the screaming and shouting and name-calling lies a morality tale about China's unprecedented, and hence deeply unpredictable, developmental policy mix that is half statist and half neoliberal.

To understand this, one must understand a bit about the history of ore trading. Prior to World War II, steel mills in Europe and North America were built next to iron-ore deposits. But with the advent of larger ships and lower transportation costs, post-war planners in Japan, Korea and Germany figured they could make internationally competitive steel based on imported raw materials. Many economists—particularly American ones sent to support the reconstruction of new Cold War allies—thought the economics of steelmaking in Japan, and particularly Korea, made no sense. They were wrong.

The Japanese, and the Koreans in their wake, built steel, nonferrous metal, and shipbuilding industries based on integrated, long-term investment and financing plans. Nonplan investment was prevented through moral suasion—industry associations in Japan and Korea were highly cohesive and effective organizations—as well as financing constraints for anyone not inside the plan.

The Japanese were particularly punctilious planners, typically looking ahead in great detail on a 10-year horizon. Critically, they did not simply plan their own activities, they also planned those of their suppliers. In the steel industry, foreign iron-ore miners became habituated to a perennial ritual of going to Japan to discuss not only order volumes and prices, but also technical details and the miners' own investment

plans all in excruciating detail.

The outcome was that the miners knew, more or less, what was going on in Japan and Korea, and Japan and Korea were able to ensure that ore output expanded in line with their import requirements. Overall, indeed, the Japanese and Koreans were adept at making miners produce a bit more ore than they really needed, so their highly profitable steel industries grew up in bearish commodities markets.

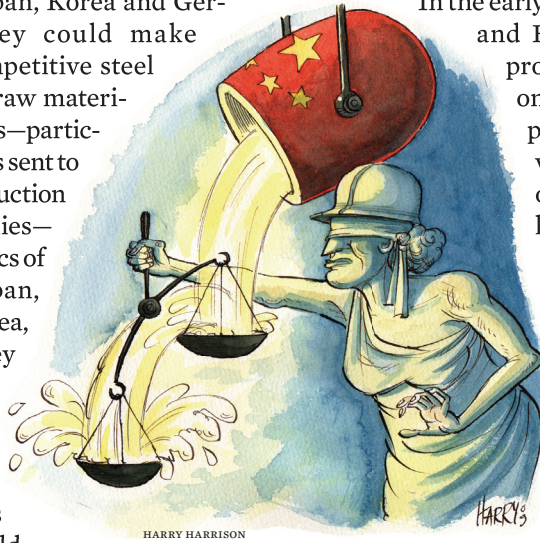
You cannot, of course, plan everything.

In the early 1980s, the Japanese

and Koreans ran into a problem with the second oil shock. Transportation is the key variable in the cost of seaborne ore and a high oil price made shipments of ore from one of the world's two key exporting regions, Latin America, increasingly uncompetitive in Asia. Japanese and Korean steelmakers

thereby faced a trend to rising dependency on Australian producers. They, and Japan's Ministry of International Trade and Industry, did not like this because of cost implications as Australian miners gained pricing power, and because at the time Australian mines were subject to frequent industrial action by powerful unions.

So the Japanese, supported by the Koreans, did a very clever thing. Despite the fact that transportation costs had gone up, the commodity market was far from bullish. Japan and Korea formed the bulk of the world's seaborne iron-ore market, which they largely created. Investment capital in the 1980s was expensive because of high global interest rates. But Japanese and Ko-



rean banks, protected by capital controls, were stuffed full of cash at just the moment Latin America was experiencing a debt crisis. So Japan and Korea offered to finance Latin American, and some Australian, mine investments and to guarantee to buy minimum volumes of iron ore. Uniquely among traded commodities, from the mid-1980s prices were to be set once a year, based on the latest year's relationship between supply and demand.

The net effect was that Japan and Korea kept Latin American producers in business in Asia. The single new "benchmark" price was agreed "free on board," or without transportation costs included. The buyers swallowed the transportation differential between Australian versus Latin American ore in the interests of a more diversified supplier base. As the oil price fell in the second half of the 1980s and 1990s, steelmakers were able to react to periodic Australian demands for higher ore prices by shifting volumes to Latin America. The miners, as one experienced Australian executive puts it, "copped it."

The moral of this story is that the Japanese and the Koreans made a plan and stuck to it. Partly as a result, they were able to build large steel industries in what continued to be a buyer's market for iron ore.

THEN CHINA ARRIVED. With the benefit of hindsight, China disrupted the iron and steel industry in two ways, first by an almost complete failure to stick to plans, and second by an increasingly important bifurcation between a group of traditional state-sector producers and a new group of private, and sometimes messily hybrid state-private, producers. The tension between these two groups is at the root of the failure to stick to plans: The former cannot be forced out of business, the latter cannot be prevented from getting into business.

That China was different should have

been apparent from the outset. To most industry players it was not because the China difference did not matter. Chinese iron and steel production began from a low base and the big producers' limited requirements for iron-ore imports—China has its own iron ore deposits, just not many cheaply accessible high quality ones—were comfortably accommodated within the benchmark-price, term-contract system. Steel output jumped by half as a result of the 1992-94 investment boom that followed Deng Xiaoping's "Southern Tour," and massively outstripped government plans, but the low-base effect was such that it did not have a serious impact on global iron-ore prices.

Fast forward to China's next investment boom, beginning in 2002. Here the underlying pattern has been the same, but the outcome very different. By 2000, China already had steel output around 1.5 times that of Japan, so the country was capable of global effects. From 2000-09, China increased output by more than three times, accounting for over 70% of all new steel capacity in the world in that period. Steel production last year, 489 million tons, constituted 36% of all steel produced on the planet. In the late '90s, the then Ministry of Metallurgy published a long-range plan in which it said the targeted upper limit for Chinese steel output was 142 million tons.

The Metallurgy Bureau has had plans, the National Development and Reform Commission has had plans, government-run producer group China Iron and Steel Association has had plans, but none has informed reality. Beijing has been unable to guide the steel industry's development—although it effectively finances it through the state banking system—with the country's 31 provinces and provincial-level cities making their own plans about how much capacity makes sense.

Some provinces, usually ones with old steel industry bases, have backed the ex-

pansion of existing state sector steel producers while others favored private sector plants whose massively increased capacity now accounts, by an estimate from Australian investment bank Macquarie, for 45% of Chinese production. Where Japan and Korea built their steel and ship-building capacity with one eye fixed firmly on the iron-ore supply situation, China has both eyes looking at capacity.

The upshot is that while global steel prices less than doubled between 2000 and 2008, the price of iron ore quadrupled. In the same period, China's iron-ore import bill went from a couple of billion dollars to \$59 billion.

China has so far exceeded expected steel output that it has blown a hole in the term-contract system for buying ore, inducing a large spot market where prices have been two to 2.5 times those set annually by the benchmark system. Even though the benchmark price went up to \$83 per ton in 2008 from \$17 in 2004, the benchmark system miners—BHP Billiton, Rio Tinto and Brazil's Vale—have been unwilling to offer higher volumes at a one-year fixed rate when the spot-market price is so much higher.

The spot versus benchmark differential means that mostly state-owned mills with access to benchmark quota have been getting ore cheaper than they would in a unified market, while mostly private mills have been paying more because about half of current supply is tied up in the benchmark system. Chinese mills and state trading companies with quota access have bought up all they were allowed to and on-sold what they did not need at or above the spot price. As one loosely indicative example, turnover at the trading subsidiary of China's then-biggest steelmaker, Baogang,

jumped 115% in the last full year before the financial crisis, to \$2.7 billion.

The differential between benchmark and spot prices pretty much guarantees corruption and ill will. There are massive incentives to pay money to gain quota access and those without quota loathe those who have it. But the overarching reality is that the whole world is paying a lot more money for iron ore because of China. A combination of dispersed political and financial power—both across provinces with

country-like populations and within central government—and an ideological uncertainty as to whether to favor plan or market, has opened the way to murderous levels of capital investment as the country has gone to more

than one-third from 10% of global steel production in less than a decade.

When the global financial crisis hit last year, the China Iron and Steel Association—largely a collection of old-style industry apparatchiks that was supposed to negotiate this year's benchmark price on behalf of Chinese mills—figured it would use China's vast capacity to beat the price down. This showed a poor grasp of business. Where the Japanese and Koreans sorted out the ore and then built the capacity, China wants to do things the other way round. The miners, now consolidated into very large firms and run by bean counters rather than the boozy engineers of yore, know that this is no negotiating position at all.

Earlier this year the big three refused to meet CISA's demands and there is now no Chinese benchmark price. Executives at the big three say that for the most part they are giving existing agreed volumes to Chinese buyers based on the 2009 benchmark price agreed with Japan and Korea. But everything else is being determined by a spot

China's development model is predicated on weak rule of law. This is unlikely to change in the foreseeable future.

market that is flying once more. The orgy of bank lending this year as China moves to debt stimulus and construction booms across the country (more than half of Chinese steel is used in the construction sector) mean that both steel output and iron ore imports will set new records in 2009. As of late August, most analysts think ore imports will break through 500 million tons, the question being by how much.

WHAT CAN CHINA do? Probably nothing. China's dirigiste ambitions versus its often chaotic reality, its competing fiefdoms and its ideological uncertainty put it over a barrel. The development of almost all manufacturing—cars, chemicals, consumer goods, and so on—has been characterized by chaotic, unplanned growth, as leaders like Premier Wen Jiabao regularly attest. Yet effective investment anywhere has to be planned in some way, either on the input side by the price and quantity of available capital or on the output side by bureaucratic fiat. China is not very good at the first, and not very good at the second. So in any given value chain when China needs something it does not have or cannot make itself, exporters to China find themselves in a strong position.

Some people say this is a temporary phenomenon. China is so big that eventually it will make and dig up everything it needs itself. But this is not presently the case with iron ore. And apparatchiks at CISA and in central government—ones who, to distill China to its current core, go to the Party School but are assigned Paul Samuelson—are enraged by what they see as a conspiracy of foreigners to take advantage of China.

This is the background to the Rio Tinto case. There is little doubt that investigators have some evidence against the Rio employees, as they have against Tan Yixin, an executive at Capital Iron & Steel who

was also detained in July and arrested in August, charged with selling commercial secrets. But even if the deputy foreign minister is right and convictions are obtained that would be upheld in Australia, where is the surprise in an industry in which government provides hopelessly inaccurate projections, regards information as a state monopoly and permits a two-tier ore price that encourages corruption?

More interesting is how the Rio defendants are treated. Senior cadres will want convictions and punishment, since anything less is an unspeakable loss of face. But if the evidence presented does not stand up to international scrutiny, China has a new problem. Stern Hu holds an Australian passport and the Australian government has made clear its intention to ensure he is treated according to international norms. If the evidence isn't up to much, the pressure will be to convict Mr. Hu and let him go on spurious medical grounds. True to form, China will then put the boot in more firmly with the Chinese passport holders.

This ought to be the biggest loss of face of all: treating Chinese people worse because they have no foreign passport. But it is not, because, as noted at the outset, China's leaders have no serious commitment to Anglo Saxon-style rule of law. When push comes to shove, they will not trade socialist rule of law for having the world think better of them.

The people who do care are other ethnic Chinese businessmen like Stern Hu who hold foreign passports. As one example, because of links to the renewable energy department of the University of New South Wales, the top-most echelon of China's solar energy industry is heavily populated with ethnic Chinese who hold Australian passports. It is that kind of person, who has made a decision to place their nationality with a different kind of jurisdiction, who will be watching this case very closely. ■