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The Art of the Steel Deal

Why the U.S. and China Need a Production Rebalance

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In early April, U.S. President Donald Trump <sup>[1]</sup> and his Chinese counterpart, Xi Jinping, met for the first time <sup>[2]</sup> to discuss relations between the world's two most powerful countries. The summit, largely focused on bilateral economic issues, ended with the announcement of a 100-day plan for trade talks between the two countries. The goal of the talks, according to U.S. Commerce Secretary Wilbur Ross <sup>[3]</sup>, would be to fulfill one of the Trump campaign's promises by reducing the \$347 billion U.S. trade deficit with China, which in 2016 accounted for nearly 70 percent of the United States' total trade deficit <sup>[4]</sup> of \$502 billion.

Last week, on May 12, the two sides announced <sup>[5]</sup> the results from some initial negotiations. China agreed, among other things, to improve market access for U.S. credit-rating agencies and to remove import restrictions on U.S. beef. The United States, in turn, made concessions on Chinese poultry and said that it "recognizes the importance of" China's One Belt and One Road (OBOR) economic initiative—a symbolic shift from the previous administration, which had reacted with indifference. The press release also had language encouraging China to receive U.S. liquefied natural gas (LNG) exports and stated that the United States "welcomes direct investment by Chinese entrepreneurs as it does by entrepreneurs from other countries."

Negotiations will continue throughout the 100-day period, which ends on July 16. But to make further progress on major issues in the bilateral relationship, Washington and Beijing will need to identify "sweet spots" that fit both of their agendas <sup>[6]</sup>. One such sweet spot is steel. China's steel production currently accounts for over 50 percent of the global total. Yet its steel industry is plagued by overcapacity and is responsible for high levels of pollution—an increasing concern for China. At the same time, the Trump administration is attempting to revive U.S. steel manufacturing, which today accounts for less than five percent of world output.

The time is therefore right for a U.S.-Chinese trade deal that would help rebalance global steel manufacturing. Such a deal would involve China cutting its own domestic steel production while at the same time encouraging Chinese investors and firms to invest in steel production in the United States. This would have an especially positive impact on the environment, given the relative carbon efficiency of U.S. steel making. Such a move, moreover, would be a highly symbolic deal on one of the most contentious subjects between the United States and China.

STEELY HAN

The rapid growth of China's steel industry played an important role in the country's industrialization <sup>[7]</sup>. Between 1990 and 2015, Chinese steel output expanded from ten percent to 50 percent of the global total. And today, facing an increasingly saturated domestic market, Chinese steel makers have set their sights on the international market. Between 2006 and 2015, exports of Chinese steel products more than doubled, from 52 million tons to 112 million tons.

Yet today, the excessive production and export of steel has become a problem for China. According to official statistics, steel has been the least profitable <sup>[8]</sup> of all Chinese manufacturing industries over the past six years, thanks to shrinking global demand as well as the improved enforcement of China's environmental laws. Decreasing financial gains come at a significant cost for the rest of the country. For example, Chinese steel exports are a major cause of international trade disputes. In 2016, among the 119 anti-dumping and anti-subsidy investigations <sup>[9]</sup> brought against China by its trading partners, 49 were concerned with Chinese steel products.

As Chinese steel makes less and less economic sense, its environmental costs loom larger. A 2014 study <sup>[10]</sup> from the Natural Resources Defense Council, for instance, found that coal, a main ingredient in Chinese steel making, would be 40 percent more expensive if the local social and environmental costs were taken into account. This comes at a time when Chinese citizens and officials alike are increasingly anxious to improve the country's environmental record—according to one recent online survey, air pollution was the single most important issue <sup>[11]</sup> to the Chinese public.

To improve the record, China will have to cut back on its exports of energy-intensive goods such as steel. One 2015 study <sup>[12]</sup> indicated that export-related production in all sectors accounted for 15 percent of the country's emissions of PM2.5, a deadly industrial byproduct that kills 157,000 Chinese people each year. Exports are also responsible for around 20 percent <sup>[13]</sup> of the country's carbon dioxide emissions—a substantial amount, given that China is the world's largest carbon emitter. Because China's steel industry uses more energy than any other domestic industries, the country needs to greatly reduce its production in order both to combat local pollution and to fulfill its commitment as part of the Paris agreement to reach peak carbon emissions by 2030.

The Chinese government is already taking some steps toward reducing production. In April, it announced a plan to create a massive “special economic zone” called the Xiongan New Area in Hebei Province. Hebei is the heartland of China's steel industry and is currently responsible for almost one-quarter of the country's steel output. To make way for Xiongan, which the government has billed as <sup>[14]</sup> a “world-class, green, modern and smart city,” many of the old polluting steel mills will have to go.

## LEAN AND GREEN

At the same time that China is looking to cut back on its steel production, U.S. steel manufacturing is once again becoming economically viable thanks to the recent revolution in shale gas production. Energy accounts for up to 40 percent <sup>[15]</sup> of the total cost of steel making; today the price of LNG is 70 percent lower in the United States than in China, and electricity for industrial consumers is almost 40 percent cheaper <sup>[16]</sup>, which makes energy-intensive manufacturing in the United States increasingly attractive. In addition to being competitive, U.S. steel is cleaner: the manufacturing process emits 24 percent less carbon <sup>[17]</sup> than in China. Some companies are already taking note. In 2017, one of the largest steel companies in Taiwan announced that it had abandoned a scheme to invest in Vietnam and was instead planning on investing \$1.6 billion to build a steel factory <sup>[18]</sup> in the United States. The opportunity is further illustrated by recent investments <sup>[19]</sup> in the United States by Chinese manufacturers in other energy-intensive industries <sup>[20]</sup>, such as glass, paper, and aluminum.

A rebalancing of steel production would cost jobs in China, but international relocation of steel capacity from China is already taking place. A number of state-owned steel conglomerates have acquired overseas facilities, including HBIS Group's purchase of the largest steel mill in Serbia <sup>[21]</sup>; Shougang Steel's investment in a new plant in Malaysia <sup>[22]</sup>; Wuhan Steel's new plant in Liberia; and Nanjing Iron and Steel's joint venture <sup>[23]</sup> with a local partner in Indonesia. A private Chinese steel company, Delong, has also recently invested in Thailand <sup>[24]</sup>. This international investment has so far been focused on countries involved in OBOR. But although such investment aligns with Xi's signature foreign policy and thus is likely to help Chinese companies' domestic legitimacy, it is economically risky thanks to these countries' weak institutional infrastructures and high levels of political uncertainty.

OBOR was initially designed in part as a geopolitical gambit to counter former U.S. President Barack Obama's pivot to Asia, symbolized by the now defunct Trans-Pacific Partnership. But today, with TPP dead and the Trump administration looking more favorably on OBOR, the geopolitical arguments for Chinese investment in the United States have become considerably stronger.

From an American perspective, meanwhile, any increase in domestic steel production would be a political victory for Trump, who campaigned in part on a promise to restore U.S. manufacturing to its former prominence. The U.S. steel industry currently employs about 269,000 workers <sup>[25]</sup>, accounting for less than 0.2 percent of the U.S. work force. However, steel production is largely concentrated in several Rust Belt states, including Indiana, Michigan, Ohio, and Pennsylvania, which played a key role in electing Trump. As a result, economic growth and job creation in these states are high on the new president's agenda. Indeed, just two weeks after Xi's visit, Trump signed an executive order <sup>[26]</sup> that launched a wide-ranging investigation of steel imports and their impact on U.S. national security, with the aim of protecting domestic production and employment.

## GETTING TO YES

Washington and Beijing are both in a position to make a deal—one that would cut steel production in China while encouraging Chinese steel companies to invest in the United States. This should include measures discouraging steel exports on the Chinese side, which would be more effective than the current punitive tariff imposed by the United States at the border. For example, China should remove incentives to steel exports, such as its value-added tax (VAT) rebates <sup>[27]</sup>, which refund to steel producers part of the VAT they pay when making export sales. China should also return to enforcing its export tariff on energy-intensive products, such as steel, which it introduced in the middle of the previous decade amid concerns about the environment and the country's resource security. Since the financial crisis of 2007–08, however, the export tariff has been largely scaled down to help the steel industry weather tougher economic conditions. By taking measures to restrict its steel exports, however, China can free itself from accusations of steel dumping while building goodwill with the Trump administration as the two countries continue to negotiate a bilateral investment treaty. On the American side, the Trump administration should make clear that Chinese investment in the U.S. steel industry is welcome and unlikely to cause national security problems.

During the past several decades, production in a number of energy-intensive industries, such as steel, aluminum, and glass, has been moved from the advanced economies to China. This movement has brought economic gains but has also had significant adverse consequences, including an environmental burden for China and a worsened economic and social climate <sup>[28]</sup> for certain regions in the developed countries. A U.S.-Chinese agreement on steel will not be easy to reach, but if done successfully, it would be a step toward rebalancing energy-intensive production globally. And by reducing the environmental costs of steel production, the deal would benefit the world.

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