In China, Beijing Fights Losing Battle to Rein In Factory Production

Some Chinese Localities Stymie Efforts to Curb Industrial Overcapacity and Pollution

By Lingling Wei Follow *and Bob Davis* Follow

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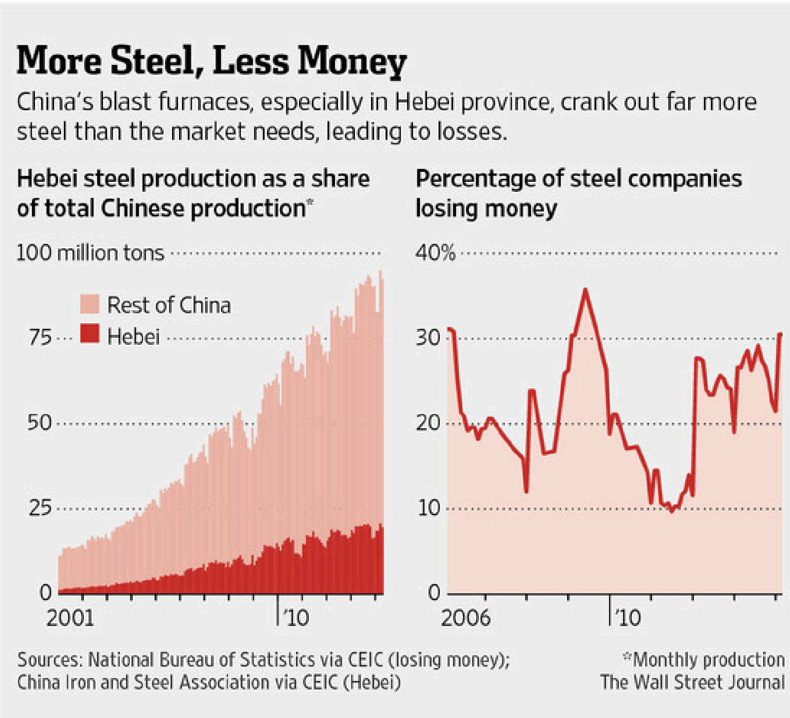
XINGTAI, China—The "steel king" of this drab city in northeast China was forced to shut down his mill and furlough some 3,000 workers without pay last November after the company's banks cut off funding.

It was a big blow for the magnate, Wang Chaojun. But it was a triumph for Beijing, which last year moved to stem excess factory production that is weighing on the economy and turning Chinese skies gray with smog. The banks, in fact, withdrew the loans, totaling $177 million, because of the central government's call to streamline the steel business.

Now, just eight months later, Mr. Wang is preparing to reignite his blast furnaces. His unlikely savior: the Chinese government, in this case the city of Xingtai, which is arranging a merger to put Mr. Wang back in business. "The local government is trying to help us resume production as soon as possible," says Mr. Wang, chairman of Longhai Steel Group.

China's most-senior leaders say they mean business when it comes to reducing industrial overproduction, which is becoming a big worry for the country as it downshifts to slower economic growth. Unneeded factories are sapping corporate profits, wasting money and worsening pollution. But leaders are running into determined opposition—from the thousands of government officials charged with carrying out Beijing's plans.

While a tug of war between local officials and China's regimes isn't as unusual as some Westerners might think, this one has already featured a rare public scolding from Beijing as well as the televised spectacle of a province blowing up furnaces without really reducing production. The stakes behind this battle are high: economists and Chinese officials say China needs to remake its economy to become less dependent on investment in capital-intensive, highly polluting industries and more on consumer spending and service industries. But to do so it will have to convince localities that are more concerned about protecting jobs and businesses.



"Don't think just of the central government" when considering Chinese economic policy, says John Zhao, chief executive of Hony Capital, a private-equity firm in Beijing. "China has 30-some provinces and powerful cities and they all run their own economic policies."

The changes are just part of the central government's economic reforms, many of which could be more difficult than controlling capacity. Beijing's agenda includes restructuring inefficient state-owned firms, revamping China's agricultural land system and remaking the tax system. Those changes also pit the central government against local officials and their allies in industry.

China's finance minister, Lou Jiwei, said that China's problems with excess capacity were discussed last week during the annual talks between the two nations, called the Strategic & Economic Dialogue. "The key is for China to take a market-based approach to digesting overcapacity," Mr. Lou said at a press briefing. A U.S. Treasury official said that resolving the problem would "foster competition and level the playing field for U.S. firms" that compete with Chinese manufacturers.

Shutting down excess capacity presents severe problems for local leaders, including unemployment, flagging government revenue and a growing number of defaults. And since local governments get the bulk of their industrial taxes from factory production, not profit, they have an incentive to keep companies operating even if they are in the red.

In a surprisingly strong rebuff, Premier Li Keqiang brought up the issue at a meeting of the State Council, the Chinese government's top decision-making body, accusing local governments of dragging their feet on reform policies. "Some [local] government officials hold the belief that doing nothing is better than doing something wrong," Mr. Li said, according to an account posted on the Chinese government's website.

Excess capacity is the difference between a factory's potential output and its actual production. The more a factory uses its machinery, the more efficiently it runs, with costs for rent, power, and other overhead spread across more products. Economists say healthy, profitable industries run at around 85% capacity utilization. Yet China's capacity utilization across all industries barely tops 70%, the International Monetary Fund says.

Many of China's industrial giants assumed the country would keep growing at double-digit rates indefinitely, allowing it to absorb extra capacity. But when the economy slowed to closer to 7.5%, mills choked with metal. "You can't overstate the urgency to tackle the overcapacity problem now," says Li Xinchuang, chairman of China Metallurgical Industry Planning and Research Institute, a state think tank that helped draft Beijing's policy to shrink the steel industry.

China's gross domestic product in the second quarter rose 7.5% from a year earlier, up from 7.4% growth in the first quarter, China's National Bureau of Statistics said Wednesday morning.

In a statement to The Wall Street Journal, the Ministry of Industry and Information Technology, which oversees the steel industry, said various levels of government are "in the process of implementing" reductions in overcapacity and that there are initial signs of progress. Still, according to China's National Bureau of Statistics, about one-third of steel, aluminum and cement makers lost money in the first quarter of 2014.

Rolls of steel sheets at the Hebei Xinjin Iron & Steel Co. in Hebei province. ILLUSTRATION: TIM FRANCO FOR THE WALL STREET JOURNAL

Companies stay afloat by borrowing, adding to China's rapidly-growing debt levels. The steel industry alone has some $480 billion in outstanding debt—more than twice the amount of five years ago, estimates the China Iron and Steel Association. Half of the debt consists of bank loans. Banks, including his own, "are feeling pressure" from the inability of steel companies to repay loans, says Xiang Songzuo, chief economist at Agricultural Bank of China Ltd.

Last year, China's Ministry of Industry and Information Technology named 19 industries marked by overcapacity, up from three a decade earlier. The State Council approved plans to reduce production in at least five of those industries: cement, aluminum, sheet glass, shipbuilding and steel. But prices and profit margins have since fallen in the targeted industries, a possible sign that excess capacity is still increasing, economists say.

The Organization for Economic Cooperation and Development in Paris forecasts that steel capacity in China will expand, rather than contract, this year and next, though at a slower pace than it has since 2011. China's excess steel capacity has quadrupled since 2006 and now accounts for more than a third of spare capacity globally, the organization says.

China's steel industry is now so vast and uncoordinated that government officials don't even know how many steel companies there are in the country—about 1,200 is the best guess. Beijing wants to cut 80 million tons of excess capacity by 2017.

Three-quarters of the cutbacks are supposed to come from Hebei, a Nebraska-sized province of 73 million people that rings Beijing like a choke collar and which provides a good vantage point for watching Beijing try to impose its policies.

An industrial powerhouse, Hebei produces about 190 million tons of crude steel a year, about twice as much as the entire U.S. It is also home to seven of China's 10 most-polluted cities, according to Chinese government statistics. Xingtai, China's most-polluted city, is encircled by dozens of steel mills, cement plants and coal pits. Its roads are wetted down to keep coal and steel dust from escaping into the air, but soot still coats the hands of visitors.

Hebei officials argue it is unfair to put so much of the capacity-cutting burden on them. Should Hebei meet its reduction targets, it would reduce tax receipts by about 10% and put 200,000 people out of work, Hebei estimates.

Eager to appear compliant with Beijing's rules, though, Hebei late last year staged an event called "Operation Sunday" in which it dispatched demolition squads to blow up blast furnaces owned by 15 mills. Video of imploding furnaces was broadcast on state television. The razing reduced the province's steelmaking capacity by 6.8 million tons, Hebei said, nearly half the province's annual goal.

Or so it seemed. All of the furnaces targeted for destruction turned out to be so outmoded that the companies that owned them didn't consider them spare capacity, steel-industry officials say, meaning they didn't help reduce the province's extra volume.

"Do any of the blasted furnaces affect capacity at all?" asked Du Wenhua, marketing chief of Jinan Steel Group, a big steel company in Jinan, east of Hebei. "No. They have been in limbo for a long time." Press officials in the Hebei provincial government declined to comment, as did the central government.

Hebei's steel production declined by 4.7%, or two million tons, in the first quarter compared with a year earlier, according to the China Iron and Steel Association. But that didn't necessarily come from destroying spare capacity. Some mills are producing less because of weaker demand, even as they maintain their capacity, while overall Chinese production keeps climbing.

Since 2000, Beijing has told Hebei to cut capacity several other times, but local officials each time rebuffed the plans. When China's planning agency ordered smaller blast furnaces be closed in 2009, for instance, Hebei Tianzhu Iron & Steel Group in Tangshan dismantled four of them and won a $785,000 bonus for doing so from the central government. The steelmaker then turned around and built a much larger blast furnace. "We didn't waste the money, but used it to expand our production capacity," says a company official, who declined to be identified.

Beijing leaders say this time will be different. Late last year, Communist Party chief Xi Jinping told local officials in Hebei that they must force through changes, even though "many will hurt the interests of someone," according to Xinhua, China's state-controlled news agency.

Premier Li, meanwhile, declared a "war on pollution" in March, which includes steep cuts in some industrial output. China plans to introduce its toughest environmental law next year, which would subject polluters to heavy fines or, for the first time, imprisonment.

Yet knowing exactly what Beijing wants can be hard sometimes. In early June, Mr. Li appeared to give local officials wiggle room by saying they would still be judged on whether they hit economic growth targets. The simplest way to do that would be to let factories keep churning out steel and other commodities.

In Xingtai, the soot-covered city of 500,000, steel magnate Mr. Wang is one of the city's largest taxpayers. Described by local media as a "steel king," the onetime steel trader built Longhai Steel from a dilapidated mill into a local giant that in the mid-2000s generated more than $1.6 billion in annual revenue and employed 4,000, according to Mr. Wang's colleagues.

But starting with the global recession, the 59-year-old had a harder time turning a profit. In 2010, he transferred a 10% stake in his company to state-owned Hebei Iron & Steel, which was scooping up companies under Beijing orders to consolidate the steel industry into 10 megacompanies.

Three years later, when Beijing changed course and told state-owned steel mills to slim down, Hebei Iron & Steel severed ties with Longhai, along with other privately owned steelmakers. Around the same time, three banks pulled their loans to Longhai.

The divestiture helped Hebei Steel argue to Beijing that it had reduced steel capacity by 10 million tons, a person with direct knowledge of the company said, even though the company hadn't actually added or subtracted any production through consolidation and divestitures. Press officials at Hebei Iron & Steel declined to comment.

Left without a patron, Longhai foundered and shut operations late last year. The only sign of action in the sprawling mill during a recent visit was in the company's executive building, where several managers anxiously waited for calls from the city government.

Steel being melted and flattened at this plant in Hebei province, a center for steel factories in China.
ILLUSTRATION: TIM FRANCO FOR THE WALL STREET JOURNAL

A telephone rang with a Wall Street Journal reporter nearby. A Longhai manager answered, talked excitedly and relayed the news. The city government had summoned another prominent local steel boss, Ding Liguo, to discuss a merger.

Mr. Ding's Delong Holdings Ltd., a Singapore-listed company, had its own problems. Its big Xingtai mill is located within 12 miles of city center, which Xingtai's environmental department decreed was too close to continue operations.

Mr. Ding, who wouldn't comment on negotiations with the local government, would have to move his mill—an expensive prospect—face possible closure or work out a deal with the city.

Longhai had already closed 2.6 million tons of steelmaking capacity, an amount similar to Delong's. Closing them both would mean Hebei would be one-third of the way to its 2014 goal of reducing steel capacity. But it would also mean a big hit to Xingtai's finances in lost taxes. Delong's finances were also intertwined with others in the steel industry, so a default could set off a wave of repayment failures.

Longhai's Mr. Wang said the two companies have signed a preliminary agreement to merge, and figures the government's backing will help him get financing he needs to restart his mill. Local government officials and advisers say if the deal were to fall through, they are committed to getting Longhai another partner so it could resume production. A senior Delong executive in Xingtai would say only the company is in talks with Longhai and doesn't have "detailed plans" to merge.

A merged Longhai-Delong steel company would retain its 5.2 million tons of steel capacity, says Mr. Wang. "We've told our employees to stay at home and wait to hear from us," Mr. Wang says.

—Richard Silk and Fanfan Wang contributed to this article.

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Corrections & Amplifications

An earlier version of this article incorrectly referred to the Ministry of Industry and Information Technology as the Ministry of Information and Industry Technology in one reference. (July 15, 2014)