Loans, Firms, and Steel: Is the State Advancing at the Expense of the Private Sector?

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China pulled its economy through the financial crisis by recourse to a massive fiscal and monetary stimulus. While successful, the stimulus has significant hidden costs that will burden the economy in the future. Because it was channeled through state banks to state firms, the stimulus strengthened the relative position of state firms and extended the state’s reach into the economy. Events in the banking and steel industry exemplify the process. Rapidly changing economic conditions open the possibility that the damage may be reversed by good policy-making going forward.

China averted recession by brute force, pumping money into the economy through fiscal and monetary expansion. The medicine was crude but effective, and the patient was pulled back from the brink of death. During the depths of the crisis, the only source of increased demand in the economy was government investment. Having access to fiscal and banking resources, government enterprises saw their bargaining power strongly enhanced at a time when private businesses merely struggled to survive. As the recovery takes hold, demand is beginning to recover in many corners of the economy. Private businesses are finding their feet and in some cases reclaiming initiative. This is an uneven process, and, because economic conditions have been changing with lightning speed since (at least) early 2008, accurate observations may quickly become outdated.

During the summer of 2009, economic policy shifted to a less-intense stimulus of the domestic economy, combined with a greater effort to shift the composition of demand toward consumption and, eventually, exports. This shift corresponds to the transition from the initial crisis phase when it was important to do something—anything—to prop up demand, to a less critical situation in which the government has to blend the stimulus imperative with other objectives. The official position is that the recovery is still fragile, and that therefore bank lending cannot be substantially dialed back.¹

In the early stage of the crisis many observers described a strengthening of the state at the expense of the private sector, and important incidents provide anecdotal support for this view. Recently, (London) Financial Times Asia columnist David Pilling titled a column “The state’s dead hand returns to haunt China.”² Though this sounds very ominous, the reality is far more varied and complex. It is probably not correct to conclude that the private sector is being rolled back in China today. However, it is certainly true that there are tendencies in this direction, and that there is lively debate over the issue. For example, Huang Mengfu, the head of the All-China Federation of Industry and Commerce (Gongshanglian) on 22 September 2009 declared that “in certain
regions and sectors, we’ve observed the phenomenon of the state advancing at the
government's expense of the private sector (guojin mintui) . . . we will pay a serious price for this.”

Huang is a vice-head of the Chinese People’s Consultative Congress, with ministerial rank. He is not part of the ruling elite, but he is highly placed in the hierarchy of consultation on which the Chinese place routine emphasis. He is also a Party member and someone who spent his career in the steel industry (the significance of this will become clear later). Thus, while there is not a “leadership split” over this issue, public discussion has definitely grown louder. Moreover, the views of Huang Mengfu undoubtedly find an echo among some people in the hierarchy, particularly those charged with economic management. To understand the current situation, we look more closely at the evolution of bank lending, and the struggle over control of firms in the steel industry.

Bank Lending

The really big event in China’s response to the global crisis was the decision to encourage banks to lend virtually unlimited amounts of money in the first half of 2009. The sums shoveled out the door were far higher than the amounts involved in the 4 trillion RMB fiscal “Stimulus Plan” announced in November 2008. In order to shovel money out the door as quickly as possible, the government had to instruct bankers to ignore prudential standards and approve projects rapidly. While the government has enormous influence over the entire financial system, direct government control is strongest over the so-called “Big Four,” the four government-owned banks that formed the core of the old planned economy financial system. These four—the Industrial and Commercial Bank of China (ICBC), Bank of Construction, Bank of China, and the Agricultural Bank—have been accounting for a gradually diminishing share of total lending as China’s financial system has become more open and diversified. With the the lending surge in the first quarter of 2009, the “Big Four” accounted for more than 50 percent of the total lending increase. After the massive volume of lending in the first quarter, the People’s Bank of China (PBC, the central bank) expected lending to moderate in the second quarter through June. Instead, the PBC was surprised by the June loan numbers, which hit 1.5 trillion RMB, almost as much as the monthly average for the first quarter.

At this point, the PBC leadership began to feel real alarm. The bank had clearly expected a loan slowdown, because they had been quietly signaling to the “Big Four” to slow the pace of lending.. In fact, the Big Four share of loans declined to 36 percent, but in the super-charged political environment all the other banks besides the Big Four ramped up their lending in June. Policy Banks and Joint Stock Banks, as well as Agricultural Cooperative Banks all joined in the loan fest. For a period at mid-year, a split over credit policy seemed to be developing between the top leadership and the bank’s leaders. The top leadership reaffirmed the need for expansionary credit policy. Now of course the central bank’s top officials don’t dare criticize government policy, but at times its former officials will. After the June numbers came out, the role of critic fell to Wu Xiaoling, who had retired as vice-head of the PBC at the end of 2007. Now vice-
head of the Finance and Economics Committee of the National People’s Congress, Wu can speak out reasonably openly, and clearly represents the thinking of the PBC. When June 2009 lending reversed the moderate downward trend of April and May, Wu Xiaoling was alarmed, and she said so. Her fellow vice-head of the NPC Finance and Economics Committee, Yi Zhongqing, said much the same at the time. The stock market reacted poorly to indications that credit would be tightened, over fears of either a sudden change of course or a split among policy-makers over credit policy.

But by September, things had begun to change. The growth of lending in September was near average patterns, not small, but not over target. Moreover, the Big 4 made only 21 percent of total loans, indicating that efforts to exert control through the administrative system were having effect. A steady stream of measures from the central bank and from the China Bank Regulatory Commission had gradually begun to tighten the reins on state banks. Moreover, the composition of lending had begun to shift toward consumers, and away from companies. Whereas in the first quarter of 2009 only 15 percent of the massive increase in lending had gone to households, by the third quarter, they were receiving 60 percent of it. Most of this increase was due to the revival in mortgage lending that came with the rebirth of the housing market. However, this was in line with policy objectives, and reflected the spreading of the economic recovery beyond the sphere of government investments. With this shift, there was emerging evidence that policy conflict over lending was subsiding. With the recovery spreading, the Chinese stock market was no longer as sensitive as it had been to hints that credit might be restricted (which had sent the market tumbling earlier in the year). At the same time, the slowing of lending seems to have mollified the critics who were speaking out so strenuously in July. Improving conditions have made it easier for the various parties to agree on policy settings, at least for the time being.

The experience of the Big Four banks, riding the credit surge up and down, also shows how quickly fortunes can change as macro policy changes. The balance of power shifted within the banking system. As PBC emphasis shifted to slowing the growth of lending—albeit moderately—the Big Four became instruments of this slowing, just as they had been instruments of the earlier acceleration. Their relative weight in the banking sector slipped. We can see evidence of similar changes caused by macroeconomic conditions in other sectors, including steel.

The Steel Industry

The steel industry can serve as an exemplar of the complex forces reshaping relations between government and private owners. Once the linchpin of the state-run economy, the industry now sees a significant share of its output deriving from the private sector. When this shift began around 2001, private output was only 18.6 million metric tons (MMT). By 2007, private firms produced 197 MMT, or about 40 percent of China’s crude steel output. Most private firms are small and they mainly produce lower-technology products used predominantly in construction. The growth of China’s indigenous industrial machinery industry during the first decade of the 2000s has meant
that domestically produced steel-making equipment is now available for half the price of imported equipment. The construction boom and technological progress dramatically lowered entry barriers to the steel industry.\(^9\)

From the beginning, there has been tension between the central government and this small-scale, and now largely private sector. The center has repeatedly stated its intention to consolidate steel production in a small number of technologically efficient and profitable large enterprises. A wave of “industrial policy” declarations began in 2003, supposedly neutral toward ownership, but in fact heavily biased toward the state sector. The central government moved steadily toward explicit support for growing three large central government SOEs into national champions: Baogang, Angang, and Wugang, and moving Shougang from Beijing to the Bohai coast. The central government is committed to these policies because they serve three objectives simultaneously: moving large mills so they can efficiently use much higher quality imported iron ore; reducing pollution and moving mills out of crowded urban areas; and reaping economies of scale and improved technology. At the same time, the steel industry began to try to establish a unified negotiation position against the global iron ore suppliers (led by Rio Tinto), but, crucially, they did not include private firms in the contract prices that they negotiated.

While this was going on, the center also began to aggressively attempt to shut down surplus capacity and low-tech, small-scale mills. In April 2007 the NDRC negotiated specific compliance contracts with the provincial government leaders of the 10 biggest steel producing provinces, and in December inked similar contracts with another 18 provinces, this time with NDRC vice-head Zhang Guobao personally signing the document, which specified targets and evaluation procedures.\(^10\) These contracts called for the closure of 89 MMT of iron capacity and 78 MMT of steel capacity by the end of 2010. But it didn’t work. Local governments would actually invest more in a site, and declare that they were converting backward capacity to more advanced capacity.\(^11\) Dire predictions about excess capacity and surplus supply made by economists within and outside China never really materialized. China grew explosively, domestic producers substituted for imports and began to export, the market adjusted, and private firms grew. One of the best was the Rizhao Steel Company, set up along the coast in Shandong by Du Shuanghua, from nearby Hebei. A chubby, unpretentious manager who dressed like an ordinary worker most of the time, Du made an impression by starting up his first steel production line at Rizhao in a mere 181 days after initiating construction (he had already built a separate private company). Du aimed to make Rizhao into a several-million-ton steel base, using primarily imported iron ore. Despite the central government’s efforts at consolidation, the private sector seemed to be holding its own in the wake of China’s construction boom.

The Crisis

The crises of year 2008 profoundly disrupted the steel market. The domestic downturn in the first part of the year—particularly evident in the housing market—severely undermined the market for structural steel produced by private firms. As in many other
parts of the economy, private firms were among the first to feel the pain of economic downturn. Moreover, when the financial crisis hit from the outside, private firms did not have many options. As we have seen in an earlier section, by the time credit became available on a massive scale—in January 2009—there was pressure on big banks to lend as quickly as possible, and it was much safer and easier for them to loan to big SOEs than to private firms. Private firms did not generally have access to support from the state banking system. Suddenly, private firms were looking for shelter, any shelter, from the storm. The alternative was bankruptcy.

For state planners, this clearly represented opportunity. Now, finally, there was a chance to implement their long-held desire for consolidation. Moreover, after November 2008, when the government decreed it would do anything to maintain domestic demand, state firms were reasonably assured of support from the state banking system, and were under no pressure to pare back their labor forces: quite the contrary, they were explicitly instructed not to lay off workers. Thus, here was the possibility to fold private firms into the embrace of state-owned enterprises, under conditions in which the private sector was particularly disadvantaged, and the state sector unusually well protected. Across China, scores of merger and acquisition plans were worked out that involved private steel firms accepting some kind of investment, shelter, and control from a state firm. Of all these stories, the one about Rizhao packed the strongest narrative punch. Since at least late 2007, Shandong officials had intended to build a big steel mill at Rizhao—with good access to iron ore imports—perhaps next door to Du’s Rizhao mill. They had also reorganized the province’s state-owned firms, including Jinan Steel and Laiwu Steel. Ironically, it was fears about the takeover of the Laiwu mill that prompted drafting of clauses in the steel industrial policy limiting foreign investment. Du Shuanghua’s back was soon against the wall—his firm lost 800 million RMB in October 2008—and he signed an agreement in principle to merge his firm into Shandong Steel on 5 November 2008.

Yet it was clear that Du, a master of understatement and giving the appearance of compliance to government edicts, was not reconciled to the loss of control of his firm. Moreover, as government stimulus money began to flow into the economy, and the market for structural steel stabilized, Du was quick to see that a new opportunity was being created. Rizhao kept producing at near full capacity through the new year, and was among the first firms to return to profitability. In January, Du pulled off a transaction in which he took a stake in a Hong Kong–listed investment company called Kaiyuan that in turn bought one of Du’s investment companies which in turn held a 30 percent stake in Rizhao Steel (paying 5.2 billion HK dollars). Kaiyuan had few assets and was a consistent money loser, but its chairman, Hu Jishi, was rumored to be related to Hu Jintao. Clearly, Du’s objective was to shelter some or all of his ownership of Rizhao by gaining the protection of Hong Kong property rights—generally respected by Beijing—and perhaps enlisting high-level political protection. Moreover, by linking Rizhao to a listed company, Du greatly complicated Shandong Steel’s takeover plan, and made it impossible for Shandong Steel to value his company at its net asset value (sometimes used as a value standard in China).
The very day that the transaction with Kaiyuan was announced, Rizhao received a “Cease and Desist” order from the State Environmental Protection Bureau (SEPA). SEPA shut down Du’s largest ongoing investment, a billion-dollar hot rolling mill. The rationale was not even strictly “environmental,” but rather based on the fact that the investment was not paired with the elimination of excess backward capacity, and thus did not correspond to the Steel Industrial Policy. Rizhao had passed environmental reviews several times in the past, and, needless to say, this requirement was not strictly enforced on other steel mills, even within Shandong Province. The government of Shandong province was sending Du a very clear message that they were going to reorganize the Shandong industry and he would not be able to mobilize central government support to prevent it. Du’s access to bank lending was suddenly problematic as well. The writing was on the wall.

Du’s Rizhao Company was making robust profits by the first quarter of 2009. In sharp contrast, the main constituents of Shandong Steel, Laiwu Steel and Jinan Steel, were consistent money-losers, despite each having total sales about the same size as Rizhao. (Rizhao turned a profit of 800 million, while Laiwu and Jinan lost 583 million and a whopping 795 million, respectively). It seems that the acquisition was backwards; but access to credit is everything in a financial crisis. Shandong Steel, from its formation in March 2008, had established lines of credit with 12 different banks that gave it access to an astronomical 240 billion RMB.13 Surrounded, Du Shuanghua signed the reorganization agreement with Shandong Steel on 6 September 2009. Shandong Steel will inject 16 billion RMB into the company and take a two-thirds stake, valuing Du’s stake at only 8 billion RMB. Clearly, Du’s maneuvers with Hong Kong’s Kaiyuan Company did not succeed in giving him the valuation he thought was warranted. Adding insult to injury, Shandong Steel is not even ready to take over management of Rizhao. As part of the reorganization, Du Shuanghua and the existing management team leased Rizhao for 3 to 5 years, with full control over profits. Perhaps there is still some room for maneuver in the future. But for now, Rizhao Steel has become part of the state sector.

Evaluation

The takeover of Rizhao Steel was a classic lose-lose situation. In the first place, it does not accomplish any of the stated objectives of central government industrial policy. It is not, in that sense, the “state” advancing, but rather a local interest group that has captured the Shandong provincial government. Indeed, Shandong Province took over Rizhao in part because the central government would not have allowed provincial officials to raise and spend vast sums of money to build their own completely new facility next door to Rizhao, and they saw no other way to build a large-scale provincial facility. Indeed, the takeover of Du’s Rizhao interferes with the consolidation of the industry, since it will mean replacing a manager with a track record of success in the middle of building a large, efficient steel mill with a group of bureaucrats with a track record of failure struggling with an incomplete merger of two medium-sized firms. In five years, Du had built an enterprise that employed 24,000 workers, in 2008, and already produced 7.5 MMT of steel. This was close to a reasonable threshold for scale efficiencies as
mandated by the central government (although the large scale was admittedly cobbled together by having many smaller furnaces side by side).

Thus, this advance of the state is nothing like a systematic wave of nationalization. It is not even anything like the odd personalized combination of socialization and power-grab that we have seen under Putin in Russia, or Hugo Chávez in Venezuela. But it is a reflection of the harmful side effects of flooding the economy with credit. It shows opportunistic local officials and businessmen, armed with public money and taking over valuable assets, all the while presenting themselves, not very plausibly, as advancing the public interest. Moreover, since Chinese policy-makers have never in the past been able to articulate clear guidelines for the privatization process, there are today no publicly stated principles that prevent government from reversing the process and converting a firm or industry to public ownership.

Indeed, from the standpoint of private enterprise, the incident sends a strong signal that the state has not credibly committed to allowing large and competitive private firms to emerge in sectors like steel. The Rizhao takeover needs to be understood in the context of a series of other incidents in the steel industry, dating back to the celebrated case of Tieben Steel Company in 2004. This involved a private entrepreneur, Dai Guofang, who, with the enthusiastic backing of the municipal government of Changzhou in Jiangsu, was building an ambitious 8 MMT steel mill. In the process, multiple violations of (real) environmental regulations were committed, as well as egregious violations of procedures governing land acquisition, population displacement, and investment approval. So when the central government sent an inspection team, forced the mill into bankruptcy, and threw Dai Guofang into prison, there were different ways to look at the case. (Moreover, there were intimations of local government defiance of central government policies, which could be seen as having elicited a strong response from the central government). But around the same time, the Jianlong Steel Company, the second largest private firm, also ran into trouble. Jianlong had outstanding access to an excellent port for iron ore in Ningbo and was expanding rapidly, but, like Tieben, had cut many corners in the investment process. The price of survival for Jianlong was to allow state-owned Hangzhou Steel to take a 43 percent stake in the firm, enough to gain control. After this, the regulatory problems disappeared. Finally, there was the case of the Xiyang Group—still one of the largest private groups in China—and its head, Zhou Furen, one of the richest men in the country. Back in 2005, Zhou purchased an American cold rolling mill, one of the most advanced in China at the time, for 3.5 billion RMB. He intended to install it in coastal Liaoning in Haicheng, where it could be supplied by imported iron ore. Project approval was suspended in the macro readjustment. In all three cases, the measures against the private firms were never overturned. Zhou Furen’s rolling mill, according to reports, sits unused to this day, bottled up at Customs in Yingkou. Dai Guofang, of Tieben, was just released from prison in April, five years almost to the day after he was arrested, while the land on which the mills was to be built still sits idle. In the Jianlong case, Baosteel, China’s top firm and a centrally controlled SOE, has just taken control of Ningbo Steel, effectively forcing out the remaining private owners and seizing management control and port access from provincially controlled SOE Hangzhou Steel. This case shows that the central government is far from immune
from the temptations of expanding control, while also demonstrating that central and local governments can be at cross-purposes in many different configurations.

Each of these three cases, as well as Rizhao, involves a bold attempt to create a modern mill at an advantageous port location. It appears that China does not have room for a large, internationally competitive, but private steel mill. In that sense, the Rizhao case sends a very clear message. Moreover, the case seriously undermines the commitments the Chinese government made to pursue supportive and nondiscriminatory policies toward the private sector outside those areas reserved for the state. These promises were made explicitly in the “36 Articles on the Non-Public Economy,” passed by the State Council with considerable publicity in 2005. In particular, Article 29 of that document states that the government encourages private firms to grow large, make acquisitions, and become nationally and internationally competitive.

It is dangerous to draw too much from a single case, but the Rizhao case is not an isolated one. In the steel industry, multiple recent situations involving the attempted consolidation of large state-owned firms have resulted in the more-or-less involuntary incorporation of private groups. Moreover, significant reversions to state control have occurred in many other sectors, including coal mines (in Shanxi), airlines (Eastern Star Airlines in Wuhan) and even dairy (Mengniu in the wake of the adulterated milk scandal). While Rizhao does not make a trend, it certainly cannot be dismissed as an aberration.

Macrotrends and Private Sector Revival

There is another side to the picture. The revival of the Chinese economy, alluded to in the first sections above, has also affected the steel industry. After the first quarter of 2009, demand for structural steel revived strongly. Inevitably, that has meant a revival of the fortunes of private steel-makers. These steel-makers not only returned to profitability, they actually began to expand investment and take capacity out of mothballs. Moreover, there continue to be examples of the old-fashioned pattern of the private sector advancing at the expense of state ownership (minjin guotui). Even in steel, we continue to see examples of restructuring where a private firm is taking over a state firm (although the state firm is typically failing). Such a bounce-back means that private firms are unlikely to find themselves in quite as weak a bargaining position as they were in 2008 and very early 2009. In that sense, there are probably limits to the state’s “advance.”

The future balance between state and private firms will depend on how the ownership issues intertwine with other macroeconomic and industrial policy issues. Currently, the government is alarmed that the revival in investment in steel is adding to the problem of surplus capacity and low efficiency, polluting industrial plant. Moreover, the Chinese government does not want to unleash a flood of steel on world markets, realizing that this would certainly set off a massive protectionist response in both the United States and the EU. Policy-makers in China certainly recognize that the small-
scale sector—generally private—has been damaged by the economic crisis, and they recognize that this will have harmful effects on the Chinese economy. Trying to redress the balance, the central government has created a new leadership small group, headed by Zhang Dejiang, that seeks to find ways to support the small- and medium-enterprise sector. In related fashion, Li Rongrong, the head of the State Asset Supervision and Administration Commission (SASAC) has recently made it clear that state firms have permission to engage in mutually advantageous restructuring with private firms (those “with good reputations”), which can be seen as a vote of confidence in the private sector. Nevertheless, these initiatives are still far from being a coherent policy package. The revival of the Chinese economy, and its growth away from reliance on government investment, creates a potential opportunity to redress the damages done over the past year. Whether or not the government will seize this opportunity remains to be seen.

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**Notes**

1. This is repeatedly stated in official policy statements. It also ran literally nonstop for three months on the English-language website of the National Bureau of Statistics as a banner headline, because it was the title of the 2009 first-half economic report: http://www.stats.gov.cn/english/nbsdt. The report itself is at http://www.stats.gov.cn/english/newsandcomingevents/t20090716_402572483.htm.


8. Quarterly bank balance sheets with this breakdown are available at http://www.pbc.gov.cn.

9. Shen Wenrong, cited in “Zhongguo gangtie channeng yanzhong guosheng” [China’s steel capacity is seriously excessive] *Zhuobao Jishu* [Foundry Technology], 30:3 (March 2009), p. 311; Meng Yonggang, “Guanzhu zhengqai xhuqi de Zhongguo Mingying gangtie qiyue” [Pay attention to Chinese private steel firms that are right now rising up], *Yejin Guanli* [Guanzhu zhengqai xhuqi de Zhongguo Mingying gangtie qiyue] [If we don’t control lending, there will be a great catastrophe], *XinhuaWang*, 20 August 2009. Accessed at http://money.163.com/m/09/0820/19/5H6CCK5K00252G50.html.

10. Pan Yifang and Men Feng, “Jiahuai taotai gangtie gongye luohou channeng de yanjiu” [A study on accelerating the shake-out of backward capacity in the iron and steel industry], *Gangtie* [Iron and Steel], 44:3 (March 2009), p. 3.

11. Ibid.


15 Gong Jing, “The court ruling on Dai Guofang draws the curtain on a sad drama that shuttered a steel mill,” Caijing [English], 22 April 2009; see Barry Naughton, “Changing the Rules of the Game: Macroeconomic Recontrol and the Struggle for Wealth and Power,” China Leadership Monitor, No. 12, Fall 2004. Tieben was the first private firm in China to seek bankruptcy protection, according to Chen Shanshan.


17 Su Mi, “Hualing chuji minqi Fangda Jituan ‘tunxia’ Nanchang Gangtie” [Hualing situation, private Fangda Group absorbs Nanchang Steel], Diyi Caijing Ribao, 9 October 2009; accessed at http://ccnews.people.com.cn/GB/10162734.html. This is a peculiar case because the northern Fangda group has financial resources but limited steel assets.

18 Chen Yenpeng, Wu Lihua, and Zhang Zhi, “Zhang Dejiang laotou xietiaoxiaozu, zhongxiao qie yue zhengce zhengji 9 yue zhengshi liangxiang” [Zhang Dejiang takes the lead in the coordinating small group, and a formal policy to support small and medium enterprises will be issued in September], Huawixa Shibao, 28 August 2009; accessed at http://finance.sina.com.cn/roll/20090828/21116679995.shtml.