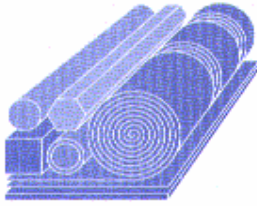


NEWS



SPECIALTY STEEL INDUSTRY OF NORTH AMERICA

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UPDATED STUDY ALLEGES UNFAIR TRADE ADVANTAGES CONFERRED ON CHINA'S STAINLESS STEEL PRODUCERS

(Washington, D.C., August 23, 2007) – International trading rules recognize that foreign governments subsidize industries when they provide financial assistance to benefit the production, manufacture or exportation of goods. This foreign government subsidization ignores free-market principles and runs counter to international trade rules, including the U.S. trade laws.

A report released today by the Specialty Steel Industry of North America (SSINA) alleges that the government of China has spent the past decade breaking these rules with its policy of conferring preferred status on the stainless steel industry, and providing it with a wide range of preferential treatment programs and direct subsidies.

According to *Chinese Government Subsidies to the Stainless Steel Industry*, updated since the last April 2007 report, these policies to ensure the viability of China's stainless steel industry—at the expense of the U.S. industry and workers—attained fruition in 2006 with China becoming the world's largest producer of stainless steel. Not content with achieving this goal in a mere ten years, the report notes that China plans to continue to expand stainless steel production capacity at a staggering rate.

“Today, the U.S. stainless steel industry remains healthy and competitive, even in the face of such egregious unfair Chinese government practices as massive cash infusions and forgiveness of debt for its stainless steel industry,” said SSINA Chairman Doug Kittenbrink. “But many U.S. manufacturers that would otherwise be competitive but for subsidized competition from China are being forced out of business. SSINA members recognize the importance of being able to address Chinese subsidies in the future should the need arise.” Kittenbrink also stated that “the industry will continue to do our research and show how China is playing by its own rules, and not those of the international community, to the detriment of all trading partners.”

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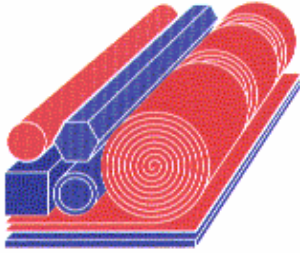
The comprehensive report, which was compiled by the Washington, D.C. law firm Kelly Drye Collier Shannon, lists specific examples of how the government of China subsidizes its stainless steel industry through debt forgiveness, preferential debt financing, government support of technological renovation projects, and preferential tax programs, among others. The entire report, *Chinese Government Subsidies to the Stainless Steel Industry – An Update*, can be found on the industry Web site: www.ssina.com.

Douglas A. Kittenbrink is Executive Vice President, Corporate Planning and International Business Development, Allegheny Technologies Incorporated, Pittsburgh, PA.

SSINA is a Washington, DC-based trade association representing virtually all continental specialty metals producers. Specialty metals are high technology, high value stainless and other specialty alloy products.

Member companies are: AK Steel Corporation, Middletown, OH; ATI Allegheny Ludlum Corporation, Pittsburgh, PA and ATI Allvac, Monroe, NC (both Allegheny Technologies companies); Carpenter Technology Corporation, Reading, PA; Crucible Specialty Metals, Syracuse, NY; Electralloy, Oil City, PA; Haynes International Inc., Kokomo, IN; ThyssenKrupp Mexinox SA de CV, San Luis Potosí, S.L.P., Mexico; North American Stainless, Ghent, KY; Outokumpu Stainless, Inc., Schaumburg, IL; Precision Rolled Products, Inc., Florham Park, NJ; Latrobe Specialty Steel Company, Latrobe, PA; Universal Stainless and Alloy Products, Bridgeville, PA; and Valbruna Slater Stainless Inc., Fort Wayne, IN.

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CHINESE GOVERNMENT SUBSIDIES TO THE STAINLESS STEEL INDUSTRY – AN UPDATE

August 2007

CHINESE GOVERNMENT SUBSIDIES TO THE STAINLESS STEEL INDUSTRY – AN UPDATE AUGUST 2007

I. INTRODUCTION

For the Government of China (“GOC”) and the steel industry in the People’s Republic of China (“China”), 2006 was a watershed year. China became the world’s largest producer of stainless steel, as the Chinese steel industry continued its unprecedented growth by increasing output more than 60 percent (or three million tons) year-on-year.¹ To policymakers in Beijing, 2006 was also significant because a fundamental objective of the GOC’s import-substitution-based industrial policy had been accomplished; namely, China ended its 20-year streak as a net importer of steel products.² While China remains a net importer of stainless and other high-quality steel products at this writing, this deficit is not likely to persist, as China continues to expand stainless steel production capacity at a staggering rate: output is expected to climb in 2007 by an additional 1.5 million tons to reach 6.5 to 7 million tons.³

In an April 2007 study entitled *Chinese Government Subsidies to the Stainless Steel Industry*, the Specialty Steel Industry of North America (“SSINA”) identified a wide range of direct and indirect subsidies offered by the GOC to support the Chinese stainless steel industry’s explosive growth. Citing numerous specific examples of subsidies conferred upon China’s largest stainless steel producers – Taiyuan Iron & Steel Company Co., Ltd. (“TISCO”) and Baoshan Iron & Steel Co., Ltd. (“Baosteel”) – this report also documents the Chinese Government’s actual implementation of this plan over the past decade.

¹ World’s Largest SS Producer, Stainless Steel World, Jan. 22, 2007, available at <http://www.stainless-steel-world.com/news/newsdetail.aspx?newsID=12495>.

² See Top Technology for Steel Giant, Siemens, Jun. 7, 2007, available at w4.siemens.de/megacities/shanghai/pages/printpage.php.

³ See China ranks first in world in stainless steel output, Hong Kong Trade Development Council (Apr. 9, 2007) available at www.tdctrade.com/report/mkt/mkt_070403.htm.

II. TRANSFORMING THE STEEL INDUSTRY: THE CHINESE GOVERNMENT'S STAINLESS STEEL DEVELOPMENT POLICIES

Since the early 1980s, the steel industry in China has undergone a substantial transformation in terms of growth in production capacity, the number and size of firms producing steel, and the types of steel products produced. At each stage of the steel industry's development, the GOC⁴ set policies that guided and assisted the industry. While domestically-produced goods dominated the market for basic steel products throughout the 1990s, the Chinese market for high-quality steel products, such as stainless steel, was initially heavily reliant on imports. Chinese Government policies implemented over the past decade were directly aimed at making the country's stainless steel producers more internationally competitive.

During the 1980s and early 1990s, the GOC's policies were aimed at increasing steelmaking capacity and producing greater quantities of basic steel products.⁵ The number of iron and steel enterprises grew during those years to around 1,600, including many small steel plants.⁶ China's steel output also increased rapidly at an average annual growth rate of 6.6 percent, growing from 37 million tons in 1980 to more than 107.57 million tons of raw steel in 1997, when China became the world's largest steel maker.⁷ Indeed, by the early 1990s, production capacity for certain basic steel products in China, such as carbon steel long products, exceeded domestic demand, resulting in falling steel prices and rising losses among Chinese steelmakers.⁸

⁴ Government of China refers to all levels of government, including federal, central, provincial/state, regional, municipal, city, township, village, local, legislative, administrative or judicial levels.

⁵ See Nolan, Peter and Young, Godfrey, Large Firms and Catch-up in a Transitional Economy: The Case of Shougang Group in China, at 2 (Jan. 2000).

⁶ Id.

⁷ See Chinese Steelmaking to See More Restructuring, Metal Producing (Sept. 1998).

⁸ See Output Controls Boosting China's Steel Industry Profit, Asia Pulse (Aug. 18, 2000).

The experience in the Chinese market for stainless and other high-quality steel products was quite different from that of basic steel products. While the Chinese steel industry supplied approximately 90 percent of the domestic demand for steel products, the remaining 10 percent of demand was met by imports of primarily high-quality products, including stainless steel products.⁹ “Compared with their foreign colleagues, China’s stainless steel manufacturers were characterized by high production cost and poor quality.”¹⁰ Because stainless steel produced in China failed to satisfy international quality standards, the market share of domestic producers actually decreased from 79.2 percent in 1989 to 29.7 percent in 1996.¹¹ Chinese stainless steel producers, moreover, experienced severe financial difficulties due to falling specialty steel prices throughout much of the 1990s.¹² Lacking government measures to support and protect the production of stainless steel in China, such as those previously applied to basic steel products, Chinese producers were unable to compete against foreign producers that offered a better quality product at a lower price.

Between 1996 and 2006, the Chinese Government sought to remedy this disparity by implementing measures that encouraged stainless steel production in China as part of a comprehensive reform of the steel sector under its Five-Year Plans.¹³ The Government intended for domestically-produced stainless steel products to replace imports and, thereby, improve China’s self-sufficiency ratio in stainless steel and reduce its reliance on imports. According to

⁹ See Chinese Steelmaking to See More Restructuring, Metal Producing (Sept. 1998).

¹⁰ See Entry Into WTO to Impact On China’s Stainless Steel Industry, Asia Pulse (Jan. 6, 2000).

¹¹ See The Mineral Industry of China, U.S. Geological Survey – Minerals Information (1998) at 13.

¹² See China’s Special Steel Sector Wipes Out Losses, Asia Pulse (Mar. 28, 2001) (explaining that special steel prices declined from the latter half of 1993 to the end of 1999).

¹³ See China Achieves Steel Import Substitution Plan, Asia Pulse (Mar. 20, 2000).

an official in the Ministry of Metallurgical Industry (“MMI”),¹⁴ the Government would support Chinese stainless flat-rolled producers to increase their production to at least 70 percent of domestic consumption during the period 1996 to 2000.¹⁵ The MMI planned to reduce imports to no more than 5 percent of all steel consumed in China.¹⁶

III. DEVELOPMENT OF THE STAINLESS STEEL INDUSTRY IN CHINA PURSUANT TO CHINESE GOVERNMENT INDUSTRIAL POLICIES

China’s economic and industrial development, including development of the stainless steel industry, is directed and managed by the central government through its Five-Year Plans.¹⁷ Issued by the Central Committee of the Communist Party of China, Five-Year Plans aim to “arrange national key construction projects, manage the distribution of productive forces and individual sectors’ contributions to the national economy, map the direction of future development, and set targets.”¹⁸ According to the Government, the Five-Year Plans establish the broad parameters defining which industries, enterprises, and products should be targeted for preferential government support.

Since the mid-1990s, the Chinese Government has designated stainless and several other high-quality steel products as key products that should be encouraged and protected.¹⁹

¹⁴ The MMI was the government agency responsible for steel industry planning. In 1997, the MMI was abolished and replaced by the State Bureau of Metallurgical Industry (“SBMI”). See The Mineral Industry of China, U.S. Geological Survey – Minerals Information (1997) at 2.

¹⁵ See Goal set for iron, steel, China Daily (Apr. 6, 1996).

¹⁶ See The Mineral Industry of China, U.S. Geological Survey – Minerals Information (1996) at 2.

¹⁷ In addition to the Five-Year Plans, the Chinese Government set long-term industrial policy in “The Outline of State Industrial Policy in the 1990s,” issued in June 1994. The policies set forth in this document are in the industrial restructuring plan offered under Ninth Five-Year Plan. See Prospect of Industrial Policy Regime After the WTO, Lu Ding (2000) at 5.

¹⁸ See What is the Five Year Plan, available at <http://www.china.org.cn/english/MATERIAL/157595.htm>.

¹⁹ See China’s Stainless Steel Production May Thrive After WTO Entry, Asia Pulse (Aug. 29, 2000).

Accordingly, the Government implemented policy measures under its Five-Year Plans that directly and indirectly supported the development of stainless steel production in China.²⁰

A. Ninth Five-Year Plan for National Economic and Social Development (1996-2000)

In March 1996, the Fourth Plenary Session of the Eighth National People's Congress provided a blueprint for national development in the “The Ninth Five-Year Plan and 2010 Long-Term Program for National Economic and Social Development” (“Ninth Five-Year Plan”).²¹ The Plan called for the Government to promote the growth of industries that were considered to be critical for economic development, such as “pillar industries” (*i.e.*, machinery, electronics, petrochemical, automotive, and construction), high-technology industries, and certain basic industries upon which other industries depended (*e.g.*, the steel industry).²² The Plan also called for the GOC to implement various policy measures to both selectively protect these strategic industries and direct resources towards them. The measures included industrial restructuring and renovation (*e.g.*, consolidation and technological improvements), controlling foreign investment, encouraging regional concentration of output, discriminating against foreign products, and promoting exports.²³ The Government also managed investments in “projects of a foundation nature” by serving as the primary financier for such projects. The “projects of a foundation

²⁰ Indeed, the Chinese Government has utilized all of the basic policy tools at its disposal in implementing its stainless steel development plan. Studies of the Chinese Government’s economic and industrial policies found that the Government’s policy tools fall into the following basic categories: (1) central government financing and planning; (2) empowering key industries with direct financing; (3) preferential interest and tax rates and favorable financing for target industries; (4) infant industry (trade) protection; (5) pricing policies; (5) administrative means; and (6) directing foreign direct investment into desired industries. See Prospect of Industrial Policy Regime After the WTO, Lu Ding (2000) at 8-9.

²¹ See Prospect of Industrial Policy Regime After the WTO, Lu Ding (2000) at 7.

²² Id.

²³ See New Competition: Foreign Direct Investment and Industrial Development in China, Guoyong Liang (2004) at 187. See also Prospect of Industrial Policy Regime After the WTO, Lu Ding (2000) at 7.

nature” primarily related to infrastructure and basic industry (e.g., energy supplies and steel production).²⁴

In accordance with the national industrial policy set forth in the Ninth Five-Year Plan, the MMI drafted a comprehensive, steel-specific policy that sought to reform the steel sector by accelerating the production of high-quality, value-added steel products, such as stainless steel, that were being imported at the time. According to an MMI official, the GOC shifted the emphasis of its policies to steel quality and variety rather than quantity.²⁵ This change in strategy led the MMI to designate stainless steel and automotive steel as its top priorities during the Ninth Five-Year period.²⁶ In line with this development strategy, a series of new policy measures were implemented to support the steel industry reforms. The policy measures included: (1) renovating and/or technologically upgrading older steel enterprises;²⁷ (2) adjusting the product mix to emphasize quality rather than on increasing output;²⁸ (3) restructuring and/or consolidating steel enterprises;²⁹ and (4) imposing stricter controls on steel imports while expanding exports.³⁰

²⁴ See Prospect of Industrial Policy Regime After the WTO, Lu Ding (2000) at 8.

²⁵ Goal set for iron, steel, China Daily (Apr. 6, 1996).

²⁶ See The Mineral Industry of China, U.S. Geological Survey – Minerals Information (1996) at 3.

²⁷ See China on Way to World Steel Power (Sept. 13, 1999) available at <http://www.people.com.cn/english/199909/14/chnmedia.html>.

²⁸ See The Mineral Industry of China, U.S. Geological Survey – Minerals Information (1996) at 2.

²⁹ Readjust Product Mix in Selected Areas, World News Connection (Dec. 31, 1997); China’s Stainless Steel Production May Thrive After WTO Entry, Asia Pulse (Aug. 29, 2000).

³⁰ See China on Way to World Steel Power (Sept. 13, 1999) available at <http://www.people.com.cn/english/199909/14/chnmedia.html> (The Director of the State Administration of Metallurgical Industry stated that, “[t]he country will impose stricter controls on steel imports and will no longer import anything that it can produce and it will make an effort to export 4 million tons of steel products.”)

To ensure that its policies were successful in reforming the steel industry during the Ninth Five-Year period, the GOC implemented various direct and indirect government support measures. For instance, the Government indirectly supported its stainless steel industry by, among other things, tightly controlling both the import market (e.g., through import quotas and licenses) and the domestic stainless market (e.g., through price floors).³¹ These measures ensured that Chinese stainless steel producers received high, stable prices. The Government also provided various direct fiscal incentives, such as the provision of subsidized financing to older enterprises through “T-bond funded technical renovation projects” to enable investment in modern production technology.³²

By instituting these measures to reform the steel industry, the Chinese Government intended to replace imported steel products with steel products produced by domestic enterprises. According to a report outlining China’s development strategy for the steel industry during the Ninth Five-Year Plan and beyond to the year 2000, Chinese firms would produce at least 70 percent of all stainless flat-rolled products consumed in China by 2000.³³ The MMI estimated that imports would decline such that more than 95 percent of all steel consumed in the country would be supplied by Chinese steel producers.³⁴ Moreover, because high-quality, value-added steel products were consumed by the industries leading China’s economic growth – the so-called “pillar industries” making machinery, electronics, petrochemicals, automobiles, and construction

³¹ See, e.g., China Introduces Unified System for Stainless Steel Imports, Asia Pulse (Jun. 14, 2001); Output Controls Boosting China’s Steel Industry Profit, Asia Pulse (Aug. 18, 2000).

³² See Profile – China’s Iron And Steel Industry (July 2003), Asia Pulse (Jul. 17, 2003). See also China on Way to World Steel Power (Sept. 13, 1999) available at <http://www.people.com.cn/english/199909/14/chnmedia.html>.

³³ See Goal set for iron, steel, China Daily (Apr. 6, 1996).

³⁴ See The Mineral Industry of China, U.S. Geological Survey – Minerals Information (1996) at 2.

materials – their demand for steel products would be matched with and satisfied by domestically-produced steel.³⁵

B. Tenth Five-Year Plan and Steel Policy (2001-2005)

The Tenth Five-Year Plan for National Economic and Social Development (“Tenth Five-Year Plan”), covering the period 2001-2005, extended many of the industrial policies implemented under the Ninth Five-Year Plan. The Tenth Five-Year Plan, for instance, called for “energetically optimizing and improving {the} industrial sector” by, among other things, enhancing traditional industries with new technologies and intensifying construction of transportation, energy and other infrastructure facilities.³⁶ According to the plan, these measures were “most important in the energy {and} metallurgy” industries. *Id.* The plan further called for the “establishment of a number of large companies and enterprise groups through stock listing, merging, association and reorganization.” *Id.* It also provided for the continued and pervasive role of the government in the economy, stating that the “state must hold a controlling stake in strategic enterprises that concern the national economy” and must also “uphold the dominance of the public sector of the economy {and} let the state-owned sector play the leading role.” *Id.*³⁷

³⁵ See China: Steel industry undergirds auto, power, oil sectors, China Daily (Jun. 6 1996); Changes in Five-Year Plans’ Economic Focus, available at <http://www.china.org.cn/english/2005/Nov/148163.htm>; Goal set for iron, steel, China Daily (Apr. 6, 1996); Readjust Product Mix in Selected Areas, World News Connection (Dec. 31, 1997); The Mineral Industry of China, U.S. Geological Survey – Minerals Information (1996) at 3.

³⁶ See The Tenth Five Year Plan for National Economic and Social Development-People’s Republic of China, available at http://www.logos-net.net/ilo/195_base/en/init/chn_1.htm.

³⁷ The industry-related policies promulgated in the Tenth Five-Year Plan are also reflected in the Tenth Five-Year Plan of Industrial Structure Adjustment (“Tenth Structural Adjustment Plan”), which included steel among its 14 target industries. See Tenth Five-Year Plan of Industrial Structure Adjustment, available at http://english.people.com.cn/200111/19/eng20011119_84877.shtml. The Tenth Structural Adjustment Plan, for instance, identified among its six objectives strengthening international competitiveness by updating and perfecting the industrial structure, and improving the structures of enterprises by developing large companies and enterprise groups. *Id.*

The Chinese Government's steel sector policy under the Tenth Five-Year Plan extended many of the objectives and policies implemented during the period of the Ninth Five-Year Plan. The development plans, for instance, continued to emphasize reform of the steel industry by encouraging the production of steel products "with top-quality, high value-added and advanced technique," such as stainless steel, as substitutes for imports.³⁸ Indeed, one of the Government's "priorities in development" during the 2001-2005 period was to construct two stainless smelting and hot rolling centers in TISCO and Baosteel.³⁹ Baosteel's stainless steel smelting and hot-rolling facility was started in 2001 and will ultimately require a total investment of RMB 10 billion.⁴⁰ Restructuring and consolidation of steel enterprises were also promoted as part of the steel sector policy during the Tenth Five-Year Plan period.⁴¹

As a whole, the policies implemented by the Chinese Government pursuant to the Ninth and Tenth Five-Year Plans to ensure the viability of China's stainless steel industry are a prime example of the Government attempting to manipulate the market and dictate outcomes by involving itself in decisions that should be made by the market.⁴² While the government employed both direct and indirect measures to develop the Chinese stainless steel industry between 1996 and 2006, the remainder of this report focuses on direct government support

³⁸ See Top-quality Steel to be Developed (May 22, 2000) at http://english.people.com.cn/english/200005/22/eng20000522_41339.html.

³⁹ See China Releases 5 Yr Development Plan for Metallurgical Industry, Asia Pulse (Jul. 9, 2001).

⁴⁰ See Stainless Steel Project Starts in Shanghai, China Business Information Network (May 16, 2001).

⁴¹ Id.

⁴² The Chinese Government continues to actively support its stainless steel industry beyond 2006. The Eleventh Five Year Plan, covering the period 2006-2010, extended many of the same policies implemented under the Ninth and Tenth Five-Year Plans aimed at improving China's industries. See Key Points of the 11th Five-Year Guidelines, available at <http://www.china.org.cn/english/20061h/160403>. Moreover, as documented in SSINA's April 2007 study, entitled Chinese Government Subsidies to the Stainless Steel Industry, the GOC maintains numerous ongoing preferential measures.

measures, such as noncommercial exchanges of unpaid debt for equity shares, forgiven debts, debt provided on preferential terms, direct payments, exemption of import duties on imported equipment, and various tax incentives.

C. Subsidies Conferred Upon the Chinese Stainless Steel Industry During the Ninth and Tenth Five-Year Plans

The subsidy programs described below were implemented by the Chinese Government pursuant to its policy to encourage the development of stainless steel production in China during the period of the Ninth and Tenth Five-Year Plans. These programs helped transform China's largest stainless steel producers, TISCO and Baosteel, into major producers and exporters of stainless steel.

1. Steel Industry Restructuring Subsidies: Noncommercial Debt-to-Equity Swaps and Debt Forgiveness

As part of its role in directing the consolidation and restructuring of the steel and stainless steel industries, the Chinese Government ensured the viability of stainless steel projects and producers in China. Specifically, the Government used the restructuring and consolidation process to carry out noncommercial exchanges of debt for equity shares and to outright forgive unpaid debts of Chinese stainless steel producers.

a. Debt-to-Equity Swap Program

Debt-to-equity swaps are one of the primary tools utilized by the Chinese Government to carry out its reform of the steel industry under the Ninth and Tenth Five-Year Plans. The Government has used this program to prop up state-owned enterprises through direct government infusions of cash. In 2000, for instance, 37 steel companies shed RMB 62.5 billion in debt, saving RMB 4 billion in interest payments in that year alone.⁴³ In the typical debt-to-equity

⁴³ See China Debt-to-Equity Swaps Help Steel Makers, China Daily (Mar. 26,2000).

swap, non-performing loans (“NPLs”) owed by steel companies are transferred from their state-owned creditor banks to one of four asset management companies (“AMCs”).⁴⁴ The four AMCs, which are owned by China’s four largest state-owned banks, include: (1) China Huarong Asset Management Corp. (“Huarong AMC”), owned by the Industrial and Commercial Bank (“ICB”); (2) China Great Wall Asset Management Corp. (“Great Wall AMC”); (3) China Orient Asset Management Corp. (“Oriental AMC”); and (4) China Cinda Asset Management Corp. (“Cinda AMC”), owned by China Construction Bank (“CCB”).⁴⁵ The AMCs then exchange the debt for shares in the companies. The steel companies may receive an additional benefit pursuant to these transactions, since many of the debt-to-equity swap agreements required the AMCs and creditor banks to continue providing assistance to the companies after the swap had occurred.⁴⁶

Both TISCO and Baosteel participated in the debt-for-equity swap program in 1999 when RMB 27.5 billion in NPLs owed by seven steel enterprises was converted into equity held by Huarong AMC and Cinda AMC.⁴⁷ TISCO, for instance, signed a RMB 2 billion debt-for-equity swap agreement with Cinda AMC to dispose of the company’s NPLs. TISCO’s poor financial performance at the time of this investment suggests that the government did not act as a reasonably prudent private investor. TISCO’s profitability, like that of the Chinese stainless steel industry in general, had declined with the price of specialty steel products in China from the

⁴⁴ See China's Bad-debt Disposal Speeds Up at http://english.people.com.cn/200211/01/print20021101_106096.html.

⁴⁵ See China’s debt-for-equity swaps proceed despite concern, Japan economic Newswire Plus (Nov. 13, 1999).

⁴⁶ Id.

⁴⁷ See China Debt-to-Equity Swaps Help Steel Makers, China Daily (Mar. 26,2000).

latter part of 1993 to the end of 1999.⁴⁸ TISCO, moreover, operated at only half capacity between 1996 and 1998; while its production capacity ranged from 130,000 to 150,000 tons per year, the company produced only 70,000 to 80,000 tons per year.⁴⁹

Baosteel also participated in this process and benefited from massive cash infusions. In September 1999, a subsidiary of Shanghai Baosteel, the Meishan Corp., signed with Cinda AMC the steel industry's first debt-to-equity swap agreement. According to Zhou Xiaochuan, president of the CCB and vice-chairman of Cinda's supervisory board, "{t}he agreement will take a heavy burden off the back of Meishan and lay a solid foundation for the new company."⁵⁰ Under the terms of the agreement, part of Meishan's long-term liabilities with the CCB were transformed into an equity stake in a new joint-stock company, Meishan Iron and Steel Co Ltd. Shareholders in the company were to include the parent company Meishan (a steel company based in East China's Jiangsu Province), Cinda, and Meishan's other major creditors, such as the Bank of China, the Industrial and Commercial Bank of China, and the State Development Bank.

Shortly after Meishan's agreement, Huarong AMC and China Development Bank signed debt-to-equity swap agreements with three more subsidiaries of Baosteel.⁵¹ Company officials admitted that the deals were necessary because the "companies all have levels of liability

⁴⁸ See China's Special Steel Sector Wipes Out Losses, Asia Pulse (Mar. 28, 2001). See also Tisco injects cash in bid to gain share, South China Morning Post (Jul. 11, 1998) (explaining that the price of certain stainless steel products fell from US\$1,650 per ton at the beginning of 1997 to US\$1,300 per ton in July 1998).

⁴⁹ See China's Nickel Industry Faces Stiff Challenges, Asia Pulse (Sept. 30, 1997); Tisco injects cash in bid to gain share, South China Morning Post, (Jul. 11, 1998).

⁵⁰ See The Bad-Debt Cops Get Going: A Firm Named Cinda Launches a Huge Workout That May Reshape China's Economy, Business Week (Oct. 10, 1999).

⁵¹ See China's debt-for-equity swaps proceed despite concern, Japan Economic Newswire Plus (Nov. 13, 1999).

considered ‘abnormal,’ hindering normal operations.”⁵² The deal with Baosteel Pudong Steel Co. was the largest of the three deals, at more than RMB 2 billion. The second agreement was with Baosteel First Steel Co. for RMB 800 million. Lastly, an agreement with Baosteel First Steel involved RMB 500 million. After the debt-to-equity swaps, the ratios of liabilities to assets for the Shanghai Baosteel subsidiaries were slashed by 20 percent on average, saving annual loan interest payments of approximately RMB 300 million.⁵³ Pursuant to the terms of these agreements, Huarong AMC was to hold most of the equity while the remaining portion would be shared among the AMCs of other creditor banks. The agreements also called on the AMCs and their parent banks to work with the companies to improve their operations.

In assessing whether to exchange unpaid debt for equity shares, including those of TISCO and Baosteel, the Chinese Government failed to act as a reasonable private investor. The GOC did not conduct an analysis of whether the investments would generate a reasonable rate of return in a reasonable period of time. Rather, the Government viewed the deals as a means to reduce the companies’ liabilities-to-assets ratios and, thereby, boost the companies’ competitiveness.⁵⁴ According to the Director of the Development and Planning Department under the State Administration of Metallurgical Industry (“SAMI”), the debt-to-equity swap program was “a big boon for debt-stricken steel enterprises struggling for profits.”⁵⁵

Further evidence of the noncommercial nature of the debt-to-equity swap transactions is the unwillingness of international investors and financiers, including the World Bank, to participate in the program. The World Bank criticized the deals as being “flawed in their

⁵² Id.

⁵³ Id.

⁵⁴ See Tisco, South China Morning Post (Jan. 4, 2000).

⁵⁵ See China Debt-to-Equity Swaps Help Steel Makers, China Daily (Mar. 26,2000).

financing plans and in identification and transfer of such funds.”⁵⁶ The foreign investment community, moreover, was skeptical of the process and did not participate in the debt-to-equity swap program.⁵⁷ Many Chinese companies considered the debt-to-equity swap program “a one-time debt write-off sanctioned by Beijing.”⁵⁸

b. Debt Forgiveness as Part of the Restructuring of Steel Enterprises and Groups

Another form of direct government assistance to the steel industry is the forgiveness of debts owed by steel companies to China’s state-owned banks.⁵⁹ This government action provides a direct subsidy to the recipients in the amount of the debt forgiven. In its restructuring of steel enterprises and groups, the Chinese Government has used various corporate devices to separate steelmaking assets from the liabilities associated with those assets in order to ensure the ongoing viability of the steelmaking facilities.

In a common restructuring scheme, which the GOC used previously to transfer the economic burden of the welfare legacy away from steel companies, a parent company spins off its core steelmaking assets to a subsidiary.⁶⁰ While the subsidiary receives the productive assets,

⁵⁶ Id.

⁵⁷ Id.

⁵⁸ See Debt-to-Equity Swaps Help Steel Makers, China Daily (Mar. 26,2000).

⁵⁹ See SSINA, Chinese Government Subsidies to the Stainless Steel Industry (April 2007). SSINA’s earlier study discusses another form of debt forgiveness that has benefited China’s steel sector – namely, the writing off or inaction regarding NPLs by China’s state-owned banks. For instance, in 1996, commercial banks and financial institutions in China were forced to write off NPLs in excess of US\$ 6.38 billion. See The Mineral Industry of China, U.S. Geological Survey – Minerals Information (1996) at 1. In 1997, moreover, the GOC issued US\$ 32.5 billion in special bonds to recapitalize state banks and set aside US\$ 5.4 billion to close out NPLs. See The Mineral Industry of China, U.S. Geological Survey – Minerals Information (1997) at 1.

⁶⁰ See Peter Nolan and Godfrey Young, Large Firms and Catch-up in a Transitional Economy: The Case of Shougang Group in China, at 9, 15 (Jan. 2000) (explaining how Shougang spun off seven production units to form an A-share company in the Chinese stock market, the Beijing Shougang Stock Holding (...continued)

it does not receive all of the debts associated with those assets. The debts that were not transferred with the core steelmaking assets have, in essence, been forgiven since the subsidiary is no longer burdened by heavy debt payments.

The GOC has also used the process of merging or regrouping steel enterprises into larger enterprises or enterprise groups to write off debts owed by these enterprises.⁶¹ In 1998, for instance, the Chinese Government wrote off RMB 2.57 billion in NPLs when 46 steel companies merged and 18 went bankrupt.⁶² The GOC wrote off another RMB 2.34 billion in 1999 as the result of the merger of seven steel enterprises and the bankruptcy of five steel companies.⁶³

2. Preferential Debt Financing

a. Policy Loans

China's banking system is dominated by the four state-owned banks – the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Agricultural Bank of China – which account for over 60 percent of all loans. These banks make so-called “policy loans” based on political directives from the central or provincial governments, rather than creditworthiness or other market-based factors. Indeed, during the Ninth and Tenth Five-Year Plans, banks in China were instructed by the GOC to provide loans to further its steel industry policies on numerous occasions. For instance, in mid-1996, the People's Bank of China (“PBC”) announced that state banks would increase “circulating capital loans” in the second half

(...continued)

Company Limited, while transferring the economic burden of the welfare legacy to other “spin-off” subsidiaries).

⁶¹ See Firm Action on 12 Enterprises to Merge or Be Closed Down, China Daily (Nov. 14, 1999).

⁶² Id.

⁶³ Id.

of the year to key state enterprises to ease shortage of operation funds.⁶⁴ In 1998, the Government put banking reform on hold to lend billions of yuan to key state-owned enterprises and infrastructure projects to maintain economic growth targets.⁶⁵

While Chinese stainless steel producers are not the only beneficiaries of these policy loans, the importance of stainless steel to the Government's policies suggests these loans were likely used to finance the producers' recently-added capacity in China. Without access to the records of the state-owned banks, asset management companies, and other lenders, it is impossible to know the full extent to which the Chinese stainless steel industry has benefited from the Government's subsidized loans. Given the industry's growth, however, it is reasonable to conclude that the level of borrowing and benefit to the industry is substantial.

Indeed, the limited information that is available suggests that TISCO and Baosteel have both received massive loans to finance the companies' investments in stainless steel production facilities throughout the period between 1996 and 2006. For instance, the initial investments by the Chinese Government to expand stainless steel production capacity during this period focused on TISCO and Baosteel.⁶⁶ The Government "decided to subsidize interest payment for 3 years for these projects," which included Baosteel's US\$900 million investment to convert its subsidiary, Shanghai No. 1 Steel Works, into a stainless steel producer.⁶⁷ Available information confirms that TISCO and Baosteel received additional loans during the 1996-2006 period, including the following:

⁶⁴ See The Mineral Industry of China, U.S. Geological Survey – Minerals Information (1996) at 3.

⁶⁵ See The Mineral Industry of China, U.S. Geological Survey – Minerals Information (1998) at 1.

⁶⁶ See The Mineral Industry of China, U.S. Geological Survey – Minerals Information (1999) at 6.8.

⁶⁷ Id.

- In 1996, the Government supported a stainless steel project at TISCO with part of RMB 850 million in loans.⁶⁸
- In 2000, Baosteel was granted credit arrangements for RMB 4.685 billion for construction capital and cash flow to facilitate its takeover of or merger with various steel enterprises in the Shanghai area.⁶⁹
- In 2001, Shanxi Province supported TISCO's investment in a 500,000 ton renovation project.⁷⁰
- In 2001, Baosteel began construction of a stainless steel smelting and hot-rolling base, requiring a total investment of RMB 10 billion.⁷¹
- In September 2004, TISCO began construction of a 1.5 million-ton cold-rolled stainless sheet production line at an estimated cost of RMB 26.7 billion, including RMB 16.578 billion in bank loans.⁷² The company planned future projects to reach a capacity of 2 million tons of hot-rolled stainless steel sheets by 2008, with its capacity reaching 3 million tons of stainless steel and 12 million tons of carbon steel by 2010.⁷³
- In 2005, Baosteel funded one half of the RMB 10 billion cost of a new stainless steel production facility with subsidized loans from state-owned banks.⁷⁴

b. The State Bond Financed Projects Program

The State Bond Financed Projects ("SBFP") program was introduced by the Chinese Government in 1999.⁷⁵ The SBFP program had two priorities. The first SBFP priority was to increase production capacity and quality of nine steel products that were largely imported, including stainless sheet. The second priority was to reduce energy consumption by introducing

⁶⁸ World News Connection (Aug. 27, 1996).

⁶⁹ See World's largest steel industry prepares for radical change, Metal Bulletin Monthly (Jan. 1, 2001).

⁷⁰ See Shanxi Province To Invest US\$1.6 Billion In 23 Key Projects, Asia Pulse (Mar. 8, 2001).

⁷¹ See Stainless Steel Project Starts in Shanghai, China Business Information Network (May 16, 2001).

⁷² See TISCO aims for annual sales of RMB 80 billion, Ferrous Metals Weekly Report (Jan. 12, 2007).

⁷³ Id.

⁷⁴ See China Corporate Culture Web, <http://www.ce-c.com/qyfc-60.htm>.

⁷⁵ See China's Steel Industry in the WTO Era, AllBusiness (2002) available at <http://www.allbusiness.com/print/133210-1-22eeq.html>.

energy saving technologies. Additionally, the SBFP program also contained an import substitution element, requiring that “the bulk of equipment must be supplied by domestic companies.”⁷⁶

According to the GOC, the SBFP program conferred a substantial cost savings upon the recipient firms. The Government noted, for instance, that a light section mill could be constructed in China pursuant to the SBFP program at a cost of between RMB 200-250 million, compared with importing a mill at a cost of RMB 400-600 million.⁷⁷

By the end of 2000, loans valued at RMB 237.5 billion, including RMB 144.2 billion of state bank loans, had been made under the SBFP program. The steel industry received one third of these loans and was the largest benefactor of the SBFP program. Specifically, 82 steel renovation projects (including at least one hot rolled stainless steel project) undertaken by 47 steel companies received RMB 75 billion, including RMB 46.1 billion as bank loans.⁷⁸ Baosteel, for its part, received RMB 17.5 billion as of the end of 2000.

3. Subsidies to Key Steel Enterprises

a. Key Steel Enterprises: Government Support of Technological Renovation Projects

As discussed above, one of the primary objectives of the GOC’s steel sector reforms under the Ninth and Tenth Five-Year Plans was to promote the production of high-quality steel products that were being imported due to inadequate domestic production capacities. To develop production of high-quality steel products in China, the Chinese Government implemented a program to upgrade the production technology in its existing steel plants. The GOC earmarked

⁷⁶ Id.

⁷⁷ Id.

⁷⁸ Id.

RMB 15.3 billion for “technological renovation efforts of the country’s old industries, including the key metallurgical industry.”⁷⁹ According to the GOC, “{t}o accelerate the production of varieties that cannot be made domestically and need import, relevant departments have designated 27 key steel enterprises as the technological renovation emphasis to conduct import substitution.”⁸⁰ The Government estimated that an investment of RMB 46 billion would be required for 96 proposed technological renovation projects at the 27 key steel enterprises.⁸¹

Both TISCO and Baosteel undertook technological renovation projects between 1996 and 2006 pursuant to the GOC’s program. In 2000, for instance, Shanxi Province stipulated that its investment in TISCO’s 500,000 ton stainless steel expansion project constituted a key renovation project.⁸² In the case of Baosteel, the company announced in 2002 that it planned to implement several technological renovation projects that would yield “the largest scale and the most advanced technologies in China.”⁸³

b. Key Steel Enterprises: Preferential Access to Government Infrastructure Development Projects

The Chinese Government, including local governments, support key steel enterprises through preferential access to infrastructure projects. Under the Ninth and Tenth Five-Year Plans, the Government sought to match the development of significant national infrastructure projects (e.g., the Three Gorges project) with development of basic industries, such as the steel

⁷⁹ See China on Way to World Steel Power (Sept. 13, 1999) available at <http://www.people.com.cn/english/199909/14/chnmedia.html>.

⁸⁰ Id.

⁸¹ See Steel Industry Aiming at Three Transformations (2002) available at <http://us.tom.com/english/202.htm>.

⁸² See Shanxi Province To Invest US\$1.6 Billion In 23 Key Projects, Asia Pulse (Mar. 8, 2001).

⁸³ See Steel Industry Aiming at Three Transformations (2002) available at <http://us.tom.com/english/202.htm>.

industry.⁸⁴ An audit of a Chinese steel producer conducted by the Asian Development Bank suggests that the Government implemented this policy, at least in part, by ensuring that key steel enterprises were in a position to benefit from the Government's massive investments in infrastructure.⁸⁵ Specifically, the ADB found that the steel company was "one of 512 large- and medium-sized companies identified by the national Government for support," and "one of 126 'key enterprises' identified by the provincial government."⁸⁶ These key steel enterprises also receive "support in such areas as fast tracking infrastructure support projects and receiving priority from other SOEs for procurement of equipment, supplies, and services."⁸⁷

TISCO has been documented as benefiting from participating in the Government's infrastructure development projects. For instance, TISCO won nine of ten bids for clad stainless steel plates used in the Three Gorges Project.⁸⁸ Given the Government's policy of matching the development of infrastructure with that of basic industries and TISCO's position as a key steel enterprise, it is likely that the company received preferential access to this project.

4. Encouragement of Joint Ventures

Under the Ninth and Tenth Five-Year Plans, the GOC used foreign investment as a tool to develop China's stainless steel sector by obtaining modern production technologies as well as needed capital. According to the Director-General of MMI's Development and Programming Department, during the Ninth Five-Year Plan, the Government "actively introduce{d} overseas

⁸⁴ See Lu Ding, Prospect of Industrial Policy Regime After the WTO (2000) at 7.

⁸⁵ Project Performance Audit Report on Laiwu Iron and Steel Company Modernization and expansion Project in People's Republic of China (Jan. 2003) at 11.

⁸⁶ Id.

⁸⁷ Id.

⁸⁸ See Taiyuan Steelworks Wins the Bid for Three Gorges Project, SinoCast China Business Daily News (Jan. 16, 2003).

investment and advanced steel producing technologies by launching joint ventures and Sino-foreign co-operative ventures.”⁸⁹ The GOC used its control over the licensing and approval of investments to ensure investments were made in preferred industries.⁹⁰ The “Catalogue for the Guidance of Foreign Investment Industries” identified “stainless steel smelting” and “hot and cold rolling of stainless steel plates” as favored industries for foreign investment.⁹¹

To encourage foreign investment in these preferred industries, the Chinese Government offered various subsidies, including tax reductions and import duty waivers.⁹² In its April 2007 report *Chinese Government Subsidies to the Stainless Steel Industry*, SSINA identified various tax subsidies provided by the Chinese Government to foreign invested enterprises (“FIE”), such as a reduced corporate tax rate, an income tax refund for FIEs that reinvest in Chinese businesses, and an exemption of the business tax on technological transfers for FIEs. Imported equipment was also exempted from the payment of customs duties.⁹³

During the Ninth and Tenth Five-Year Plans, the Government successfully directed foreign investment and technology transfers into numerous stainless steel projects. Baosteel, for instance, has three stainless steel joint ventures: (1) Shanghai Krupp Stainless is a joint venture between Baosteel’s subsidiary, Shanghai Pudong Steel, and Krupp Thyssen Stainless; (2) Ningbo Baoxin Stainless Steel is a joint venture between Baosteel and Japanese producers Nisshin Steel

⁸⁹ See Goal set for iron, steel, China Daily (Apr. 6, 1996).

⁹⁰ See The Mineral Industry of China, U.S. Geological Survey – Minerals Information (1996) at 2. See also Lu Ding, Prospect of Industrial Policy Regime After the WTO (2000) at 12 (explaining that among the few categories of foreign investment projects supported by the GOC are projects that meet the demand of the international market, open markets and expand exports).

⁹¹ See Catalogue for the Guidance of Foreign Investment Industries, Jan. 7, 2003, <http://www.chinataiwan.org/web/webportal/W5029562/A5120231.html>.

⁹² See Revised Catalogue for the Guidance of Foreign Investment Industries, Jan. 2005, <http://www.tdctrade.com/alert/cba-e0501a-5.htm>.

⁹³ See China is World’s No. 1 Stainless Steel Consumer, Asia Pulse (Apr. 11, 2002).

Corp., Hanwa Company Ltd., and Mitsui & Company; and (3) Shanghai STAL is a joint venture between Baosteel and Allegheny Ludlum Corporation.

5. Preferential Tax Programs

i. The Steel Import Substitution Program

A primary objective of the Chinese Government in reforming the steel sector during the Ninth and Tenth Five-Year Plans was to reduce import penetration by encouraging the production of steel products that were being imported at the time, such as stainless steel and other high-quality steel products. Indeed, the Government stated repeatedly that its policy measures relating to stainless and other high-quality steels were meant to encourage domestic production that would replace imports. In 1998, the Chinese Government introduced a subsidy program to further this objective, the Steel Import Substitution Program (“SISP”).⁹⁴ The SISP encouraged export-oriented processing enterprises that would otherwise have used imported steel to increase their purchases from domestic steel works by granting a 17 percent value-added tax (“VAT”) rebate to the purchasers.⁹⁵ According to the SBMI, 27 steel producers sold 3.2 million tons of steel under this program in 1999.

Both TISCO and Baosteel participated in the steel import substitution program and were among 12 steel producers that over-fulfilled their annual targets.⁹⁶ Baosteel alone delivered 1.37 million tons, accounting for over 45 percent of the year’s target.

⁹⁴ See China Achieves Steel Import Substitution Plan, Asia Pulse (Mar. 20, 2000).

⁹⁵ Id.

⁹⁶ Id.

b. Exemption from the Coordinating Tax for Direction of Fixed Capital Investment

Stainless steel producers in China benefit by being exempted from the coordinating tax for direction of fixed capital investment (“coordinating tax”). The coordinating tax is levied on the amount of fixed capital investment made by Chinese enterprises in a given year.⁹⁷ While the general tax rate applied to fixed capital investment was 15 percent, a zero tax rate was applied to fixed capital investment in projects “urgently needed by the state,” which included key raw materials.⁹⁸ Since the Government encouraged the development of stainless steel production as one of its priorities under the Ninth and Tenth Five-Year Plans, stainless steel projects were likely deemed to be urgently needed by the state. Fixed capital investments in these projects, therefore, would have been taxed at a zero rate.

IV. CONCLUSION

The Chinese stainless steel industry was not forged by market forces; rather, it is the product of a comprehensive Government policy to support the production of high-quality steel products in China in lieu of importing such products from U.S. and other established producers. Since the mid-1990s, the Chinese Government has implemented this policy using direct and indirect measures to encourage the development of stainless steel production in China and to ensure its on-going viability. In particular, the Chinese Government implemented this policy over the past decade primarily by conferring massive direct and indirect subsidies upon the stainless steel industry in China. TISCO and Baosteel, China’s two largest stainless steel producers, particularly benefited from substantial subsidies throughout the entire ten-year period.

⁹⁷ See Prospect of Industrial Policy Regime After the WTO, Lu Ding (2000).

⁹⁸ Id. On the other hand, the government penalized projects that were judged to be “of an inefficient scale,” employing outmoded technologies, or making products already in excess supply, by applying the highest rate of 30 percent to these projects. Id.

Moreover, subsidization of the industry is likely to continue unabated, as the Chinese government recently adopted an official policy that requires it to continue subsidizing its stainless steel producers. The consequences of these actions have been profound. The growth of the Chinese stainless steel industry to the point of excess capacity has been at the expense of its international competitors. The economic stability of the international stainless steel market and the financial viability of U.S. stainless steel producers demand that the Government of China end its policy of subsidization of the Chinese stainless steel industry.

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