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Overcapacity of China's Industries & Suggestions for De-capacity

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Background

- Huge overcapacity in China, partly attributed to resource-wasting zombie companies, has been seriously hampering the country's economic development. Against such a backdrop, China's government takes de-capacity as a primary task for the year, in order to ease downward pressure on economy, thus to facilitate economic transformation and structural adjustment, and achieve sustainable development.

- To push forward de-capacity, cases involving receivership must be handled more efficiently, and new projects should be under strict control. Meanwhile, financial support is needed for assets disposal and personnel placement.

- Servitization of manufacturing -- a key step for industry transformation and upgrading.

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- **1. Growing overcapacity in manufacturing industries**
- In 2010, China took the place of the US to become the country with largest manufacturing industry in the world, with its productions of industry products under more than 220 categories out of the total 550, ranging top in the world. Meanwhile, growing overcapacity began to emerge as a serious problem.
- In 2014, only 78.7% of total industry capacity in China is utilized, with the rate touching years-low. Statistics revealed that 19 manufacturing industries in China utilized less than 79% of total capacity, while the rates of 7 industries were below 70%, indicating that China is facing serious overcapacity. Industries of low utilization rate concluded not only traditional industries like steel, coal, cement and electrolytic aluminium, but also new industries such as photovoltaic, poly-Si and wind power.

I. Oversupply in China, and how to define a Zombie Company

Overcapacity with main industries:

- （1）Steel: The capacity utilization rate of crude steel in China was 67.0% in 2015, down by 15 percentage points compared with in 2010, and 3 percentage points lower than world average, indicating that the industry had heavy overcapacity.
- （2）Coal: Utilization rate of coal industry fell to 64.9% in 2015, with a considerable number of mines idled or run rate cuts. Around 70-80% of mines in southwest China stopped production, while those in Erdos of Inner Mongolia, which enjoyed more geological edges, also saw half of them down.
- （3）Cement: The utilization rate was at 73.8% in 2015. Overcapacity of the industry is still piling up due to fast increase of new investment. According to estimation of Cement Association, the utilization rate will fall to 62.9% in three years if new projects scheduled and in construction would all be commissioned by then.

I. Oversupply in China, and how to define a Zombie Company

- （4）Plate glass： The utilization rate was at 67.99% in 2015. According to a report of China Building Material Federation, 42 float glass lines had been taken down during the year, accounting to 30.5% of total capacity in cutback compared with16.3% in 2014.
- （5）Electrolytic aluminium: The utilization rate was at 75.4% in 2015, 4.2 percentage points lower than world average.
- （6）Ship building: The utilization rate was below 70% in 2015, 6 percentage points lower than world average.
- （7）Poly-Si: The utilization rate was merely at 31.3% in 2012. Overcapacity began to ease since 2014 as the country's government provided a series of supporting policies to expand demand.

I. Oversupply in China, and how to define a Zombie Company

- **2. What are zombie companies**
- At end of 2015, China's central government set about dealing with zombie companies as a key step of de-capacity.
- In China, zombie companies are defined as companies living on government's subsidy and bank's reloaning, with debt-to-asset ratio above 85%, and suffering loss for more than 3 successive years, in a status of shut-down or half-down. Zombies usually fail to meet the country's standards regarding energy consuming, environment protection, quality and safety, etc. By the year of 2014, around 10 percent of China's publicly listed firms are zombies, while unlisted ones took a even larger share.
- It was proposed in the executive meeting of the State Council in Dec 2015, that zombie companies should be disposed. Companies, which suffer loss for more than 3 successive years and not live up to government's requirement of structural adjustment, will have their assets disposed. Thus, operating losses of companies are expected to see substantial decrease by 2017.

II. Factors behind growing overcapacity in China

- **1. Overcapacity is a consequence of poor performance of market in resource distribution.**
- **—Exaggerated role of GDP.** In China, as local governments' performance is mainly assessed by GDP, administrators turn to be in favor of heavy industries, which usually bring notable GDP increase. Overcapacity thus piled up when governments blindly chase after GDP.
- **—Inadequate government subsidies.** Various subsidies，tariff rebate, easy admittance, and still many other preferential policies for manufacturers helped to relieve the burden of factor costs and shield them from fair market competition.
- **—Unreasonable eliminating system.** Currently in China, standards about capacity elimination is generally attached to production scale, and instead of focusing on upgrading and innovation, producers are thus rather to concentrate on capacity expansion.

II. Factors behind growing overcapacity in China

- **2. Overcapacity comes to be more outstanding when demand is curtailing at home and overseas**
- As the aftermath of global financial crisis, economy growth slowed down all over the world, with annual growth rate at around 3% during 2008-2015. Demand for exports from China thus shrank significantly, with foreign trade export growth rate falling below 10% from above 20% during the first decade of the century. In 2015, the rate even fell to negative 2.8%.
- Domestic economy growth is also under increasing downward pressure. In 2012, for the first time China's GDP growth rate fell below the 8% mark, and for the first time below 7% in 2015. The rate fell further to 6.7% in the first quarter of 2016. With domestic demand from the key housing and automobile sectors gradually descending, overcapacity turned to be an outstanding problem for related industries such as steel, cement, glass, etc.
- Overcapacity comes to be more outstanding when demand is curtailing at home and overseas

II. Factors behind growing overcapacity in China

- **3. Overcapacity keeps increasing also due to a lack of efficiency in policy implementation**
- **In many cases, administrators failed to effectively implement policies to eliminate inefficient capacities, as they had also the mission to ensure economic growth. Taking steel industry as example, though elimination of old capacities is required on an equality with new projects, it is often the case that old capacities are not completely moved, resulting in greater overcapacity. Meanwhile, central government's policies for standardized management concerning environment, land usage and disposal funds are not always carried out adequately.**

II. Factors behind growing overcapacity in China

- **4. Regional protection of inefficient capacities**
- **Overcapacity usually lies with industries of great contribution to regional economy and employment. It is nothing strange that local administrators see little initiative to cut capacities.**
- **Heavy industries, such as steel, contribute the largest part of local governments' income.**
- **Regional protection is common in China due to market separation, particularly with regard to state-owned enterprises, whether they are of overcapacity industries or not.**

II. Factors behind growing overcapacity in China

- **5. Banks and enterprises do not like capacity-cut**
- **As for banks, there is worry that elimination of overcapacity would bring more bad loans and bank's interest is thus damaged. As for enterprises, it is not loss that they fear most. State-owned enterprises, in particular, usually count on government to help them survive doldrums. Without concrete budget to bound them, they are unlikely to take initiative to cut capacity.**

III. Solutions to overcapacity

- **1. Intervening measures and strict investigations before approval**
- **Intervening measures geared to different types of overcapacity. As for industries of absolute oversupply, such as steel and coal, ineffective capacities should be driven out of the market, through measures including differentiated water and power cost, and higher environment standards. As for those of structural oversupply, such as glass and ship manufacturing, government shall encourage innovation and develop of high-end products.**
- **New projects, retrofit and expansion with industries of overcapacity shall be banned. There should be a complete set of energy-saving and environment protection standards for industries of overcapacity. Existing projects without approval, but living up to those standards shall be allowed to operate, while those failing to meet standards shall be stopped, with the owner penalized and possibly commanded to scrap the built buildings.**

III. Solutions to overcapacity

- **2. More financial supports for eliminating**
- **Special fund from central government，to help local governments and enterprises dispose assets after capacity-cut, and also re-employment of workers. The number of fund allocated to regions shall be calculated according to the quantity of eliminated capacity.**
- **Regional governments shall be allowed to issue term bonds, to help transition of local industries. Central government shall allow provincial governments to issue and refund the bonds, and give them necessary liberty to handle funds collected, while central government gives them interest subsidy.**

III. Solutions to overcapacity

- **3. Better handling of assets from industries of overcapacity**
- **Non-Performing Assets Securitization (NPAS). Government should support financial institutions in their works of writing off bad loans and mortgage. Existing and new assets management companies should be utilized to help banks get rid of non-performing loans, and reduce financial risks through NPAS.**
- **Financial market should play a key role in merging and reorganization. Banks may take part in merging and reorganization in the form of debt-to-equity, while social capitals such as insurance funds should also be encouraged to participate. Government shall also support security companies to engage in merging and reorganization. Asset managers may also get involved through private equity fund, industrial investment fund and buyout funds.**

III. Solutions to overcapacity

- **4. Rules should be established regarding distribution of security funds for lay-offs.**
- **It should be put into details ASAP how the special subsidy of 100 billion yuan from central government should be distributed, thus to ensure adequate distribution, management and monitoring of the funds.**
- **To determine what proportion of security funds for lay-offs from zombie companies should be afforded by each region. Special funds should be managed and accounted separately, with fixed contribution ratio and duration, thus to give clear guidance to market, enterprises and employees.**
- **Fixed proportion of the special fund for overcapacity elimination should be allocated to placement of lay-offs. To companies which contribute to re-employment, central government and regional administrators shall provide capital and policy rewards. Free vocational trainings should be provided to those who could not immediately find new jobs.**

III. Solutions to overcapacity

- **5. Less influence from non-market factors**
- **To eliminate insufficient companies by accelerating receivership and bankruptcy proceedings according to relevant laws, thus to ensure players quitting in an orderly manner.**
- **To normalize government's performance, namely to stop inadequate interference and regional protection, including invisible subsidies and preferences provided to enterprises regarding land and capital, etc. Asset management and re-employment of eliminated enterprises should be handled appropriately according to law.**

III. Solutions to overcapacity

- **6. Internationalization strategies**
- **Expanding our share in world market.** **Enterprises are encouraged to take initiative in various trading practices, seek for innovation in international trade methods, and contract more engineering projects overseas of a larger variety, such as key infrastructure, large-scale industries, energy, communication and mineral projects, with higher quality and better performance. Through these activities, Chinese enterprises will be able to export technologies, equipments and managing services, thus to bring our domestic brands to the world.**
- **To enhance transnational cooperation.** **Enterprises are encouraged to invest in manufacturing bases overseas, thus to achieve higher cost efficiency, enhance machinery manufacturing and reinforce cooperation with overseas manufacturers.**
- **B & R strategy.** **To construct a more efficient land-ocean transportation network in countries on the Belt such as Mongolia and Kazakhstan, and those on the Road including Thailand, Indonesia, Vietnam and India, etc, thus to assist companies removing overcapacity through trading and investing activities overseas.**

IV. Perspective of industry growth based on three presuppositions

- **Currently in China, utilization rate of cement capacity is at around 66%, while that of steel is at around 70%， compared to the 80% of general standard of the world. De-capacity will be a necessary pain to take in order to reach this standard, and it is foreseeable that China's industry will experience years of falling growth rate, while the nation's economy will grow at slower pace during the coming 2-3 years.**
- **Three presuppositions of capacity utilization changes by the year 2020 based on de-capacity plan of central government.**
- **1. Utilization rate remains below 70%**
- **2. Utilization rate picks up to around 75%**
- **3. Utilization rate picks up to around 80%**

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IV. Perspective of industry growth based on three presuppositions

- **1. Utilization rate remains below 70%**
- **The presupposition is on the premise that the de-capacity plan meets many holdbacks in its implementation, with utilization rate seeing little change from the level during 2013-2015. Based on this presupposition, by the year of 2020, annual production of cement, crude steel and steels should be cut by 34.79 million tons, 885kt and 1,312kt respectively, through market elimination or other means.**
- **Given handful of supporting policies and steady progress of de-capacity, such a presupposition is less likely to realize. If it do take place, we will take more time for de-capacity, and industry growth will continue to slow down, with growth rate reducing to around 4%.**

IV. Perspective of industry growth based on three presuppositions

- **2. Utilization rate picks up to around 75%**
- **75% utilization rate will be achieved if the de-capacity goes well. Based on this presupposition , by the year of 2020, annual production of cement, crude steel and steels should be cut by 79.93 million tons, 16.19 million tons and 22.87 million tons respectively. In such a script, we have made progress in structural reformation of industry production, but structural problems remain, and industry growth may maintain a steady rate of 6% .**

IV. Perspective of industry growth based on three presuppositions

- **3. Utilization rate picks up to around 80%**
- **80% is an optimistic estimation for what we can achieve. Based on this presupposition , by the year of 2020, annual production of cement, crude steel and steels should be cut by 119.43 million tons, 29.58 million tons and 41.74 million tons respectively. To achieve this, overcapacity in traditional sectors shall be replaced by uprising industries, indicating completion of industrial transformation. Based on this presupposition, industry growth rate may be pegged at 7-8%, with the country entering the stage of post-industrialization, characterized with high-value-added, high tech and mid-to-high-end products.**

V. Servitization of manufacturing -- a key step for industry transformation and upgrading

- **Currently, manufacturing industries of China are less servitized. According to a survey by China Machinery Industry Federation (CMIF) covering 198 domestic machinery manufacturers, 78% of them had their service income accounting for less than 10% of revenue, while 81% manufacturers' service businesses contribute less than 10% of net profit, far below world high standard. With China's progress of industrialization almost completed and per capita GDP rising, service industry will gradually take the place of manufacturing as the main drive for economic development.**
- **Advantages for China's manufacturing servitization**

V. Servitization of manufacturing -- a key step for industry transformation and upgrading

- **1. New-type urbanization is bringing more demand for services.**

- **Counties and towns lie in the center of new-type urbanization. Restricted by environment and resource condition, they will not be able to follow the traditional method of urbanization by establishing industrial parks, but have to focus on modern service construction.**

- **Municipal managing services of high level and efficiency is necessary for new-type urbanization. Developing modern service industry is the only way to improve urban regions' comprehensive performance and habitability.**

V. Servitization of manufacturing -- a key step for industry transformation and upgrading

- **2. Integration of Information Technology and Industrialization + internet Plus serve the target of manufacturing servitization**
- **Integration of Information Technology and Industrialization promotes application of information tech in manufacturing industries, while Internet Plus serves service upgrading. Manufacturing industries should give higher priority in R&D while pursue more added value, forging a complete industry chain including product service, packaging, design, R&D and after-sales services rather than merely providing products. Producer-service industries should improve their services to meet high-end demand. Central government comes with the plan of Internet Plus, to facilitate social division of work, and bring more new occupations of service industry. Internet is involving more and more traditional territories such as entertainment, finance, traffic, tour, health and education, etc. Internet Plus is forcefully promoting service upgrading.**

V. Servitization of manufacturing -- a key step for industry transformation and upgrading

- **3. To replace business tax with value-added tax, as a measure to lift tax burden**

- **It helps to lift the tax burden on service industry. Thanks to this policy, SMEs that serve to people's daily life may enjoy a tax rate of 3%, rather than the original 5%, with their tax reducing by a sharp 40%. It will greatly benefit service suppliers, with the feature of large number, small scale and sophisticated division.**

- **It encourages manufacturers to improve their service performance. When a manufacturer detach its businesses other than production, such as design, installing, transportation and marketing, and establish a service-oriented agent to handle them, then the parent company and the subsidiary will pay 11% and 6% value-added tax respectively, instead of the original rate of 17% afforded by a single company with comprehensive businesses.**

V. Servitization of manufacturing -- a key step for industry transformation and upgrading

- **4. Efforts of regional governments in developing service industry**
- **Shandong province: special funds to support service industry. In 2015, administrating government of Shandong province allocated a special fund of 120 million yuan to encourage innovation of service industry, and a fund of 148 million yuan for upgrading of service industry, thus to support key projects and demonstrating projects. Weifang city focuses on solutions for financing difficulties of service industry, with the plan to set up private equity fund and financing security fund. As another measure, a larger variety of mortgages will be admitted.**
- **Heilongjiang: High tech to support development of technology services.**
- **Chongqing : Quantified targets for financial services.**
- **Guizhou province: Better environment and cooperation for development of service industry.**

Thank You!

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