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British Tata Steel Collapse - What Happened?

ECONOMIC DIPLOMACY

> We must come back, however, to the issue of temporal character of the problems. Greybull paid only 1 pound for the whole business. This shows how high the risk is for any new owner

Any firm, large or small, must generate profit. The only difference between them is that the former can sustain the losses for longer. However, is a 2 billion pounds loss in five years enough to quit? For Tata Steel, it was and we cannot blame it for this. The reasons for such decision listed by the firm were, among others, huge surplus of steel in the world market and high costs of its production in the UK.

This is not the first British producer, which closed its steel mills. In September 2015, Sahaviriya Steel Industries UK, 100 percent owned by Thailand's largest steel producer, Sahaviriya Steel Industries PLC, stopped its production in North East England Recar plant citing poor trading conditions and a drop in world steel prices. This left only 450 workers out of 2150 just to keep the plant up until better times. Tata also tried to survive by cutting its labour. Since the middle of 2015, it dismissed 3000 workers.

The Steel World Market and China

There is one common reason mentioned by the two steel producers; too much steel in the world market and this seems to be the problem. The world prices of steel dropped by 26.42 percent on average in 2015 with some products losing more than a third, see chart 1.

The 2015 trend, shown in chart 2, is typical for last several years. All steel products experienced it and it does not seem that it would be reversed. In spite of the world economy recovery, not only the British market suffers, the whole world industry is affected.

Therefore, we should pose a question - what are the reasons for such situation? There seems to be just one answer - the crisis of 2008 and the Chinese Central Government response to it. The original sin was committed in 2009, when it stimulated the Chinese economy by a huge investment packet. From macroeconomic point of view, it seemed to work; the GDP growth, which had been more than halved between 2008 and 2009, skyrocketed then from 6 to 12 percent the following year.

This, however, had quite dangerous long-term results. The money was spent by regional governments in infrastructure. With huge resources, not all projects were economically effective and viable. Furthermore, this created a great boom for heavy industry and the steel producers. It accelerated the growth of steel industry, which over last 25 years increased its output more than 12 times the size while the European Union output fell by 12 percent and the United States' remained largely flat. This made China the world's biggest steel producer, accounting for around 822 million tonnes a year.

However, in 2011, the Central Government cut the financing to cool down the economy. This meant that the steel production capacity became too high relative to Chinese needs. The Central Government was aware of the fact and asked Regional Governments not to open any new ventures and to rationalise the current production. The plan was to cut the steel production by 100-150 million tons and coal production by 500 million tons. On the other hand, Regional Governments relied on the heavy industry, which generates taxes and is the highest employer. The Central Government plans would have meant 5-6 million jobs lost in heavy industry in the next 2-3 years, according to the Reuters. In steel and coal industry, it would mean 1.3 million and 0.5 million lost workplaces. It recalls the situation of 1998-2003, when 28 million workers lost their jobs in preparation for the World Trade Organisation membership as a result of closing factories having been managed before, not necessarily according to market principles.

The rationalisation of 1998-2003 was undertaken when the Chinese GDP rate of growth amounted to almost 9 percent. Still, the consequences in the form of strikes and riots are still remembered by the Regional Governments, even if rationalisation decreased the growth only temporarily. Moreover, the growth is officially just above 6 percent and the real estimates set it at 4 percent. The Regional Governments do not have any appetite for such troubles again. They use asymmetry of information; the oldest factories are closed and then open again under new label. This is financed by credits from banks that are under Regional Governments' influence. This game does not ease the situation leaving still huge surplus, which something must be done away with.

The easiest solution is to flood the world market with it. It is helped by export subsidies. The Office of the United States

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Trade Representative estimates that over $1 billion were paid to exporters, including the steel producers. Therefore, the overflowing of melted pig iron from Chinese steel mills kills the world steel industry covering it like lava-covered Pompeii. In 2015, the European Union imposed anti-dumping duties for 6 months on some steel imports from China and Taiwan, but it did not seem to help much. On April 18, 2016, representatives from more than 30 countries met in Belgium and concluded that world steel overcapacity had to be dealt with in a swift and structured way. After this, the United States, Canada, the European Union, Japan, Mexico, South Korea, Switzerland and Turkey issued joint statement calling for 'ongoing international dialogue' to remove 'market-distorting policies' and promote greater transparency in the global steel industry. The United States also explicitly blamed China for the situation and warned of possible trade action if Chinese didn't cut overcapacity. China denies responsibility but on the other hand cancels the export subsidies mentioned above. World steel workers are also enraged; in April 2016, 40,000 German steel workers protested on the streets of European capital Brussels.

The Chinese Steel and Britain

Britain is also not immune from this situation. In 2013, the import of Chinese steel was equal to 361,000 tons but last year it rose almost threefold. It is not surprising as the price of Chinese steel, according to Eurostat, is 583 euro while the British steel is 897 euro for a ton. This makes British steel production unsustainable and no one can blame the Tata steel or any other producer for attempt to close their steel mills. The amount of 2 billion pounds mentioned at the beginning is a hefty enough bill for waiting for better times. This way, 20,000 workplaces might be wiped out with all the negative consequences. Therefore, the British Government has to do something about this.

However, the Government is not in an easy position. It is under attack from Opposition Labour Party and trade unions. They claim that there is not enough action at the European Union level to defend the industry; the British side is not able to impose unilateral customs duties as this is the decision to be made at the European Union level. This, however, gives a weapon to the Brexit supporters claiming that leaving the EU would allow for unilateral measures. Another problem is that the government must balance interests of all economic players and not only the producers. The substantial increase in customs duties would hit domestic consumers and might halt economic recovery through increasing investment costs among others in infrastructure. Furthermore, the cost of British steel is much higher than the Chinese. The British steel producers must pay more for greenhouse gas emission as compared to other continental European Union members.

Economic theory, even in its liberal version, claims that in the case of positive externalities, the state should intervene. Such positive externality could mean that industry which has only temporal problems should be supported. Expectations of positive future performance and beneficial social effects should overweigh current costs. However, the British political and economic tradition, especially in its conservative version, is very cautious where the public involvement is concerned. This is the reason why Prime Minister David Cameron ruled out steel industry nationalisation. The government, however, declared that it could buy 25 percent stake in bankrupting business. Such guarantee could encourage potential buyers by increasing prospects of survival for factories bought. Investment fund Greybull took the challenge and bought European part of Tata Steel producing construction steel. The undertaken business employs almost 5000 workers with 4400 in the UK, and it's headquarter is in Scunthorpe in North East England. The new owner promised to invest 400 million pounds in the venture.

We must come back, however, to the issue of temporal character of the problems. Greybull paid only 1 pound for the whole business. This shows how high the risk is for any new owner. Chinese are not keen to cut production and face all problems resulting from this. Furthermore, we can also doubt whether due to organisation of the Chinese economy and the game played by the Regional Governments, it would be possible at all within a time horizon acceptable for any private investor. Other aspects are the British costs of production, which also must be cut. The Greybull, for example, assured the costs rationalisation. As such, this involved new agreement with trade unions and suppliers. In case of the Port Talbot in South Wales, the biggest British steel mill employing 4000 workers, such negotiations could be even more difficult as they include problems of pensions and energy subsidies. The process here would also involve Welsh Regional Government, which is facing elections soon. All of this does not ease the situation.

Prospects for the British Steel Industry

Tata invested £3 billion into its UK operations and is losing £1 mn a day. No wonder that it is difficult to find a buyer for its British steel business. Greybull Capital, which specialises in turning around underperforming businesses, is to invest only 400 million. Steel, commodities and property group Liberty House of Sanjeev Gupta bought from Tata two Scottish plants, Clydebridge and Dalzell, but they only employ 270 people.

There is also a space for investors like Wilbur Ross. He is a US billionaire, Wall Street investor and chairman of WL Ross & Co merchant bankers. His dealing with the sale of Northern Rock in 2011 and Bank of Ireland involvement among others earned him labels of 'vulture investor' and a 'shark'. In the United States, he was overtaking struggling steel plants and formed International Steel Group. Subsequently, it was sold to Mittal Steel, the biggest steelmaker in the world. He is still a director of ArcelorMittal. The question, however, is still here, if this would be welcomed by the British stakeholders.

The worst case scenario would be closure of the steel industry in Britain followed by rationalisation of production in China. It is easier to close something than to create it again, even if conditions are favourable. This would make another British manufacturing industry extinct. On the other hand, the issue here is how long it might take for the Chinese to rationalise their steel market. It might be too long for everyone in Britain and the world.

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