ECON1001 Term Paper

The Australian Steel Industry

The Australian Steel industry has recently been struggling; the year on year output has dropped by 26%, compared to a 1% worldwide drop in production. There are a number of reasons for this; firstly, there is an increased supply from emerging markets in Asia, and demand has signifinicantly dropped due to the financial crisis. Furthermore, the strengthening of the Australian dollar (AUD) has made foreign steel much more attractive and a better value prospect. These factors have led to large losses being made in the national industry. Ways in which the industry attempts to alleviate the issues include diversifying their product lines and moving into different markets; for example, Bluescope has entered the white goods market with Asian backing. Despite this, there is still danger ahead; Arrium has just fought off a takeover attempt from Asian investors, and an effective recovery plan is yet to be put into place.

The Australian steel industry, once an economic powerhouse, has started to follow a global trend of struggling to maintain profitability due to a number of factors. Arrium, one of the country's largest producers of steel, considered a takeover approach from Asian investors in an attempt to recover lost ground. This essay explores both the local and global situation and how the industry attempts to adapt to this ever changing situation.

The global steel industry has changed enormously over the past 40 years. As recently as 1970 the Asian countries produced a negligible quantity, while Australia was a powerful player in the industry with significant market power. Nowadays, numerous emerging economies are placing extreme emphasis on the production of steel. These include China, which according to Gonzalez and Kaminski, has more than doubled production over the past 20 years. This has led to a decrease in market power for Australian exports, as the market model moves towards one of perfect competition, where the firms act as price takers selling a homogeneous product.

The rising levels of steel production in growing Asian economies such as China and India have proved problematic for the Australian industry. More firms entering the market leads to the supply curve shifting to the right, which can be seen in figure 1. A rising supply contrasts with a significant decrease in demand, partly originating from a slow recovery to the financial crisis, which has resulted in building projects being cancelled. The disparity between supply and demand has given rise to a large level of excess capacity which, due to the high proportion of fixed costs (Gonzalez and Kaminski (2011) claim that, depending on the techniques used, these can be up to 70% of the total cost,) leads to great losses (the lower equilibrium price also contributes to this,) even when plants are shut down.

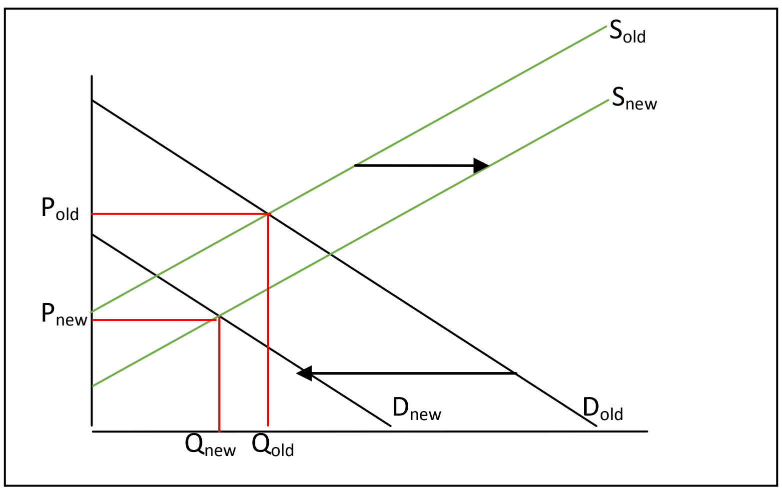

Figure 1: Graph showing decrease in equilibrium quantity and price

The increasing value of the Australian dollar (AUD) is also a significant concern for the industry. Since June 2008, the Australian Dollar has appreciated by over 35%, and Yahoo Finance (2011) currently states that it is worth $1.06 USD (08/10/2013.) A strong currency is an advantage to countries that primarily import goods, due to the lower cost of purchase, and affects exporters negatively, as it costs the importing countries more to purchase goods. This harms the steel industry in two ways; firstly, the high cost to foreign importing countries leads to a lower quantity exported. Furthermore, the domestic market is also losing out as it becomes cheaper for Australian firms to import goods from emerging producers. Therefore, the demand for Australian steel is further diminished. What's more, Talley (2012) states that China artificially undervalues its currency by refusing to allow it to be sold on the open market, which has an opposite effect to the aforementioned strength of the Australian dollar, enabling China to have an advantage in exports.

In the short term, only variable costs can be avoided by shutting down production. Generally, this occurs when the steel price drops below the average variable cost, though whilst ceasing production helps to save capital, as previously explained, high fixed costs remain. Chambers (2011) gives the example of the Port Kembla blast furnace, which was closed by Bluescope as they move towards reducing exports and concentrating on the domestic market, in which they have a stronger presence. Therefore, in the long term, another solution needs to be found to reduce total costs.

In the Australian steel industry, measures have been taken to encourage an upturn in fortunes. For example, Bluescope has created links with a number of Asian firms that aim to enter alternative steel markets, such as white goods. Theoretically, entering a new market provides an opportunity to sell to more customers, increasing a firm's demand. It also helps to reduce risks, as if one market crashes the company still has other opportunities to supply a product. Other companies have decided to move towards a more diverse portfolio, which follows the same principle.

To conclude, a variety of issues have affected the steel industry in Australia in recent history. Global supply has vastly increased as rapidly growing markets ramp up production, whilst demand has decreased at the same time. A number of different solutions have been proposed, from shutting down plants to diversifying product lines, and entering new markets. The government is also trying to help, by putting together a $300m package to reduce the impact of a carbon tax. Whether these measures are effective, however, remains to be seen.

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