Dave Phelps
President
American Institute for International Steel (AIIS)

ASD Fall Conference Speech

First I want to thank Steve and Ron for inviting me to speak to you today here in beautiful central Florida. It has been some while since I have had the honor of speaking to your group, the last time was in Vegas – but the rule is not to speak of what happens there, so I won't…….

I think it would be appropriate first to speak of things of the past -- the past that certainly pre-dates even my grey hairs. As I am sure most of you know, in the beginning, there were only distribution operations run by the domestic industry. Most independents lived on secondary materials, rejects and damaged goods, from which they took the good stuff, cut it, straightened it and made it prime material whenever they could. A good business model given that the big mills did not want your business. Then came the imports. By the end of the 1950s, the import trend had started. Strike activity is often cited as the incident cause of the new suppliers coming to the market, as we know. Then, as the threat of labor strife rose each time a new contract was being negotiated, consumers started hedging their bets by buying imported more products in advance of the date and after a while they began to value the quality, timely delivery and service associated with those off-shore suppliers – mostly from Europe and Japan at that time.

This process began the inexorable decline of the unionized mill-owned service centers and distributors. Simply put, the big mills could not compete in the new environment. With those companies' costs substantially lower than at the unionized mills' service centers, the final outcome was preordained and the mills began abandoning their own service center operations in favor of the independents. Of course today independent distributors and service centers are the largest single customer group of the mills.

So in a sense, importers have contributed to the creation of a mostly non-union, competitive distribution industry. This is important for us all.

Think about it. The US is structurally short of steel. As we all know, we must import to fill the gaps. An economist would look at this model and say that the first, say, 20 million tons of imports – in a normal year – do not compete with domestic products. Of course, that is a theoretical argument. But look at the EU. They have an excess of steel capacity and they are still big importers, some years they actually import more steel than the US. Theoretically, the first ton of imports for them competes with available domestic production. Well, what does this mean? For the US, it means that for steel to be attracted to the US market there must be some kind of premium for selling in our market. Since we are short of steel that is normally not a problem.

But what does that mean for US consumers of steel – not distributors – but those companies who actually consume the steel? Well, it means that they start at a competitive disadvantage to their international competitors. And our customers are internationally competitive; they have survived for decades in this structural environment. But they have not just survived, but thrived. Steel consumption has not declined over the decades. Until this most recent recession, we were in a very slow growth mode.

Many so-called pundits and experts have proclaimed the end of American manufacturing – something I have been hearing for decades by the way. What is the truth of the matter? Simply put, it is nonsense. In 2006, the American manufacturing sector had a record year of both profits and output. Yes, I did say output. And in 2007, output increased again, with profits down, but only slightly. Of course, we also know that the domestic steel industry had its most profitable year in history in 2006, and almost set a shipment record. Things went well in 2007 for them too. Not until the fourth quarter of 2008 did things turn down for the domestic industry and in fact, through the first three quarters of 2008, they were on track to set a new profitability record. Of course, the other evidence that the so-called experts point to is the decline in manufacturing employment as further proof of the slow death of American manufacturing. But that ignores the issue of productivity. US workers are the most productive in the world and, as noted above, in 2006 fewer workers produced both record output and profits. The steel industry is the perfect example. Take LTV. When LTV went into Chapter 7 bankruptcy at the end of 2001, they had around 8,500 union workers. When they emerged from bankruptcy, they produced the same amount of steel with less than 4,000. Non-union employment declined even more, according to those inside the company with whom I spoke at the time, those numbers declined initially by 90 percent.

So, where do we stand now? There is not a lot of good news to report on the overall economy, but there is some. Many believe that the third quarter GDP will show some small growth, after declining 6.4% in the first quarter and 1% in the second. Unemployment increased in August to 9.7% and the overall economy shed more than another half million jobs. Even the president, and presidents usually like to sugar coat such predictions, now says that they expect unemployment to rise further. [Some analysts believe that the increase in August in unemployment might be the result of some workers re-entering the job market and not an actual increase in unemployment.] Manufacturing was hard hit with closures, some of which will probably be permanent. Median household income declined 3.6% so far this year, the steepest decline in 40 years.

I think that is enough bad news. On the good news side, we have things that I categorize as hopeful reading of the tea leaves, especially since some of the improvements I will cite are improvements from very low base levels. For example, industrial production rose 0.8% in August. Overall capacity utilization rose to 69.6%. Exports rose by 2.2% in July. Housing starts rose 1.5%, but still remains at a low 598,000 units. There are other data that suggest that we are at the end of the recession, such as new orders are up, durable goods saw a strong monthly increase, etc., but I think you get the point.

For steel importers, this is the longest importer recession in memory -- the market has been weak now for two years, with the exception of the explosion in demand for oil and gas related pipe and tube during 2008, driven by sky-high energy prices and a shortage of OCTG and other pipe and tube for that sector. When will that turn? We are beginning to see some hopeful signs in our monthly importer survey – www.aiis.org. This makes sense. As we all know, when prices begin to increase and lead times stretch out a bit, imports become more attractive. Until recently, distributors and consumers were all reducing inventory with a vengeance, but now, with very low inventories and some improvement in demand – in part lead by the auto sector and "cash for clunkers," and the start of a new model year, the financial and price risk of buying the larger lots imports require is becoming less problematic.

Several times during this year I heard distributors say in public that demand was down by around 1/3 when the domestic industry was operating at around half of capacity. This is obviously not a sustainable situation and we are now seeing the pricing power shift slightly in favor of the seller as distributors need to replenish inventory and intra-industry transfers of excess inventory are less and less practical as everyone is in the same low inventory situation. According to press reports, $600 per ton hot rolled is the question for later fourth quarter deliveries. So far, the domestic industry's price increases have stuck, we shall see about the $600. Other products have similar scenarios.

Of course, there are those who say that demand has not improved all that much and that the fourth quarter price increases that the domestic industry has announced will not hold. I have also read that some see a "W" shape to the cycle we are in and that in 2010, we will experience another dip in prices and demand. I believe that one reason that the second dip might not arrive is that after a year, some of the infrastructure spending from the stimulus bill should start to kick in. Anyone who knows even a little about major construction spending knows that "shovel ready" really means one year to a year and a half from conception to procurement. That puts us early in 2010 when the impact of the stimulus spending should begin. And yes, I am an optimist – a rare thing for an economist.

The bottom line for importers is that the price increases need to stick and the perception that demand is actually recovering before we see real significant improvements in demand for imported steel. Until then, distributors and consumers will hedge their bets as much as possible by buying small lots to refill inventory holes from the domestic mills whenever they can.

One bright spot for steel traders in recent years has increasingly been exports. The combination of the weak dollar and strong growth rates in many developing countries during 2007-2008 resulted in a surge of exports to record levels. In addition, the free trade agreements negotiated during the Bush Administration and prior eliminated duties on steel exports to many countries, such as the CAFTA – Caribbean area countries -- which previously had been an export market dominated by European steel producers. Going forward, the dollar will remain weak and some of the developing countries have emerged from the worldwide recession much faster than say Europe and the US and even this year, we have seen US steel exports remained more of a positive than certainly the domestic market for many products. We expect that exports will grow in importance for the trading companies and their partners, the domestic steel mills.

Now to the trade scene.

Back in 2001 when President Bush filed the Section 201 case on steel, many were surprised given the president's strong free trade rhetoric during the campaign. However, as we quickly grew to know about President Bush, when he said he was going to do something, he did. During the campaign, many steel companies were in dire straights and they came to Governor Bush and told him of their plight and asked for help – of course in return for their support. Naturally, their message was that there problems were all due to imports – ignoring the obvious problems of legacy costs and other inefficiencies. Secondly, while every president since FDR has been at his core a free trader and all have pushed trade liberalization agenda, since the LBJ times, it has been my observation that first term presidents provide trade protection for politically important constituencies, such as steel, textiles and other industries. President Bush was no exception to the rule. Of course, their motivation has always been to court favor with those who could help them in their re-election bids four years hence.

President Obama has continued that trend. Recently, he approved a three year protectionist tariff against low-end tires from China under what is called Section 421. This was a critical decision. Section 421 was put in place when China became part of the WTO back in 2000. It is essentially another 201 statute that applies only to China. Like the 201 law, the case starts at the International Trade Commission which decides whether or not to recommend to the president some form of relief. If they decide against the case, it dies. If they decide there are grounds under the law – which has a lower standard for injury – to make a recommendation, they find injury and send the case to the president, who has complete authority to accept, change or deny relief to the petitioning industry. In the tire case, the Steelworkers union filed the case and none of the tire companies joined in the case – in fact they opposed it. During the Bush Administration, every 421 case that got to his desk was denied, always due to his stated view that to grant relief to the petitioners would damage consumers more than it would benefit the petitioners. Three of the cases involved steel – pipe and tube, coat hangers and fittings. Given the close relationship President Obama has with the unions (and the steel industry – he was a member of the Steel Caucus during his time in the Senate) he sided with the union. This, notwithstanding his strong statements about open markets, the threat protectionism to the struggling world economy, etc.

While we hope that this is President Obama's political payment to his friends in the union and closes that book, we are very concerned about the precedent that the decision set. With the standard for injury much lower than the Section 201 case, the shorter time frame for making the decision than either the 201 or anti-dumping statute as well as the focus on China, this is a very attractive option for protectionists. Stand by.

As they almost always do, the protectionist winds blow hard during recessions and this recession is shaping up to be no different. In the last two weeks alone, four anti-dumping and CVD cases have been filed by domestic petitioners – two of which were on steel products – fasteners and pipe and tube. Of course, the focus of these cases has been China, although some other countries are also being sued.

The good news so far under the Obama Administration is that they have made all the right statements about the global recession and the dangers of protectionism. In fact, when the stimulus bill was under consideration, it was the Obama Administration that opposed the protectionist version of the Buy American provision that had passed the House. That version would have abrogated all of our trade agreements involving government procurement at the WTO and with our bi-lateral partners, such as Canada and Mexico. Fortunately, the Senate agreed with President Obama and added a provision that the Buy American provision had to be applied in a way that did not violate our international treaties or obligations. So far, so good. In the end, the Buy American provision is protectionist and set a bad example early in the global recession. We saw Buy Canada, Buy Australia and even Buy Indiana grow from our mistake. In addition, we have learned that the Buy American provision is so complicated that it has slowed down procurement, confused procurement officers and even in one example, caused layoffs. Getting the government involved in international manufacturing and distribution is not a good way to "run a railroad."

The Obama Administration also has said all the right things about the Doha Round, even though not much progress has been made since he took over in January. We shall see if the good intentions create good results. During the Bush Administration, problems related to agricultural trade and manufactured goods tariffs stalled and be-deviled the negotiations. With a high level meeting in December 2009 along with positive and encouraging statements coming from Geneva, Washington and other capitals, we are crossing our fingers that the Doha Round will get back on track. This is our best chance to change the US's most protectionist trade law elements.