Special Report

The Chinese Steel Industry in the New Normal Era

Overcapacity has been a chronic problem in the Chinese manufacturing sector. Investment in the steel industry surged in the aftermath of a massive stimulus package during the global financial crisis, making overcapacity even worse. Chinese President Xi Jinping has announced that "China has ended its era of high economic growth and is shifting to a new economic structure." The Chinese manufacturing industry is agonizing over a solution to the issue. This Special Report focuses on the steel industry, investigating the progress of and forecast for manufacturing.

Shim Sang-hyung _ Senior Principal Researcher, POSCO Research Institute
shshim@posri.re.kr

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Will the New Environmental Law Ease Oversupply in China's "Winner-takes-all" Steel Industry?

Xin Chang Tai (新常態), which means the "new normal," has been recently talked about in the Chinese media. The heated debate started after Chinese President Xi Jinping visited Henan province in May, 2014. "China is still in a significant period of strategic opportunity. We must boost our confidence, adapt to the new normal condition based on the characteristics of the current phase of China's economic growth, and stay cool-minded," Xi said.

Xi's "new normal" has no massive stimulus package

The term *new normal* refers to standards that emerge with the changing times. A good example of the new normal is the expansion of the government's role in the aftermath of the Great Depression in the 1930s. While pursuing a new standard to replace the current invalid standard, it is difficult to distinguish whether changes are only temporary or fundamental. China's recent economic slowdown has provoked mixed views: it is a temporal slowdown after the global financial crisis, or the Chinese economy has entered a new chapter.

President Xi's remarks on the "new normal" confirm the Chinese leadership's determination that the Chinese economy is basically different from what it was three decades ago. As the Chinese economy has entered a new era of low structural growth, the authorities will not implement a massive stimulus plan, but will continue to pursue regime reform centered on the market. Although China's output growth in August 2014 slowed to its lowest level since the 2008 global financial crisis, Chinese Premier Li Keqiang stressed that growth is "reasonable and under control." His remark is also in line with market-oriented reform.

Steel oversupply in China spills over into other countries

Recently, the Chinese economy is facing mounting difficulties. With economic growth rates of 7.8% and 7.7% in 2012 and 2013, respectively, China saw its policy of maintaining an 8% annual growth rate (保八) broken. China's economic growth rate further plunged to 7.4% in the first half of 2014. China's industrial production had a growth rate of 6.9% in August 2014, the lowest since December 2008, and accumulated fixed investment had a 16.5% growth rate, the lowest since 2001. The Chinese economy, which is no longer able to depend on economic stimulus, is experiencing confusion and instability while transitioning to the new normal.

> As the Chinese economy has entered a new era of structural low growth, the authorities will not implement a massive stimulus plan and will continue to pursue regime reform centered on the market.

Offshore oil drilling pipes [Shutter Stock]

The steel industry is no exception. China saw its crude steel output increase 2.6% year-on-year to 550 million tonnes in the first eight months of 2014. Demand for crude steel merely increased by 3% as real estate investment declined and manufacturing output increase rates slowed. China's steel sector purchasing managers' index (PMI) decreased to 48.4 in August, the fourth consecutive month below the 50-point mark. (A reading above 50 indicates expansion and one below 50 contraction.) This suggests that the steel industry will remain sluggish for a while. As domestic demand remains stagnant, exports are surging. China exported 56 million tonnes of steel products in the eight-month period, up 34.3% from a year earlier, and total exports for the year 2014 are expected to surpass an unprecedented high of 80 million tonnes.

Steel prices have declined for three consecutive years since 2011. The grade-3 rebar average price was 2,938 yuan per tonne as of September 15, 2014, a 43.6% decrease from its highest point, in August 2011, and a 16.7% fall from early 2014. The sluggish steel market conditions spill over into the industrial ecosystem. China's coking coal prices declined by 26.5% in 2014, and by 57% from their last high. Global iron ore prices plunged to 50% of their previous high. In the heated competition among steelmakers, about one-third of steel e-commerce companies are idle. Steelmakers, desperate for customers, have increased direct sales even to small companies, narrowing the purview of distribution companies.

Confusing policies despite government willpower to address oversupply

The Chinese economy has a problem of "double

China's new environmental protection law, which took effect on January 1, 2015, will become a strong tool for restructuring. Chinese steelmakers are required to construct additional environmental facilities, which are estimated to increase steel costs up to 15-20 yuan per tonne.

excess (兩過)," which refers to industrial overcapacity and massive debt overhang. A good example is the steel industry. The average utilization rate for all manufacturing hovered just below 80% in 2013, and the utilization rate for the steel industry was even lower, at 74.3%. Continuous facility expansion makes it all the more difficult to resolve oversupply.

In the first half of 2014, 88 major Chinese steelmakers had a mere 1.1% increase in sales year-on-year. Profit margin was only 0.4%, far lower than China's manufacturing average of 5.6%. The aggregate sales growth rate plunged to 0.9% in the first seven months of 2014. Of the 88 Chinese steelmakers, 12 companies ran deficits, five of which had deficits of more than RMB 500 million. In general, financial expenses, including interest, increased 28.6% compared to the year earlier, short-term borrowing rose 5.6%, and trade receivables rose 12%. The deterioration of cash flows is attributed to debt and interest increasing, and the increasing difficulty of collecting money from sales.

Double standard for large state-owned enterprises

The Chinese government seems determined to reduce the side effects of overcapacity. Since late 2012, the Chinese government has investigated the status of steel production facilities and released a list of companies and plants that are non-compliant with environmental standards or have failed to obtain proper permits for facility construction or expansion. Given that overcapacity has not been addressed amidst continuous facility construction and expansion, China's new environmental protection law, which took effect on January 1, will become a strong tool for restructuring. Chinese steelmakers are required to construct additional environmental facilities, such as desulfurization facilities, in order to comply with the new law. This is estimated to cost as much as RMB 300-400 billion. As such facilities are estimated to increase steel costs up to 15-20 yuan per tonne, the steel industry, which is low-profit, cannot endure the rising costs. It remains to be seen whether the new environmental law will be effective in addressing overcapacity.

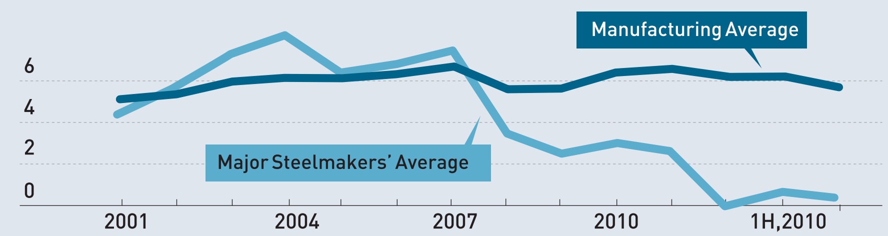
Close attention should be paid to the choices of Chinese steelmakers, which have already reached a critical point, and to the response of the Chinese government. In April 2014, the Chinese government did nothing about the default of Haxin Iron and Steel. This inaction came right after Premier Li Keqing warned in the National People's Congress in March that the individual defaults of some companies and financial products are "unavoidable." This was the government's first instance of practicing market principles to solve the problems arising from financial companies' reckless corporate lending and local governments' unethical subsidization of poorly-performing companies.

However, *China Business News* and *China Metallurgical Newsletter* have recently reported that approximately 30 listed steelmakers suffering from poor performance received government subsidies of RMB 4.47 billion and 2.83 billion in 2012 and 2013, respectively. Market principles work in the default of small and medium-sized steelmakers, but the government still supports large and state-owned steelmakers in their poor performance, because the collapse of such companies could shock the market. It is a difficult choice for the Chinese government, which is responsible for eliminating confusion. Their decision is the very reason that the government makes no progress in restructuring.

New normal era poses threats to Korean steel industry

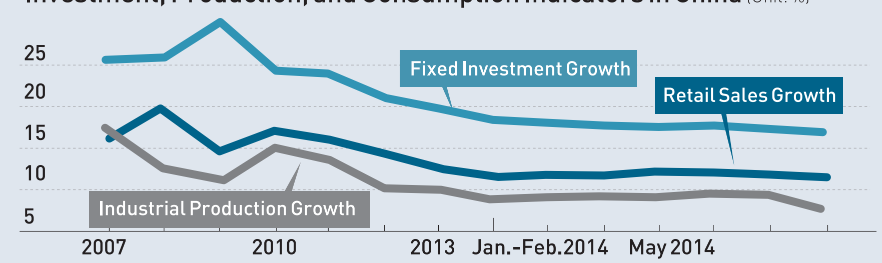
As the Chinese steel industry enters a low-growth

Profit Margin of Major Chinese Steelmakers (Unit: %)



Source: National Bureau of Statistics of China (www.stats.gov.cn)

Investment, Production, and Consumption Indicators in China (Unit: %)



Source: National Bureau of Statistics of China (www.stats.gov.cn) phase, companies are increasingly on opposite ends of the spectrum. In the first seven months of 2014, China's ten most profitable steelmakers accounted for 98% of total profit, while 70% of losses came from the five worst-performing steelmakers. A new environment of restructuring has been created wherein weak companies are pushed out of the market and strong companies become stronger still. Baoshan Iron and Steel has strengthened technology management by setting up "Golden Apple" teams for foreign patent applications, and is implementing outpacing strategies, including a strategy to expand its auto-parts business. Anshan Iron and Steel has also been taking bold measures, as seen in its merger with a stainless steel company.

The Chinese economy is undergoing transition and the steel industry is experiencing changes, which are naturally accompanied by pain. The issue is that this process has a significant impact on the Korean steel industry. China's unprecedentedly high exports have already intensified competition in the global market, and higher trade barriers of advanced countries have a great impact on Korean exports. There is no way to stop the inflow of Chinese steel products into the Korean market. As Korea accorded China full market economy status in late 2005, Korea cannot use anti-dumping or subsidies as bargaining chips, as it does with the USA and Europe. This will become a serious problem in the future, as pressure is mounting from competition with Chinese steelmakers, which will become even stronger through depression. Now is the time for the Korean steel industry and the entire Korean economy to think long and hard about survival strategies in the "new normal" era.

New Normal Solutions for the Chinese Steel Industry

The Chinese steel industry's survival strategy is changing, mainly because current methods no longer work.

Integration of global capital, distribution channels, and Chinese steel production

In late September 2014, China's largest steelmaker, Hebei Iron and Steel Group, announced its taking a 51% stake in Switzerland-based Duferco International Trading Holding. The deal, with an investment of about USD 400 million, is in the process of government approval and is expected to be closed by the end of 2014. This deal is noteworthy because it is a new model wherein global assets and distribution channels are combined with Chinese manufacturing.

In March 2013, Tangshan Iron and Steel (Tangsteel), which is affiliated with the Hebei Group, invested USD 78 million to acquire a 10% stake in Duferco. In late 2013, Deutsche Bank, together with a parent company of Duferco, arranged an USD 800 million structured steel pre-payment loan to Tangsteel to facilitate the pre-payment of its steel exports to Duferco. Tangsteel, which suffered from profit decline due to oversupply in the domestic market, received a funding lifeline.

Tangsteel is utilizing Duferco as a channel to expand exports, as Duferco is the most effective marketing channel accessible to approximately 28,000 customer companies in Europe, and North and South America. Tangsteel's exports, which were 1.42 million tonnes in 2012, exceeded 3 million tonnes in 2013, and the goal for 2014 is 4 million tonnes. Tangsteel exports nearly 30% of its 12 million tonnes of total flat production.

Duferco took a step further to improve the competitiveness of Hebei Group by transferring its steel technologies and knowhow to Hebei and supplying iron ore at preferential prices. Hebei Iron and Steel Group was established in 2008 with the merger of six state-owned steelmakers that produced mid-to-low grade steel for construction, including Tangshan Iron & Steel, and Handan Iron & Steel, based in Hebei province. Hebei Group is China's largest steelmaker by output; however, it is vastly inferior to Baoshan Steel, the de facto No.1 company in the country, by technology, business management, and globalization. Duferco and Hebei Group pledged to jointly increase production for auto steel, which is still promising in China, and to construct a new steel plant with an annual capacity of 5 million tonnes in South Africa.

This is the integration of a distribution company of an advanced country that wants to make profit from price competitive steel products of Asia and other emerging countries through global sales channels, and a Chinese steelmaker that has turned its eye to overseas markets to avoid competition in China but is struggling to establish its own distribution networks. This kind of model, which expands exports of Chinese steel products, is a big concern for Korean steelmakers.

New private investment company for merger of steelmakers

China Minsheng Investment Corp. (CMIC, 中民投), which was formed by 59 domestic private companies, is a private investment company that was launched in China, which aims to integrate steelmakers on the brink of restructuring. In late August 2014, CMIC was set up with the aim of operating businesses through M&As across a number of areas in new and renewable energy, steel, mining, asset management, home appliances, pharmaceuticals, machinery, and manufacturing. CMIC announced the merger of four private steelmakers and other companies to establish a large steelmaker with an annual capacity of 100 million tonnes, and build a value chain from iron ore purchase to the establishment of a steel distribution company. If successful, the private investment company will serve as a model wherein the private sector takes the lead in easing severe restructuring pressure. However, it is questionable whether CMIC has the capability for business management and mobilization of massive funds.

Lee Byung-woo _ Head of General Administration & Support Division
Korea Iron and Steel Association (KOSA)
byungwoo.lee@ekosa.or.kr

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Chinese Steel Products Spill Over into the World Market and Raise Global Trade Barriers

China's steel exports have reached an unprecedented high, spilling over into the world market. Korea has been China's largest steel export destination over the past decade. This year, the share of Korea's steel imports from China is rising rapidly.

China's crude steel production reached 550 million tonnes in the first eight months of 2014, a 2.6% increase year-on-year. Because China's frozen domestic construction and manufacturing markets have led to stagnant demand for steel, China is exporting its steel surplus. In those eight months, China's steel exports totaled 56.8 million tonnes. If this trend continues, China's crude steel production will reach 830 million tonnes, and its exports will increase by 44% to 85 million tonnes in 2014. If this happens, China's exports will account for 27% of global steel exports in 2014, which will stand at 312 million tonnes, excluding 95 million tonnes of intra-EU trade.

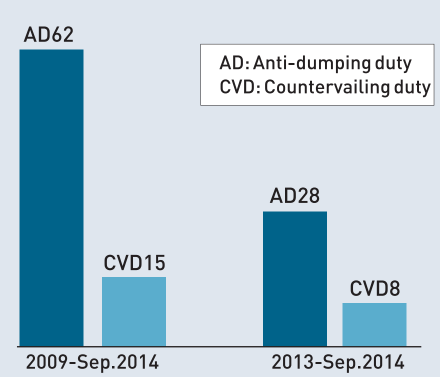
China's steel exports rose by 27% from January to August of 2014, compared to a year earlier. Given that China's exports of steel products had an annual increase of 10-15% for three years from 2011, this was a two-fold increase. China's main destinations for steel exports are Korea (15.2%), the USA (6.7%), Southeast Asia (19.0%), and the EU (16.2%). Korea imported 8.12 million tonnes of Chinese steel products in the same period and is expected to import 12 million tonnes in 2014, becoming the largest importer of Chinese steel products.

Examining exports by product from January-August 2014, exports of long products increased by 27%, a similar rate to previous years. However, exports of flats jumped by 42%, after reaching no higher than 7% in the previous three years. Flats are leading the increase of China's steel exports: hot-rolled steel (80%), cold-rolled steel (46%), galvanized steel (31%), and medium and thick steel plates (26%).

The increase in China's steel exports to Korea follows a similar trend. China's steel exports to Korea (January-September 2014, according to Korea Customs Clearance) increased by 37%. In detail, exports of long products rose by 18%, while exports of flats soared by 49%. China's exports of steel products to Korea rose above the global average: hot-rolled steel (56%), cold-rolled steel (31%), galvanized steel (56%), medium and thick steel plates (35%), and color sheet plates (93%).

The global steel industry is witnessing a domino effect, whereby countries follow in the footsteps of a country that has filed petitions against China, for fear of Chinese steel products being diverted to their countries.

AD and CVD Cases Against China



Source: Japan Iron and Steel Federation (JISF)

Warnings and trade restrictions on Chinese steel products

As China's steel exports have jumped, many countries have increasingly imposed trade restrictions on Chinese steel products. The global steel industry is witnessing a domino effect, whereby countries follow in the footsteps of a country that has filed petitions against China, for fear of Chinese steel products being diverted to their countries. As the United States has filed anti-dumping (AD) and countervailing duty (CVD) cases against grain-oriented electrical steel from China, the EU has followed suit. After the United States lodged AD and CVD cases against China's steel pipes in 2009, a number of South American countries, including Brazil, Argentina, Colombia, and Peru, also filed AD cases against China, alleging that Chinese steelmakers had dumped seamless steel pipes into the Latin American market.

The steel industry is traditionally marred by trade disputes. In particular, the number of disputes rises exponentially when the market is depressed. During the Asian financial crisis (1998-2002), as many as 130 AD and CVD safeguard measures were filed against China each year. During the global financial crisis, trade disputes declined until 2011, as exports fell. However, as the USA and other advanced economies started to recover and imports increased, steel trade litigation began to rise. From 2009 to September 2014, 20 countries filed 91 trade cases (including safeguard measures) against Chinese steel products. Of the 91 cases, 62 were anti-dumping cases, 15 were countervailing cases, and 14 were safeguard measures.

Recently, ASEAN countries have set up a primary line of defense by imposing anti-dumping duties on cheap Chinese steel imports, and then instating safeguard measures for double protection. After Indonesia imposed safeguard duties on Chinese twisted-pair wire imports in 2010, other countries followed suit: Malaysia (hot-rolled steel) in 2011; Indonesia (galvalume steel), Thailand (hot-rolled special steel) in 2012; Philippines (galvanized steel) in 2013; Indonesia (wire rod, shape steel), Thailand (hot-rolled sheets, plates), Malaysia (plates) in 2014. The ASEAN has imposed six safeguard measures against China since 2013. As a result, the Southeast Asian steel market is becoming fragmented, with high trade barriers set in place by various anti-dumping and safeguard measures. A safeguard is an emergency measure that is supposed to limit imports of a certain product from all countries indiscriminately. However, safeguards are being used recklessly to control imports from China.

Will China's steel exports reach 100 million tonnes in 2015?

In 2014, the landscape of China's steel exports has changed rapidly in many aspects, including increased rate and quantity. First, long products have shown the highest increase in exports so far, but recently, exports of flats have increased significantly. Second, China's steel exports soared to 43 million tonnes in 2010, and 57 million tonnes in 2012. They are estimated to reach 85 million tonnes in 2014, a 98% increase from 2010. As China's demand for steel is expected to remain low, no higher than 0.8% in 2015, the question of wheth-

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The Chinese government must cut import duties drastically and liberalize foreign investment in the steel industry in order to address oversupply.

er China's steel exports will reach 100 million tonnes is drawing much attention. Third, Chinese steel exports are 20-50% cheaper than the domestic steel prices of importing countries, devastating their domestic markets. For example, Chinese plate exports cost USD 470-475 per tonne, almost half of the U.S. domestic price of USD 936-992 per tonne. In Korea, Chinese H-beam exports cost KRW 630,000 per tonne, while Korean H-beam is KRW 800,000 per tonne. Depending on unfair trade petitions filed by importing countries, the gap between the price of Chinese steel exports and the domestic price of an importing country can be even wider. Fourth, Chinese exports benefit the most from a 9-13% value added tax rebate for boron steel and other special steel. This is the Chinese government's strategy for expanding exports. This is why many countries include special steel in their anti-dumping and safeguard measures against China.

As cheap Chinese steel exports devastate other countries' domestic markets and entrench low-

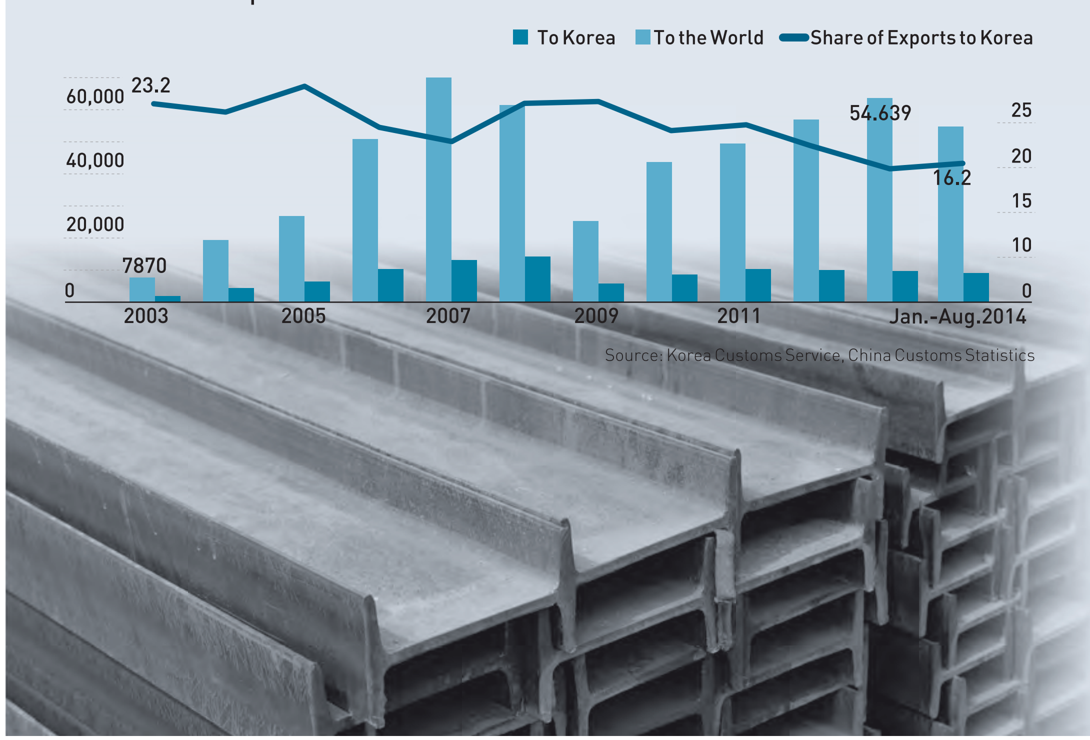
A worker at a steel plant in Luannan, Hebei Province, China

Safeguard Measures Against China

	2009	2010	2011	2012	2013	Oct. 2014	Total
Emerging Countries	India (HR) GCC (H-shaped beams)	Indonesia (Twisted-pair wire)	Malaysia (HR)	Indonesia (Galvanume), Thailand (HR special)	India (Seamless steel pipes) Russia·Belarus·Kazakhstan (STS pipe), Philippines (Zinc-coated)	Indonesia (Wire rod/Other shape steel) Thailand (HR/Plate) Colombia (Long products) Malaysia (Plate)	Eight Countries
Total	2	1	1	2	3	6	14

Source: Korea Iron and Steel Association

China's Steel Exports to Korea and the World



Source: Korea Customs Service, China Customs Statistics

profit structures across all industries, the global steel industry is facing problems so severe that they prevent restructuring. The OECD Steel Committee has announced that the steel industry would require a 17% average EBITA margin to be economically sustainable, but recorded only 10% in 2013. According to analysis of listed Korean steelmakers, operating profit margin plunged in the first half of 2014, and two in ten Korean companies have been unable to pay interest on their debts from their operating profits for the past three years.

As cheap Chinese steel products encroached into the Korean market, the share of Chinese imports rose from 19.2% in 2013 to 23.5% in January-August of 2014, a 4.3%p increase in eight months. By product, Chinese H-shaped steel beams have a 30% share of the Korean market, steel bars 28%, wire rod 28%, hot rolled sheets and medium heavy plates 22%, and color sheet sheets 34%. Japanese and Chinese imports combined account for 40% of the Korean steel market, and more than a 30% share of each of the steel products mentioned above. In order to reduce damage to the market, the Korean steel industry filed an anti-dumping petition against Chinese H-beams in July 2014. Historically, the USA enacted a law to rationalize its steel industry and reduce its share of imports from above 20% to 17-18%, and adopted quotas for each country. The EU imposes anti-dumping duties when the share of imports exceeds 10%. These cases show that the large share of imports in Korea poses a serious threat to the Korean steel industry.

One characteristic of Chinese steel exports is that China exports not only steel materials, such as hot-rolled sheets and wire rod, but also final products. Therefore, it weakens the business base of Korean machining companies that produce cold-rolled sheets and steel pipes. In other words, cheap Chinese final products eat into the final product market, which is dominated by Korean machining companies that use cheap Chinese steel materials. For this reason, ASEAN countries, which usually have more re-roller mills than integrated steel mills, are desperate to protect their domestic markets from Chinese imports.

Activation and opening of market functions are solutions to overcapacity

Overcapacity in China is not a short-term problem that can be solved by exporting surplus products, but a structural problem. It is not in China's interest to continue with overproduction and increase exports without pushing poorly-performing companies out of the market. It has no benefit or justification; its only result is creating trade conflicts with foreign companies. If China's steel exports reach 100 million tonnes in 2015, international criticism of China will mount. The sound recovery of the global steel industry is directly related to the interests of China, which occupies the majority of the global steel market.

Addressing oversupply and promoting sound recovery depend on activation and opening of market functions. To this end, the Chinese government must cut import duties drastically and liberalize foreign investment in the steel industry. Above all, the Chinese government needs a drastic shift in its policies to make the market more vibrant, for example, eliminating support to weak companies, such as the value added tax rebate on boron steel.

Shim Sang-hyung _ Senior Principal Researcher, POSCO Research Institute
shshim@posri.re.kr

China's Steel Industry Has to Adapt to the New Normal of Low Growth and Corporate Reform

In this article, Chindia Plus Quarterly listens to a leading expert in China's steel industry who designs the government's restructuring plan for the steel industry, and is involved in amending the new environmental law and planning corporate development. Shim Sang-hyung, Editing Director of Chindia Plus Quarterly, has a telephone interview with Chi Jingdong (遲京東), Deputy Secretary of the China Iron and Steel Association (CISA), who oversees the business of "environmental protection, energy saving, and sustainable development."

The Chinese government is well aware that oversupply cannot be addressed by exports. It is conducting research into measures to control expedient increases in exports.

Chi Jingdong (遲京東), Deputy Secretary of the China Iron and Steel Association (CISA)

Q: What is the current mood of China's steel market?

A: First of all, China's crude steel output is estimated to increase to 830 million tonnes in 2014, and exports might reach nearly 90 million tonnes. However, steel usage will increase by less than 2% in 2014, slightly above the level of the previous year. China's steel industry is greatly affected by sluggish consumption. With the construction of new production facilities one after another, China's steel capacity currently stands at about 1.1 billion tonnes. China's steel price index is 86-87, meaning that it has fallen to 86-87% of the 1994 level of 100. Even taking into account recent declines in iron ore prices, steel prices have declined more than expected due to the unstable climate. Consequently, the profit margin of the steel industry remains below 2% in 2014.

Q: How are Chinese companies responding to the situation?

A: As Chinese companies have inadequate means of response, prices continue to decline. Some companies lead the market in specific steel products, but in most cases, price is the only means of competition. Leading companies are trying to save costs, increase exports, and develop products and technologies, but market conditions are still difficult.

Q: Despite the unfavorable situation, we hear no news of an increasing number of Chinese companies going bankrupt. Why is that?

A: China's steel industry still has leeway to handle the situation. In response to increasing financial risk, Chinese steel companies are strengthening control over their inventory, asset management, and business administration. Even though they have no troubles in their financing systems, they are extending debt repayment plans by strengthening relations with banks. Furthermore, production costs have decreased in many cases, as many companies have completed their depreciation schedules for existing facilities. Above all, steel demand in China is slowly growing, not declining.

Q: The "new normal" of the Chinese economy is being much talked about. How is the Chinese steel industry responding?

A: The "new normal" is meaningful to the steel industry for three main reasons. First, the Chinese economy is transitioning from achieving a high growth rate of 9-10% to maintaining medium growth of below 8%. The era of high economic growth, which drives up steel consumption, has ended. Second, the government has transferred its authority to the market in the process of "deepening reform." Now steel companies have the authority and responsibility of investment. They decide for themselves to make and implement investment plans. They do not have to undergo the ratification process of the National Development and Reform Commission or regional government authorities. However, social costs incurred as a result of investment are managed by the government. Actually, the government is controlling the situation more stringently through environmental protection laws and standards. The final issue is reform of Chinese steelmakers. In particular, they must increase economic efficiency, which has been low due to the legacy of state-owned companies. Large state-owned steelmakers have already set out to take their own reform measures. They are in the process of internal reform, including reorganization of management, outsourcing of certain functions, and merger and abolition of duplicate businesses. It is a big challenge for the government to adopt modernized business models for these stated-owned companies, and the government is prioritizing research into a solution.

Q: Worries are mounting over China's surging exports. It is estimated that China's exports will reach nearly 100 million tonnes in 2015. What are your projections?

A: The government's position is that exports by basic materials industries, including the steel industry, is undesirable, because they consume a large amount of resources and energy and generate environmental pollution. China is well aware that oversupply cannot be addressed by exports. The government is conducting research into measures to control expedient increases in exports such as boron steel. I do not expect China's exports to reach 100 million tonnes in 2015. Global demand should be considered in conjunction with China's oversupply, because global demand is not expected to improve in 2015 compared to the previous year. China's exports will increase no more than 2% in 2015.