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INTERESTING TIMES

Last month, the Congress approved the Central American Free Trade Agreement (“CAFTA”) by an extremely narrow (two votes in the House) margin. Passage required some extraordinary efforts by the leadership (including a personal lobbying visit to the Capitol by the President), bending of the rules and, reportedly, some pretty generous promises for special treatment under the ensuing highway bill.

CAFTA is not highly significant to the United States from an economic point of view. The trade numbers are fairly small, and the countries concerned already enjoy the benefits of very low US tariffs on most products that they sell to us, and our industries that are sensitive to low cost imports were given special treatment. Thus, on the surface, CAFTA promises to give US producers easier access to markets in the region by lowering duties now imposed by Central American countries, without unduly changing the access of their products to our market.

Why then was it so difficult to get CAFTA approved? Most observers noted the opposition of American labor to the Agreement, but many believe that there were deeper issues at play. Opponents noted that manufacturers in developing countries have substantial advantages over their American competitors – cheaper labor and freedom from the great number of government requirements imposed in the US, particularly environmental controls.

These issues were also mentioned in the course of approval of the North American Free Trade Agreement (“NAFTA”) by the Congress in 1994. At that time, they were addressed by the addition of “side letters” to that Agreement that required Mexico to take certain steps in the environmental area and to provide workers’ rights. This time, such agreements were not enough to dampen a good deal of opposition, even though the economic stakes were much, much smaller than those at play under NAFTA.

What happened?

I have written before about the traditional approach by economists to international trade. Simply put, they have asserted that there are long-term benefits to free (and fair) international trade that outweigh the short term dislocations. They say that every country will prosper if each is permitted to employ its comparative advantages to produce and market products sold on the global market. It is this fundamental assertion that is now under reexamination. Many economists now believe that a corollary must be added to the traditional trade rules to address the ability of countries with large populations of low wage workers to create massive manufacturing sectors that can simply overwhelm their competition in developed and developing countries alike.

We in the steel industry have seen this development up close in the case of China. The Chinese steel industry is enormous, and it is going to get much bigger. The government there is converting its industry from a large number of mostly smaller producers into a group of about ten companies, each making at least 30 million tons of steel products annually. Foreign investors will be limited to minority interests. There will be limits on the export of inputs like coke and scrap and of primary products like billet and slab. So far, much of the Chinese production has been used domestically; however, when internal demand slackens for any reason, China will be positioned and even compelled to offer very low priced exports of downstream steel products to the rest of the world. Will Chinese production outstrip internal needs? The answer, of course, is yes, sooner or later, and the sooner looks more likely as production continues to escalate breathlessly (which it did to the tune of over 28% in the first half of 2005).

The US already imports oceans of Chinese products, more than we sell them by \$162 billion in 2004 and over \$90 billion in the first half of 2005. This trade imbalance creates another problem that the traditional theories of free trade have not addressed – the accumulation of gigantic foreign exchange surpluses with economic and political implications that have never been tested. Briefly, the question that will overarch US-China relations in the future will be whether they see it in their interest to continue to underwrite American consumers if the dollar assets they hold continue to sink in value. Traditional theories of international trade do not provide answers on this issue.

These factors help to explain the current unease with agreements like CAFTA and with the current international trade negotiations know as the Doha Round. Until these new problems are addressed, if they can be, future trade agreements will be difficult to conclude and even harder to adopt. We live in interesting times.

Some specifics for this month:

- Scrap and Pig Iron. Prices for #1 dealer bundles and #1 busheling (Chicago) have zoomed upward to \$240 mt, an increase of \$80, or 50%, since last month. Increased export demand explains part of this increase, but domestic market factors must have been at play as well, as buyers calculated their needs for the second half of 2005. Brazilian pig iron (cif New Orleans) increased from \$225 mt last month to \$240 in August, and reports of sales between \$250 and \$260 mt have appeared in the *American Metal Market*.
- Ocean Freight. The Baltic Capesize Index continued its five month decline in July. It is now at 2570, the lowest level since March, 2003.
- Natural Gas. With crude oil going through the roof, it is hardly surprising that natural gas has followed suit. The Nymex contract price in early August was \$8.80 mcf, up by \$1.35 over July and exceeding the record high of November, 2004.
- Foreign Exchange. The dollar lost ground against the euro and the British pound last month. The euro is currently worth about \$1.23 and the pound \$1.81. The Canadian dollar has also strengthened to 83¢.

As usual, we are posting this letter on our website www.coreysteel.com. It will also appear on www.steelonthenet.com. Please let us have your thoughts.