How the Great Rare-Earth Metals Crisis Vanished

China's attempt to control the market for materials essential to the tech industry is turning to dust.

Joseph Sternberg, Wall Street Journal, 1-9-14

There was a time, not so long ago, when the world feared China was going to use its dominance of the global rare-earth-element industry to crush Western economies and militaries in a strategic vise. Those were the days. Recent developments highlight how wrong those alarmist predictions were.

Rare earths are the metals at the bottom of the periodic table that are exceptionally useful in many high-tech applications, from lasers to solar panels to electric car batteries to smartphones. China is the world's major extractor and only processor of rare-earth ores.

Beijing aroused worries in late 2010 when it apparently limited exports of the minerals to Japan amid a territorial dispute. The episode stoked fears that China would use its sole-supplier status for nefarious ends.

Except that it turns out Beijing doesn't have the wherewithal to execute such a dastardly plan. Consider the new plan Beijing unveiled last week to consolidate its rare-earth industry into six large extraction and processing companies. As a start, Inner Mongolia Baotou Steel Rare-Earth Hi-Tech Company (yes, that's its name) is buying nine of its smaller competitors in the north, with more mergers and acquisitions to come.

This is at least the second time in roughly a decade that Beijing has attempted rare-earth rationalization. The first foundered when faced by opposition that included the local officials who so often sponsor projects away from Beijing's watchful gaze.

The consolidation drive is a sign of weakness, not strength. The impetus is Beijing's need to resolve the problems its past interventions in the market have created.

Export restrictions kicked in three years ago, officially justified by the need to reduce the pollution caused by mining and processing. Global prices rose dramatically, creating an incentive for new miners to start production, and an opportunity for them to profit from circumventing export blocks via endemic smuggling.

Meanwhile, Beijing's economic stimulus policies lowered the cost of credit, making it easier to fund this investment. But once the global panic subsided and demand slackened, rare-earth prices fell by as much as 60% from their 2011 peaks. Oversupply is the new worry.

On a related note, the export restrictions also have not helped Beijing mitigate the environmental damage caused by the rare-earth industry. Processing the ores is messy work, and Beijing seems to have hoped that whatever other mercantilist objective it might achieve, limiting export quantities would also lead to a cleanup of the industry at home.

Not so, because the restrictions stimulated new mining by small, illegal operators with even worse environmental practices than the big companies. Now lower global prices and the resulting thinner profit margins make costly environmental compliance that much harder.

Don't suppose for a minute that centrally arranged consolidation will solve any of this, since consolidation doesn't fix the underlying problem with China's approach to rare earths: Beijing still steadfastly refuses to

allow the market to operate. Just ask yourself, when is the last time that politically allocated capital; administrative controls on price, production, export or other disposition of an output; and centrally determined corporate structures resulted in a rational industry, in China or anywhere else?

For guidance on better options, Beijing could look abroad. The other big rare earths story of the moment highlights the extent to which Beijing's non-market machinations have triggered helpful market responses elsewhere.

A Pentagon report leaked last month noted that reliance on Chinese rare-earth metals, while still high, is declining. New supplies for most rare-earths are coming online, as uncertainty over China's reliability and a period of higher prices stimulated investment in new mining projects elsewhere. Greenland and Russia both have opened new tracts to rare-earths exploration in the past year. China's share of global production now is down to as low as 80% from 95% in 2010.

This overseas rare-earth industry is not so different from the Chinese version, insofar as it's sustained, for now at least, by readily available capital thanks to the post-2010 surge in investor interest. But what the foreigners do have is a market mechanism for industry rationalization over time, as more profitable miners prosper and others go bankrupt or merge into their healthier peers via an organic process of consolidation.

Meanwhile, note an especially piquant detail: Manufacturers are rethinking their dependence on the metals as an input. One suspected goal of China's export restrictions was to force foreign manufacturers to shift more of their high-value-added, high-tech production into China in pursuit of more readily available domestic supplies.

Instead, foreign high-tech companies increasingly invest in new recycling methods, or products that rely less on rare earths. They have not weaned themselves off the metals by a long shot. But the technology frontier is shifting ever so gradually away from rare earths, and from China.

This does not add up to a major industrial-policy victory for Beijing. It's safe now to put away our smelling salts.