CHAPTER 5

Reforms and Restructuring Abroad

Introduction

There are some encouraging signs that the key overseas steel producers involved in the U.S. steel crisis are prepared to address market-distorting practices. Japan, Russia, Korea, and Brazil have each suffered from severe or prolonged economic downturns. In the face of these downturns and to stimulate economic renewal, these countries have begun to implement market-based reforms. In turn, such reforms could help curb market-distorting practices that have plagued global steel trade.

- The governments of Japan, Korea, and Brazil have announced measures to address the significant **structural problems** confronting their financial and industrial sectors.
- Brazil is attempting to address the problem of **anticompetitive business relationships** among members of their steel industry. There are some indications that there may be increased competition within the Japanese steel industry.
- Russia's new leadership has made a **commitment to reform**.

These efforts have had mixed success to date. It remains to be seen whether they will have a lasting impact on the global steel market. To the extent that reforms are achieved, the U.S. steel industry and the national economies of these countries will share in the benefits of a healthier international steel marketplace.

Russia

Developments in Russia since August 1998 offer bright prospects for the future: the economy is growing; barter is down; and, taxes and wages are being paid. This period of relative economic well being creates an opportunity for reform. Politically, President Putin and Prime Minister Kasyanov have recognized the need for reform. If the Russian steel industry uses this opportunity wisely, it can become a world-class steel producer and can compete fairly in the future.

In a five-year development strategy issued in late 1999 under President Yeltsin, the government of Russia laid out a plan for modernizing the industry with a limited amount of government assistance. Issues such as the nonpayment of taxes and wages and barter are discussed, although tangentially (in the context of the need to control input pricing and restructure companies' debts).[1] President Putin's recently announced economic plan, however, does aim to address many of the structural problems that have distorted the business environment of the Russian steel industry.

Opportunity for Change in Buoyant Russian Economy

Recent economic growth gives Russia breathing room to pursue reforms. The Russian economy is performing better than at any time since the breakup of the Soviet Union. In 1999, economic growth was up over 3 percent. Russia's industrial sector grew by 8 percent in 1999 and more than 10 percent in the first quarter of 2000.[2] Economywide growth is expected to be up to 5 percent in 2000.[3] Domestic steel consumption rose 10 percent in 1999 and was up approximately 15 percent during the first five months of 2000.[4]

Tax receipts are up too and, due to the government's insistence, so is the percentage of taxes collected in cash. Some barter payments for regional taxes remain, but at a reduced level.[5] Wage arrears are down throughout the economy.[6] Reportedly, the three largest steel companies are current on both their wage and tax bills, and the rest of the industry appears to be current on their wages. Steps have even been taken to address the issue of input pricing; although utility rates remain below world levels, gas rates were raised in February 2000, and electricity rates in May 2000.[7]

The extent of bartering in the overall economy has dropped from 54 percent to 36 percent.[8] In January 2000, cash payments to the natural monopolies (the gas, electric, and railroad companies) rose to 63 percent, from 46 percent the previous year. In the steel industry, the numbers are even better. Overall, the latest industry estimate is that barter has dropped to 15 percent of domestic steel sales; two companies have even reported barter sales have been eliminated.[9] The 1998 ruble depreciation caused export-oriented industries such as steel to suddenly become highly profitable. While costs (mostly ruble-denominated) dropped dramatically, revenue (mostly dollar-denominated) increased markedly. The sudden infusion of hard currency has made barter transactions less attractive, at least temporarily.[10]

With the domestic economy doing well and domestic demand for steel on the rise, Russian steel producers have a chance to improve their profits and, perhaps, decrease their dependence on exports.[11] In fact, two of the largest Russian steel companies are currently reporting a slight decline in exports due to the strong domestic economy.[12]

The government is forecasting that domestic demand for steel will increase nearly 50 percent by 2005. Demand for steel from the power generation, transport and heavy engineering sectors is expected to propel demand, increasing by 70 percent. The defense and automobile industries are expected to increase their need for steel by 65 percent and 45 percent, respectively. As a result, production of rolled steel products is expected to increase 30 percent by 2005. Exports of Russian steel are expected to increase slightly.[13]

Over the longer term, Russian steel industry and government representatives emphasize that when the Russian economy gets back on its feet, domestic demand for steel will increase significantly. For instance, industry and government officials point out that many of Russia's 120,000 kilometers of rail lines and 400,000 kilometers of pipeline will need to be replaced.[14] These two undertakings alone will require several million tons of steel.[15] If increased domestic demand leads to higher profits, the Russian steel industry has the opportunity to invest these profits in becoming a world class steel producer and a fair trader on the global steel market.

Hopes for the Future

Not only is the economy doing well, there are encouraging signs that Russia's new leadership has a grasp of Russia's economic problems and the will to go forward with significant economic reforms. President Putin has described the problems of the Russian economy as follows:

> The current dramatic economic and social situation in the country is the price which we have to pay for the economy we inherited from the Soviet Union. …We had to install market elements into a system based on completely different standards, with a bulky and distorted structure. And this was bound to affect the progress of the reforms.[16]

Recognizing the need for change, President Putin has called for the end of "nonpayments, barter, and other pseudo-monetary forms of settlement."[17] Similarly, Russia's new Prime Minister, Mikhail Kasyanov, has called for reform and emphasized that recent economic growth is not sustainable and will only continue if structural reforms are enacted.[18] "We cannot ease the pace of reforms, or else we shall end up standing in one place and eventually get mired in stagnation," the Prime Minister stated in May 2000.[19] To help integrate the Russian economy into the world economy, prompt economic reform and foster the movement towards a market economy, President Putin is also pursuing Russia's entry into the World Trade Organization.[20]

Russia's 1999 Steel Development Strategy

As in its previous five-year program (1993), Russia's steel development strategy of 1999 focuses largely on modernizing facilities and upgrading equipment. The stated goals of the strategy are (1) to ensure the supply of competitive products to domestic and export markets by improving the quality of Russian steel and increasing operating efficiencies and (2) to raise the level of technology employed in the manufacturing process. Meeting these goals, according to the strategy, will raise production for domestic consumption, increase foreign currency earnings, enhance Russia's economic security, and ensure social stability.[21]

Centrally Planned Restructuring—Picking Winners

The strategy's primary objective—restructuring production—calls for the modernization and renovation of "promising" companies by:

- Improving the quality of traditional products.
- Producing new products, including galvanized sheet for cars, rails for high-speed trains, and large-diameter pipe for gas pipelines (*see box*).[22] The production of new products appears premised upon a policy of import substitution.[23]

To facilitate modernization, companies have been ranked according to their importance to the Russian economy as a whole or to the economies of specific regions. The ranking may be used to determine the

Building a New Plate Mill

Late last year, the government of Russia requested bids for a $1 billion project to build a new extra-wide steel plate mill, known as Mill-5000, to make large diameter pipe for the Russian gas company Gazprom. Currently, Gazprom imports roughly 750,000 metric tons (MT) of pipe each year from Japan and Germany. Production from the new mill would replace these imports.

The government is leaning towards awarding the project to Nizhny Tagil, although financing remains an issue. Based on press reports and U.S. embassy reporting, the Russian government is considering taking a substantial ownership interest in the new project. Tax incentives may also be provided for the new project. Other bidding consortia continue to say they will look to put together the plate mill project with private sector financing.

In recent years, Nizhny Tagil has been close to bankruptcy. Industry speculation before the announcement was that Nizhny Tagil's relatively weak financial position would actually be an advantage in the selection process.

priority of targeted state subsidies, either through the direct allocation of resources, or indirectly, through tax breaks and other privileges. Russia's economic security in metal production was a prominent consideration. The following measures were identified as necessary to ensure economic security:

- Maintaining an adequate level for each stage of production, from mining to final product manufacturing.
- Launching facilities to substitute domestic production for imports.
- Ensuring a certain volume of export sales with a view to replenishing the foreign currency reserves of the state.[24]

While the five-year development strategy is less than ideal in its lack of market orientation, it sets out important modernization goals, which if combined with the pursuit of other economic reforms would provide a real basis for optimism. Russia's steel industry needs real restructuring. Without new investment, a plant that was old and uncompetitive in 1991 is now even older and less competitive.[25] Companies that do not restructure and become competitive will form a natural constituency opposing the imposition of normal market restraints and supporting artificially low-priced inputs in order to maintain production and continue exporting. The longer that normal market restructuring is postponed, the more painful the process will be. If the Russian steel industry is fully restructured, however, Russia's comparative advantages of a skilled, low-cost workforce and ample supplies of energy and other inputs will make it a strong competitor that will be able to compete fairly in the global steel trade.

Japan

The decade-long economic downturn in Japan has brought key structural problems out into the open and increased the pressure on the financial and industrial sectors—including the steel industry—to restructure with an eye toward increased competition and better management of market risk.

- Steel consumers are demanding a more competitive Japanese home market.
- Long-awaited banking reform may have some positive effects on the Japanese economy, including the steel sector.
- Government initiatives may encourage companies to reduce capacity.

But the long-term impact of such developments on the steel industry remains to be seen.

- Large Japanese steel firms have announced plans to increase capacity.
- Banking sector reforms may lose momentum and have a negligible role in steel sector restructuring.
- And government initiatives intended to urge companies to scrap excess capacity may in fact make it easier for steel producers to avoid hard choices.

The Setting: Dependence on Exports to Sustain Production

In the wake of U.S. trade actions against the surge of dumped Japanese steel exports, a respected Japanese business journal summed up the state of the industry in mid-1999:

> The steel industry has moved toward liberalization of production. Now that companies can no longer depend on exports, which had been considered their trump card for survival, they face the heavy burden of excess production capacity. Although it is unclear whether they plan to liberalize production for the domestic market, only two choices remain for the large blast furnace steelmakers: amalgamating or being weeded out through competition.[26]

While this analysis is largely correct, it did not anticipate the strength of the Asian recovery from late 1999 and into the current year, which has alleviated the pressure for some kind of reckoning for the Japanese steel industry. Increased regional demand allowed Japanese producers to continue to use exports as an "escape hatch" to maintain—or even increase—production and capacity levels in the face of continued weak home demand. For the fiscal year ending March 31, 2000, total Japanese exports, according to JISF statistics, had risen to nearly 30 million metric tons (MT), their highest level in thirteen years.

Japanese exports to the United States, while down from record levels in 1998, have remained at or above the average export levels in the years leading up to the export surge.[27] Meanwhile, domestic shipments had yet to recover from their collapse in 1998 as of Spring 2000, and imports have failed to make headway into the Japanese market. As a result, Japan's steel trade surplus has remained at over 20 million MT annually.[28] These developments, along with a large rise in production over the past year and recently announced capacity expansions by Nippon Steel and other major producers, make it probable that the industry may become even more dependent on export markets in the future, despite some recent evidence of renewed economic growth in Japan.

Pressures on Apparent Coordination Among Major Producers

Japan's approach to international steel markets would be unsustainable if not for the fact that Japanese steel producers are able to command high prices in their home market with the help of apparent coordination among major producers. The high domestic prices charged by Japanese producers under this system reinforce the problem of low domestic demand, while providing the means to subsidize low prices in export markets. Therefore, elimination of any such coordination is one of the most important structural issues facing the Japanese steel industry.

The extreme rigidity of longstanding production shares under the cooperative system was underscored recently when a change of less than 1 percent was viewed by industry analysts as a watershed event warranting extensive commentary on the future of competition within the industry. The Nihon Keizai Shimbun announced that changes from 0.5 percent to 1 percent among major producers in late 1999 "represents the largest-ever change in production share."[29] While marginal in absolute terms, it remains to be seen if this change signals transformation to a more competitive marketplace in Japan. Developments over the past year indicate the possible emergence of meaningful competition among major producers, including:

- Japan's largest steel buyers, the major automotive customers, have pressed for more competitive domestic market pricing.
- A reported increase in competition from industry leader, Nippon Steel, vis-á-vis the other integrated firms.

Big Buyers

Japanese customers' demand for lower domestic pricing has put pressure on the steel producers, particularly with respect to automotive sales. Major automotive customers used to spread their steel purchases among each of the five major integrated producers.[30] Now customers are reducing the number of their steel suppliers to increase competition among steel companies for their business, seeking out price reductions in return for higher volume purchases.[31] For instance:

- In July 1999, Mazda announced plans to limit its purchases of electrogalvanized sheet to two suppliers, Nippon Steel and Sumitomo.
- Shortly thereafter, Nissan announced that it would demand a 17 percent decrease in prices over a period of three years and would reduce its steel plate suppliers from five to three as part of its business rehabilitation plan. In April 2000, Nissan selected three suppliers, Nippon Steel, Kawasaki Steel

Corporation, and NKK Corporation.[32] This move is expected to precipitate a drop in prices for steel plate, a key revenue source for the steel makers.[33]

It is noteworthy that both Mazda and Nissan have significant foreign ownership, by Ford and Renault, respectively. In the first quarter of 2000, Daimler-Chrysler completed a deal with Mitsubishi Motors similar to the Renault-Nissan arrangement. To the extent that foreign ownership introduces fierce international competition in the automotive sector into the Japanese market, Japanese automotive producers may become increasingly unwilling to subsidize Japanese steel producers by paying high prices.[34]

Heightened Competition, Ambiguous Impact

The fact that Nippon Steel was selected as a priority supplier by both Mazda and Nissan touches on another widely noted development: the perceived readiness of Japan's leading producer to compete with the other major steel producers. Increased competition by Nippon could reduce domestic prices and result in a shakeout of the five major integrated producers.[35] However, the net effect on the Japanese steel industry is unclear, for two reasons:

- The production facilities of smaller producers may simply be absorbed by larger producers, rather than shuttered.
- Nippon appears to view increased competition in Japan as part of a larger strategy to expand production and capacity in order to regain its status as the world's biggest steel producer.

As one industry report put it in discussing Nippon's recently announced plan to increase capacity by 10 percent, "It can be said that the reason why Nippon Steel decided to expand its production capacity through restructuring of blast furnaces is because it will no longer maintain the 'cooperative production scheme among five blast furnace makers.'"[36]

Nippon's current plans appear to reflect a "bigger is better" attitude due in part to the success of Korean producer POSCO in becoming the world's largest and one of its most efficient steel producers, while Nippon's production has declined from its historic highs in the 1970s.[37] Nippon's strategy is to expand its way into more efficient production through increasing economies of scale. Nippon Steel Chairman Imai has been quoted as saying, "The minimum level of production is 26 million tons, and we will never decrease from it."[38]

Net Effects

Steel analysts, the Japanese press, and others are watching carefully to see if the apparent coordination among the major integrated steel companies is eliminated. By themselves, these developments do not appear sufficient to conclude that the Japanese industry is now in a state of meaningful competition. The small changes in production share that have occurred to date can be attributed to changes in production for export, while domestic restraints remain in place.[39] Similarly, the drop in prices paid by the largest domestic buyers in early 1999 may simply reflect the fact that Japanese producers had to increase domestic shipments as a group after being forced to reduce exports to the United States. One report from December 1998 predicted the price drop in the domestic market in just those terms: "Meanwhile, supply pressure is likely to build: prolonged production cuts and the narrowing of the U.S. market forces Japanese makers to settle for adequate utilization rates at the expense of easing domestic prices."[40] To date, prices in Japan for the largest buyers remain high relative to other major markets despite continued weakness in domestic demand.[41]

Impact of Financial Sector Restructuring on Japanese Steel

In 1999, Japan's top banks announced a series of "mega-merger" plans, to take effect in 2001 and 2002, that hold the potential of reshaping the Japanese financial sector into four main groups. In terms of assets, these four heavyweights will be able to claim top rankings in international comparisons of size. However, it is important to recognize that it is still too early to judge what effects these merger plans may have on the broader economy, particularly given the rather poor history of financial sector tie-ups in Japan. Moreover, the Japanese financial system, though stabilized by significant government measures, still requires further steps to free itself from massive debt overhang. The “bigger is better” rationale alone will not justify the tie-ups; it will remain critical for the new institutions to focus on disposal of bad assets to improve their balance sheets and to bolster operational profitability in order to survive in international competition. There are two characteristics of the soon-to-be merged megabanks that might give some impetus to much needed corporate restructuring in Japan, even within the steel industry:

- Some of the resulting banks cut across the traditional ties among Japan’s industrial conglomerates (or *keiretsu*).
- These banks appear to be more focused than in the past on maximizing profits.

Reduced *Keiretsu* Cross-Shareholding

Traditionally, most *keiretsu* have had a so-called “main bank,” or primary lender, at their core. Now some of these main banks have agreed to merge. Two of the major banking merger deals announced in 1999 were tie-ups among the main banks of the major steel companies.[42] The plans for the unprecedented cross-*keiretsu* bank merger for the Industrial Bank of Japan, Dai-ichi Kangyo Bank, and Fuji Bank could, according to one source,“likely increase pressure to reorganize in a range of industries.”[43] Some analysts also predict that the pending merger could affect restructuring and competition within the steel industry itself, because the newly merged bank will become the ‘main bank’ for four of the five major steel companies.

One characteristic of the *keiretsu* system is the practice of cross-shareholding by member firms. Banks also participate, though by law are restricted to a maximum of 5 percent stake in any one firm. By one private analyst estimate, Japanese financial institutions currently hold 23 percent of total corporate equity ownership, compared with just 4 percent in the United States.[44]

Large Japanese corporations and financial institutions have been unwinding cross-held shares, spurred by changes in accounting and financial statement reporting. One potential consequence for Japanese manufacturers, including in the steel industry, resulting from these bank mergers may be the weakening of the cross-shareholding system, since some mergers will cut across *keiretsu* ties.[45]

For example, as part of the merger two of Nippon Steel’s main banks are selling their shares in *keiretsu*-member companies.[46] As the direct linkages of banks to steel producers weaken, traditional business relationships are expected to evolve, and changes to the banking system may lead to industry restructuring. It will take time, in any case, for these changes to occur and for the results to become apparent.

New Focus on Bank Profitability

The top Japanese banks posted extremely poor performances in the late 1990s.[47] Almost all of them recorded losses for three consecutive fiscal years as they grappled with rising funding costs on the one hand and a deteriorating lending environment and increasing levels of nonperforming loans on the other.

Though most reported profits in the FY 1999, core profitability remains weak. Recently, some of Japan’s banks—including those involved in merger plans—have shown signs of a new focus on profitability, such as adopting lending techniques that incorporate better assessment of customer risk in order to improve their asset portfolios and raise profit level. Reflecting this new approach to lending, Yoshiro Yamamoto, president of Fuji Bank, stated that “[n]ow our lending practices are based on rational criteria. We are trying to maximize profits.”[48]

The New Role of the Development Bank of Japan

In the late 1990s, Japan's banking crisis and the scarcity of commercially available capital led some of the steel companies to the Development Bank of Japan (DBJ) for their financing needs. In response to the credit crunch, the Japanese government established a Tight Credit Countermeasure, allowing companies to obtain credit which they would have been able to get from private banks before the credit crunch. In addition, as part of its economic stimulus plan, the government expanded the range of uses for DBJ loans to include redemption of corporate bonds and long-term operating capital.

In 1999, the DBJ became the largest creditor for both NKK (with loans of 75 billion yen) and Sumitomo (37.5 billion yen—which exceeded lending by its main bank). In July 1999, *The Economist* suggested that the DBJ had replaced the main banks as the deep pocket for the big steel companies. "Japan has committed itself to creating a competitive banking industry. That is why, in a way, the government's huge emergency programme of loan guarantees and other direct lending to troubled industries is a step forward for Japan. Because the banks are no longer willing or able to provide soft loans for the welfare industries, the money has to be found by the government, and the cost is no longer hidden." While some see this as a positive step, this movement by the government raises serious concerns about whether the financing will be market based.

The three-year decline in gross bank lending may be partly attributable to enhanced sensitivity to risks in the current economic environment. Already, Japan's banks have begun adjusting their lending to major firms, including to the steel industry. As banks have begun to limit their lending, a few of the large steel companies have turned to the DBJ for financing *(see box)*.[49] The banks involved in mergers may hasten that trend.

As of March 1999, three of the banks involved in one merger held almost 330 billion yen (approximately $3 billion) in debt from four of the major steel makers.[50] When the three banks start to jointly set loan targets, companies unable to meet the higher-standard loan assessment criteria may fail. One industry observer predicts that a major steel industry reorganization is likely to be set in motion before the new bank's operations are consolidated in the spring of 2002.[51]

The impact on the steel industry will depend on the timing and degree to which lending banks introduce new lending policies and interest rates based on stronger risk assessments of steel customers, *i.e.*, how aggressively the new bank will seek to spread its loan risk and achieve higher profit levels.[52] Since information concerning specific interest rates for loans is not available, the specific impact of such changes will be hard to measure.

Mixed Results to Date

Most observers of Japan agree that real financial and banking system reforms have taken place and that the effects from the reforms will continue. However, in early 2000, some sources reported that reform efforts appear to have lost momentum.[53] The major causes for this slowdown are:

- A lack of expertise, properly trained personnel, and computer models to conduct risk assessment.
- A lessened sense of urgency as stability was restored to the banking sector.

Banking reform in Japan is still not complete, and the ultimate impact of financial sector restructuring on the economy, while important, is difficult to gauge. It remains to be seen how these changes will effect a transformation in the steel industry.

Government Initiatives to Encourage Restructuring

In response to the prolonged economic downturn, the Japanese government enacted laws to promote business restructuring in the late 1990s. These laws have allowed Japanese manufacturers, including steel producers, to retool, restructure, expand operations or make additional capital investment at a greatly reduced cost. Their role in bringing about much needed restructuring in the steel sector has been mixed.

Industrial Revitalization Law

The most recent measure is the October 1999 Industrial Revitalization Law (IRL), which superseded the 1995 Business Reform Law.[54] The IRL encourages corporate mergers and spin-offs, as well as pursuit of more successful enterprises and the shedding of excess capacity.[55] Several measures are available to a firm whose restructuring plan has been approved:

- Exemptions from certain commercial law requirements.
- A raised upper limit to the amount of preferred stock in the case of a debt-equity swap, which should facilitate mergers and spinoffs.
- Support for management and employee buyout plans.
- Financial measures such as low-interest loans and guarantees.
- Tax incentives, such as allowing longer periods to carry forward losses (from five to seven years), reduced registration and license taxes for new firms, and accelerated depreciation allowances (18–30 percent).

Although the goal of the IRL is to urge companies to scrap excess capacity through preferential tax treatment, this has not happened to a significant degree. Many observers in the media, Diet and economic groups fear that the IRL is little more than a "welfare plan" for large companies.[56] Only one company out of the twenty that have received approval for measures (Japan Sheet Paper) has decided to scrap facilities and equipment.[57] As of mid-March 2000, only two steel companies had applied to qualify for IRL measures: Sumitomo and a small coated steel producer. One explanation is that more encouraging signs of economic growth have prompted companies to shelve plans for restructuring or the scrapping of facilities and equipment.[58]

There are also questions as to whether the IRL is more of a subsidy to certain companies rather than an inducement to restructure. Sumitomo Metal Industries Ltd., the only steel maker among the big five facing a recurring loss in FY 1999, was the first steel company to apply for IRL measures. Sumitomo's application was expected to smooth the way for plans to spin off two factories and obtain loans from governmental institutions.[59] In November 1999, Japan's Ministry of International Trade and Industry announced that Sumitomo's restructuring plan had been approved and that Sumitomo would qualify for preferential tax treatment providing tax breaks of approximately 110 million yen and other support under the IRL. Sumitomo received approval for IRL assistance based on expectations that, with this treatment, Sumitomo's profit-to-stockholder equity ratio will improve by 5 percent by the end of March 2001.[60]

Korea

As a result of the Asian financial crisis and in fulfillment of its obligations under an International Monetary Fund (IMF) Stand-By Arrangement, the government of Korea has begun to implement a comprehensive program to address structural weaknesses in its financial and corporate sectors. The breadth and depth of these restructuring and reform efforts reach into virtually all facets of Korea's economy, including the Korean steel industry. However, it is still too early to gauge their effectiveness and permanence. A recent report from the Organization for Economic Cooperation and Development warns that the Korean government is moving too slowly in its overall reform efforts, and that Korea could be on the brink of another crisis should restructuring fail and government intervention in the economy continue.[61] The initial restructuring stage in the aftermath of the crisis is over, and the Korean government is now entering the longer-term process of corporate and financial institution reform.

- The Korean government has established general guidelines for restructuring the steel industry over the next several years. However, while some individual firms have committed to reducing capacity, restructuring efforts by the industry in general have been slow, in spite of continued low capacity utilization rates in 1999.
- Another problem is the government's continued role in POSCO, Korea's largest steel producer.
- The government has made important progress in financial sector restructuring and reform. However, its direct ownership of several nationalized commercial banks could allow continued intervention in the financial sector and could impede corporate restructuring, including in the steel industry.
- The government has also enacted new bankruptcy laws and implemented out-of-court market-oriented exit procedures that should address the problem of steel producers staying in the market well beyond their financial viability.

Steel Industry Restructuring Leads to New Giants and Additional Capacity

During the period leading up to the Asian financial crisis, underlying structural weaknesses in the financial and corporate sectors contributed to market distortions in Korea's steel industry. Heavily indebted firms such as Hanbo and Kia continued to borrow for investments in production facilities, contributing to excess capacity and, ultimately, to insolvency.[62] Over the last few years, Korean steel companies have reduced some of their debt burden, mainly through debt-to-equity swaps. However, it is difficult to ascertain whether these swaps were market-based and what effect they had on the health of steel companies.

The Korean government's overall economic restructuring plans include general guidelines for steel industry restructuring to take place over the next several years:

- Finalizing and implementing the liquidation and workout plans in progress.
- Increasing capacity utilization by rationalizing production capacity.
- Supporting financially weak, but viable, steel producers by allowing creditor banks to offer conversions of debt into equity, reductions in interest rates, and new loans.
- Promoting mergers, acquisitions, liquidations and plant shutdowns.
- Persuading the steel industry to adopt strategies focused on core competencies along company or product lines.[63]

Undoubtedly, corporate restructuring cannot be accomplished overnight. The government has yet to fully implement these guidelines, which have been in place for some time now, and steel sector restructuring appears to be progressing slowly. The slow pace of these efforts raises concerns about further market distortions in the steel sector, particularly with respect to the financial support provided to weak steel companies.

Mergers and Acquisitions

Under the above guidelines, several mergers and acquisitions are pending or have already taken place. Merging and further privatizing steel companies should help to eliminate or rationalize uneconomic capacity while improving the efficiency of existing capacity as consolidated companies focus on core operations. In addition to the purchase of Hanbo Steel (*see box, next page),*[64] there have been major changes, which include the following:

- In March 2000, Inchon Steel absorbed Kangwon Industries, creating the world's second largest mini-mill producer after U.S. firm Nucor. This merger could lead to accelerated capacity reductions, particularly for carbon steel angles, shapes, and sections.

U.S. Firm Takes Over Hanbo Steel

Protracted negotiations for the purchase of Hanbo Steel concluded in March 2000 when the Nabors Consortium (a U.S.-based investment firm) signed a purchase agreement to pay approximately $500 million in cash for the insolvent mill. Once the final sale is concluded, Nabors is expected to liquidate Hanbo and establish a new company to take over Hanbo's assets and employees. The new company would be free from Hanbo's debts, while Hanbo's creditors (many government-controlled) and public funds will absorb the reportedly significant balance of the debt not recovered by Hanbo's sale.

Nabors plans to diversify its new steel production from Hanbo's current production and to collaborate with U.S. Steel and Hylsa of Mexico in rehabilitating the ailing steel producer. Current plans for the new company include:

- Restarting the hot-rolled carbon steel coil mill (capacity: 1.8 million MT) as soon as the final sale is concluded.
- Completing a cold-rolled carbon steel mill (capacity: 2 million MT of crude steel).
- Completing the Corex mill (capacity: 2.5 million MT of hot-rolled carbon steel coil) within the next few years.

- In May 2000, Inchon Iron & Steel (Inchon Steel), now a subsidiary of the Hyundai Group, announced that it would acquire Sammi Steel. If the acquisition is approved by the Korea Fair Trade Commission (KFTC), the new company will surpass POSCO as Korea's largest stainless steel producer, holding 43 percent of the market, while POSCO will hold only 31 percent of the market.[65]
- Industry experts expect the Hyundai Group to further merge Hyundai Pipe into the new Inchon Steel.[66] The Hyundai Group plans to spin off the merged steel firm later this year.
- Acquisitions across borders have also taken place. A Japanese investment company purchased a 41 percent equity interest in Hyundai Pipe, making it the largest shareholder.[67] These industry developments could lead to the emergence of a steel giant out of the former Inchon Steel, Sammi Steel, Kangwon Industries, and Hyundai Pipe.

Restructuring of the Korean steel industry holds great promise for eliminating or rationalizing uneconomic capacity. Some individual firms have committed to reducing capacity. However, restructuring efforts by the industry in general have been slow in spite of continued low capacity utilization rates in 1999. The government has not announced specific actions it will take to implement the restructuring guidelines and address this problem. Again, the future of the Korean steel industry depends largely on the will of industry and the government to sustain momentum for change.

POSCO's Monopolistic Position in the Domestic Market

Before competition can truly take hold in the Korean steel sector, the Korean government must follow through with its privatization of POSCO. As Korea's—and the world's—largest steel company, POSCO has a monopolistic position in the Korean market for certain major steel products and maintains its power over the distribution sector. As part of the Korean government's privatization program, and at the urging of the U.S. government to fully privatize POSCO, a portion of POSCO's shares held by the government-owned Korean Development Bank (KDB) were sold in July 1999. During that offering, KDB's ownership position was reduced from 21 percent to 13 percent. At that time, the Korean government stated emphatically that the rest of the shares held by KDB would be sold by the end of 1999.

Even though KDB offered 12 percent of POSCO shares in December 1999, the sale was called off due to differences in bid prices for the shares and the price that the government wanted to obtain for the shares.[68] However, immediately after the failed December bidding, KDB sold 3 percent of those shares to POSCO, while still retaining over 9 percent of POSCO's shares. The terms of that sale were not disclosed. In early June 2000, the government of Korea again announced that it would complete the privatization of POSCO, this time by selling KDB's 7 percent shares through American Depository Receipts (ADRs) in the U.S. market and selling the remaining 3 percent of KDB's shares directly to POSCO. The announcement failed to address the remaining 6 percent shares held by the government-owned Industrial Bank of Korea (KIB). However, later in June KDB delayed that sale yet again due to a weak price in the U.S. market for existing POSCO ADRs.[69] Even though the open market offering was cancelled, during the previous week, the government had sold the promised 3 percent shares directly to POSCO.[70] Following previous patterns, the terms for that sale were not disclosed.

In bilateral discussions with the Korean government, the U.S. government has repeatedly pressed for the sale of the remaining 15 percent government-held shares in POSCO. The repeated delays of the planned privatization are discouraging. Until POSCO is fully privatized, there will continue to be concerns that it benefits from special governmental treatment and is used by policymakers to further the government's steel agenda. Moreover, unless the anticompetitive concerns of the KFTC are addressed, POSCO's dominant position, and the potential trade-related effects, could continue to undermine market forces in the Korean steel industry.

Restructuring the Financial Sector—
Redefining the Korean Government's Role

Corporate restructuring, following the government's guidelines, has largely been driven by financial institutions that are required to improve their own asset quality, capital adequacy, and profitability. For needed reductions in debt levels and excess capacity to occur, operational restructuring must go hand in hand with financial restructuring.

The Asian financial crisis exposed weaknesses in Korean bank lending to the country's industrial conglomerates, or *chaebol*. The legacy of government-directed lending, of which the steel industry was a major beneficiary in the past, left the country's financial institutions unprepared to pursue sound lending practices. Until Korean financial institutions establish sound banking and lending practices, there is a danger that corporate restructuring, including the restructuring of the steel sector, will be delayed. Financial sector initiatives now under way, including the resolution of nonperforming loans *(see box)*,[71] will help to

The Problem of Nonperforming Loans

The Korea Asset Management Corporation (KAMCO) has been an instrumental player in restructuring the financial system. After Korea's financial crisis, KAMCO was responsible for effectively liquidating non-performing loans (NPLs). This is a critical job for at least two reasons:

- The total cost of restructuring is reduced by the income generated from NPLs sales.
- Effective disposition of NPLs directly affects the success of both financial and corporate restructuring efforts and the credibility of the financial reform program.

By the end of 1998, NPLs totaled approximately 104 trillion won (23 percent of GDP), growing to 113 trillion won by September 1999 (not including potential NPLs from the Daewoo workouts). By November 1999, KAMCO had acquired NPLs with a face value of more than 55 trillion won (approximately $47 billion). It is currently disposing of these NPLs through sale of assets, international auctions and issuance of domestic asset-backed securities.

KAMCO also plans to enter into equity partnerships with foreign financial institutions and investors to facilitate further purchases of NPLs resulting from ongoing corporate restructuring deals.

ensure that the commercial banks follow market principles in their lending practices and that the government no longer intervenes in the lending decisions of private financial institutions.

Bank Restructuring

The greatest progress has been acheived in the recapitalization and restructuring of private commercial banks.[72] The Financial Supervisory Commision (FSC), an independent agency, now has regulatory and supervisory jurisdiction over all bank and non-bank financial institutions, including the state development banks.

Under FSC supervision, significant bank reform measures have been implemented in the past two years. Among these measures are the following:

- Redefining exposure and legal lending limits.
- Adopting accounting principles and practices consistent with international accounting standards.
- Reducing and restricting "connected lending" and cross-guarantees of one corporate affiliate to another.[73]
- Strengthening the accountability and governance systems of banks by requiring, for example, the appointment of outside directors and the publication of audited financial statements.
- Increasing emphasis of bank management on profitability and prudential soundness.[74]

Potential for Government Interference In Steel Restructuring

The Korean government has been actively involved in bank restructuring, both through nationalizing nonviable banks and through recapitalizing viable institutions.[75] As a result, the Korean government now holds majority shares in at least six commercial banks and holds minority shares in seven others, in addition to its ownership of KDB and KIB. This heavy government involvement in the financial sector has the potential to counter the overall restructuring and reform effort, including corporate restructuring of the steel sector. For example, the bankrupt Kia Steel was brought under the ownership of the Korean government by KDB's conversion of debt into equity.[76]

The concern is that the Korean government could change its policy and could interfere with corporate restructuring and operational consolidation. Therefore, while the government's financial sector reform and restructuring efforts have been generally successful, it is still too early to assess whether the market distortions caused by past government interference in the financial sector have been completely removed.

Insolvency Procedures: Need for a Well-Functioning Exit Market

In an effort to bring its businesses in line with international best practices, the Korea government has launched a variety of reform and restructuring initiatives in the corporate sector.[77] One of the main objectives is to establish a market-oriented exit system by improving basic insolvency procedures. Such a system would address the problem of some steel producers staying in the market well beyond the point of financial viability. Of course, even with the appropriate laws and processes in place, such a system will not function properly if government intervention is excessive.

To address procedural inadequacies in Korea's insolvency laws, several amendments were enacted in 1998 and 1999 intended to streamline the corporate restructuring process, to curb debtor abuses, and to facilitate a smoother exit system for nonviable firms.[78] These amendments allow Korean courts to force insolvent companies into bankruptcy and even liquidation if they are deemed to have no hope of recovery.[79]

The effects of these laws on corporate restructuring have been mixed, particularly for the steel sector, given the government's willingness to intervene to keep steel companies afloat.

Court Actions

In June 1998, creditor institutions under the direction of the FSC announced that fifty-five corporations were nonviable (and *de facto* in default).[80] Of these fifty-five firms, twenty-five have been liquidated, fifteen sold, eleven merged, and four put into court receivership.[81] The four companies put under court receivership were all steel companies, *i.e.*, Hanbo, Sammi, Hwanyung, and Shinho. To facilitate the exit of these nonviable corporations, their creditor banks were prevented from extending new credit and financial assistance within business groups was prohibited.[82]

Out-of-Court Workout Scheme

One week after this announcement, 236 financial institutions signed and entered into the Corporate Restructuring Accord (CRA), an out-of-court workout scheme.[83] Under this program, viable companies experiencing temporary management and financial problems enter into workout plans with their creditor institutions, which must abide by specific workout procedures.[84] Workouts under the CRA can involve a wide range of options, including deferred payments of principal or interest, interest rate reductions, debt forgiveness, provision of new credit, cancellation of existing guarantees or other obligations, debt-to-equity swaps, and sales of non-core businesses.[85] Any losses resulting from debt restructuring are shared fairly by the creditor institutions.[86]

By March 1999, fifteen *chaebol* entered into the CRA workout process.[87] Of the 248 companies in these fifteen *chaebol* groups, twelve were deemed financially healthy and 198 were disposed of by merger, liquidation, or sale.[88] The thirty-eight remaining firms entered into the CRA program along with another twenty-eight companies from smaller *chaebol* and twelve independent enterprises.[89] By September 1999, seventy-nine companies had finalized their workout plans, restructuring a total of 35 trillion won ($29 billion)[90] of debt.[91]

Under the Korean government's guidelines for restructuring the steel industry, support for selected steel producers that are financially weak but potentially viable is encouraged. The main types of "support" to be offered by a company's major creditor banks are: conversion of debt into equity, reductions in interest rates, and new loans. It is difficult to tell at this time which Korean steel companies have entered into such "support" arrangements with their creditor banks or how successful CRA agreements have been.

Brazil

Brazil, like Japan and Korea, has taken positive steps toward structural reform. The main obstacles standing in the way of effective steel industry restructuring include the anticompetitive behavior of Brazilian steel companies and the lack of any meaningful import competition. A web of affiliations between members of the steel sector has restrained competition within the Brazilian steel market. With the Brazilian market still largely insulated from imports, Brazilian producers have been able to launch aggressive exporting strategies. Steps taken by the Brazilian government and industry to address these market distortions include the following:

- Enforcement of antitrust laws to combat anticompetitive behavior.
- Promotion of steel sector restructuring to eliminate cross-ownership.
- Continuation of macroeconomic reform including lowering of interest rates to create a sustainable increase in domestic steel consumption.

Again, while these efforts hold promise for change, a tremendous amount of progress is needed on each front to effectively restructure the steel industry.

Investigations of Cartel-like Behavior

Collusion in the Brazilian domestic steel market remains a serious problem. During a 1999 investigation, Brazilian authorities uncovered collusion to fix high prices. Then, in May 2000, CADE, Brazil's antitrust agency, announced that it would begin investigating whether the steel makers had formed a cartel to uniformly increase prices by 12–14 percent earlier that month.[92]

This most recent probe indicates that the job of curbing the anticompetitive behavior of the steel producers has only just begun and underscores the need for the Brazilian steel industry to untangle its web of cross-ownership.

Untangling the Web of Steel Sector Cross-Ownership

Brazilian antitrust authorities have long expressed concern over potential conflicts of interest resulting from cross-ownership in the steel industry and interlocking directorships among steel producers.[93] Given a growing consensus among government and industry officials that the problems created by cross-ownership need to be addressed, it appears that the Brazilian steel industry is entering a period of merger and consolidation.[94] A 1998 analysis of the Brazilian steel industry in the *American Metal Market* predicted that "[w]hat are now confusing and, in some cases, conflicting intra-company ownership patterns, will be straightened out."[95] Although consolidated ownership may give rise to unforseen problems, it is hoped that the elimination of cross-ownership will create a more competitive market.

Toward a solution, the Brazilian national development bank, BNDES, has stated that it is "open" to using its financing to consolidate ownership in the steel sector. Maria Luisa Amarante de Andrade, manager of the BNDES Mining and Metallurgical Studies Department, declared that "[o]nly by consolidating steel-sector ownership in this manner will the sector gain the economy-of-scale-linked efficiencies needed to compete with other far-more-consolidated steel makers, especially in Europe and Asia."[96]

Industry reports indicate that several steel producers are discussing the possibility of merger.[97] Brazilian steel producers Usiminas and Cosipa have already taken the plunge (*see box*).[98] These mergers may ultimately create three large independent steel companies and foster strong competition within the domestic market. More robust competition could force Brazilian steel makers to eliminate excess steel capacity and focus steel production on domestic and export market demand. However, the ultimate outcome of these discussions of mergers and consolidation remains unknown.

It is also unknown what these possible mergers could mean for Brazil's position in the global steel market. Some analysts believe that Brazil is rapidly becoming a world-class steel producer with the potential to rival leading steel-producing nations.[99] Brazil's aggregate steel production capacity is already expected to grow by over 19 percent by 2005. Therefore, the long-term impact of restructuring, in particular the effect it will have on the U.S. market, remains to be seen.

Anatomy of a Merger: Cosipa-Usiminas

In 1993, when Cosipa was partially privatized, a consortium of investors led by Usiminas took control of the company. Usiminas has since acquired additional voting capital stock and currently controls 49.8 percent of the common shares of the company. When Cosipa neared bankruptcy in 1998, Usiminas engineered a major restructuring via a debt-equity swap. Usiminas took on part of Cosipa's debt in the form of convertible debenture, which can be converted to equity. Upon conversion of these debentures, Usiminas will own approximately 98 percent of Cosipa.

Economic Challenges: Need for Stable Growth and Increased Steel Consumption and Imports

An additional barrier to a fully competitive Brazilian domestic steel market is the lack of meaningful levels of steel imports. Import barriers, such as a nonautomatic licensing regime, remain as fully intact as they were during the U.S. steel crisis. In addition, the exorbitant cost of capital prevents potential importers from financing purchases of imported steel. The lack of competition from imports plays a crucial part in keeping domestic prices high.

Nonautomatic Licensing Regime

Brazil's use of a nonautomatic import licensing system for certain steel products may contribute to the relatively low level of import competition in the Brazilian market. Brazil requires a license for the importation of nearly any product. Licenses for most products are typically obtained within five days.[100] However, the Brazilian government has made several products subject to nonautomatic import licensing, including steel wire rod and stainless steel. Significant delays in securing import shipment clearance under this system may discourage importers and foreign suppliers.[101] It may also have a chilling effect on the importing of steel products not subject to the nonautomatic procedures given the lack of transparency in Brazil's decisions to impose such procedures.

Capital Costs

The high cost of capital in Brazil has a particularly pronounced negative impact on the importation of steel, including steel from U.S. producers. Because of the high expense of borrowing, potential importers cannot afford to finance the necessarily large purchases of imported steel.[102] Furthermore, with interest rates for short-term loans currently hovering between 25 percent and 30 percent, it is simply not economical for producers or traders to maintain inventories. Instead, steel purchasers buy just what they need on a weekly, even daily, basis,[103] forcing them to rely on domestically produced steel.

More affordable domestic financing in the form of lower interest rates would provide importers greater opportunity to purchase steel produced by the United States and other countries and would promote a more open steel market in Brazil. The resulting competitive pressures could provide the incentive needed for Brazilian steel producers to complete their restructuring efforts.

Macroeconomic Reform

A sound economic foundation in Brazil would help to create a more stable currency environment, eliminating the artificial price advantage that Brazilian exports have enjoyed relative to U.S. domestic products.

The package of macroeconomic reforms prescribed by the December 1998 Brazil-IMF arrangement (*see box, next page*)[104] promises to stabilize the Brazilian economy. By controlling inflation without resorting to high interest rates, these reforms allow for more stable and reliable infrastructure development and insulation from future capital flight shocks.

Greater infrastructure development in the overall Brazilian economy, along with the planned expansion of Brazilian automotive manufacturing, should absorb some of the expected increases in Brazil's steel production and thereby reduce the pressure Brazilian steel companies feel to export new production to the United States and other world markets.

Brazil-IMF Reform Program

Throughout 1998, the government struggled to keep its currency, the real, afloat in the face of challenges such as investor flight and international loan defaults. Tactics employed included massive spending cuts and dramatic interest rate hikes.

In October 1998, the central bank raised interest rates from 29.75 percent to 49.75 percent in an effort to stem the outflow of capital and relieve the downward valuation pressure on the real. Although inflation was reduced, high interest rates restrained economic growth and stifled domestic demand, including demand for steel products.

In December 1998, the IMF and the government of Brazil entered into a 36-month stand-by arrangement involving over $18 billion in loans. Under the arrangement, Brazil and the IMF developed economic policy measures aimed at:

- Steadily increasing national savings.
- Reducing the burden of public debt.
- Facilitating a sustainable decline in interest rates.

The Brazil-IMF reform program provides a foundation for the continued strengthening of the Brazilian economy and helps make it more secure from external shocks, such as the attacks on the real in late 1998, and its collapse in January 1999.