

THE GLOBAL DEBT PROBLEM AND THE TWO KOREAS

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The Global Debt Crisis

The international financial system has been endangered by a huge accumulation of debt in the third world (\$630 billion at the end of 1982) and Eastern Europe (\$80 billion), at a time when unprecedented recession made servicing this debt very difficult. About \$400 billion is owed to commercial banks, the rest to official institutions. In mid-1982, banks became frightened by the debt crises in Mexico and Argentina and lending to the third world contracted by half in only six months. This created a financial crisis even for many countries which in normal times could have serviced their debt. Thus, countries holding debts of \$200 billion are now rescheduling their debt. According to Morgan Guaranty estimates, by the end of 1982, countries with \$280 billion of commercial debt will be rescheduling. This compares with the total capital and reserves of the world's 80 largest banks of only \$132 billion.

Causes

The global financial crisis has multiple causes:

OPEC. The 1973 and 1978-9 oil prices caused huge accumulations of funds in the Arab oil countries and desperate need for funds in those LDCs dependent on oil; simultaneously they caused a recession in the industrial countries.

Banks found themselves with a huge supply of petrodollars and, because of the recession, very low demand. This imbalance between supply and demand created a hyper-competitive environment, in which the real interest rate (i.e., after adjustment for inflation) sank to minus 2% for countries like Brazil and some traditional lending standards were relaxed.

LDCs had to borrow to pay for imported oil or else face massive development setbacks and human suffering. Encouraged by negative real interest rates, they borrowed on the assumption that rates would remain low or moderate and that the world economy would support their growth and thereby facilitate repayment. Many did not quickly implement politically difficult adjustment programs.

Governments, fearful that failure to "recycle the petrodollars" would undermine global financial stability, encouraged banks to undertake this balance of payments lending. Moreover, in the name of detente, Western governments strongly encouraged banks to lend to Eastern Europe. When banks held back, Western European governments decisively pressured their banks to lend; when U.S. banks stopped increasing their loans to Poland, the U.S. government stepped in with government guarantees.

Blame

A great deal of the debate in the United States, especially in Congress, has concerned blame for the crisis. As the previous paragraph shows, all parties contributed to the accumulation of debt. Then the inflation of the Carter years raised nominal interest rates to spectacularly high levels (the prime went from 6.25 to 20 under Carter, costing Brazil an additional \$4.6 billion interest per year). Worse, the tight money policy and huge government deficits of the Reagan years raised real interest rates to untenably high levels, causing an additional two years of recession in the rich countries and an untenable payments situation for the poor countries. Banks and LDCs had not allowed for the possibility of nominal interest rates more than double historical peaks, real interest rates four to five times their usual level,

and a global recession three times the average length. Since all therefore share the blame, the politics of blame is unproductive.

Risks: Sudden Deflation

Given the huge problem debt, and its concentration in a few countries (especially Brazil, Mexico, Argentina, and Poland), there is a risk of panic. For instance, if Brazil were unable to make its interest payments, there could be a run on vulnerable banks in Luxembourg, the Bahamas, or Hong Kong, and this could spread to parent banks in the U.S. or elsewhere. In theory, this could cause a global financial collapse and depression. This risk was very important so long as the Reagan administration was refusing to acknowledge the existence of a problem, or of government responsibility to help cope with whatever problem did arise. However, by the end of 1982, the U.S. Federal Reserve, the Bank of International Settlements in Basle, and the availability of the U.S. Currency Stabilization Fund had combined to make possible effective crisis management procedures. This risk has therefore receded.

Risks: Withdrawal of Liquidity

The withdrawal of banks from international lending, or from lending to critically important borrowers such as Brazil or Mexico, is what triggered the 1982-3 crisis. Further continuation of this trend could make the crisis too big for crisis management procedures and normal banking operations to handle. If this occurred, governments would be faced with a choice between bailing out the system, at the cost of severe inflation, and allowing financial collapse and depression to occur. For this reason, the Federal Reserve and the IMF have pressed banks to continue their LDC lending. The situation has

stabilized for the time being, but this risk remains the most severe current danger. Stabilization depends on:

- continuation of pressures on banks not to withdraw precipitously from international lending;
- strong IMF pressure on indebted LDCs to pursue politically difficult austerity and energy-adjustment programs;
- a cooperative attitude in the major LDCs;
- world economic recovery and recovery of world trade, so that LDCs can earn foreign exchange.

Risks: A Debtors' OPEC

The major debtors could theoretically group together and impose their terms on the international financial system. The largest four debtors alone have more debt than double the combined capital of the international commercial banking system. However, the principal debtors are also those who have been most opposed to a debtors' OPEC. They benefitted greatly from access to the international financial system, and their leaders fought hard at home for cooperative policies within that system. They will not lightly abandon the approach that has brought national success and personal prestige. The principal advocates of a Debtors' OPEC on the other hand have been countries with relatively trivial amounts of debt: Cuba, Nicaragua, Ecuador, Bolivia, and the Seychelles. Hence, if the rich countries restore their own growth and behave in a sympathetic fashion, there is little likelihood of a debtors' OPEC. But there are policies which could precipitate a debtors' cartel: sudden Northern withdrawal from LDC lending; persistent U.S. budget deficits of a scale that raise interest rates and perpetuate recession;

spreading protectionism which makes it impossible for LDCs to earn foreign exchange; and harsh anti-LDC political rhetoric which fails to recognize the part Northern governments played in causing the debt crisis.

Risks: A Decade of Stagnation

The 1960s and 1970s were an era of unprecedented growth in the third world. This growth consolidated much of the third world into a pattern of cooperation with Western economic systems (despite a great deal of rhetoric to the contrary) and eliminated vulnerability to communist subversion in much of the third world (e.g., in all of the big countries of Latin America and all of insular Pacific Asia). A continued flow of funds to the third world was a precondition of this development. If the 1980s are to a decade of rescheduling and diminished flow of funds, these foreign policy successes could lose momentum and reverse.

Risks: Excessive international lending

This is a risk that has already occurred, for reasons outlined above: petrodollars distorting financial markets, banks and LDCs assuming that relatively favorable global economic conditions would persist, government pressures for petrodollar recycling and detente lending. Such a constellation of pressures is unlikely to recur in the near future. Moreover, for a good many years, banks are going to be involved in difficult rescheduling negotiations which will continually remind them to be cautious about international risks. Therefore, for most of the 1980s the most important risks are in the opposite direction: withdrawal of lending leading to deflation or stagnation.

Policies

To cope with these risks, there are a number of tasks to be performed:

Crisis management measures must be adequate to cope with the cash flow problems of major borrowers, to prevent sudden deflation. Existing emergency procedures involving the Fed, the Bank for International Settlements, and the Currency Stabilization Fund need to be continued. The CSF may need to be increased. The U.S. bears an excessive share of the burden for these procedures, so Japanese and West European involvement needs to be increased.

Liquidity must be provided to help LDCs through a period of adjustment, recession, and contraction of international lending. This cannot be accomplished by official institutions alone, since their funds are insufficient, and it cannot be accomplished by commercial banks alone, since they feel overextended already. Therefore, official funds must be used to leverage commercial funds:

- (a) IMF and World Bank funding must be increased;
- (b) IMF programs should continue to be used as the standard by which countries are judged creditworthy for commercial lending;
- (c) IMF loans should continue to be made conditional upon further lending by commercial banks so that official money is not simply used to pay out commercial banks;
- (d) Banks should not be penalized by regulators for additional lending to countries which are following an IMF program;
- (e) Governments should monitor rescheduling agreements to ensure that inter-bank competitiveness does not lead to circumvention of the IMF role or its equivalent.
- (f) The IMF should be permitted and encouraged to raise funds in private markets.

LDC economic adjustment must be enforced. Only the IMF has the legitimacy and expertise to certify that an adjustment program is adequate. Commercial banks are too competitive to certify adjustment programs. U.S. government efforts to impose adjustment requirements would be regarded by most LDCs as imperialism. To retain its role in enforcing adjustment, then IMF must have sufficient funds of its own, and must continue to be the principal "trigger" for commercial bank lending to troubled countries. There is a common complaint that IMF adjustment programs are too harsh and that they tend to press everyone to contract imports and expand exports simultaneously -- a logical impossibility. At this time, however, the problem is not so much excessive harshness as doubts about the IMF's ability to enforce real adjustment at a pace sufficient to rescue the system. The problem of universal deflation can be resolved through a return to growth in the rich countries.

The world economy must return to substantial real growth, so that there will be demand for LDC exports. The principal requirement for this is a reduction of real interest rates. At present, real interest rates are higher than the expected rate of return in many industries. Thus there is little investment and growth in either the rich countries or the poor countries. Moreover, poor countries are paying absurdly high real interest rates on old debt. The cause of the high interest rates is the huge government deficit in the U.S. and some West European countries; the \$235 billion U.S. government deficit eats up a very large proportion of total funds available and therefore creates excessive competition for funds. Thus the deficit must be brought down by some combination of decreasing military spending, decreasing non-military spending, and raising taxes.

The cycle of protectionism must be reversed. Third world countries cannot pay their debts if they cannot earn foreign exchange. They cannot earn foreign exchange if their exports are blocked. Currently, most of the heavily indebted LDCs find most of their exports blocked to some degree of protectionist measures on sugar, textiles, radios, televisions, steel, and a host of other commodities. Although most protectionist measures are targeted at Japan, the countries hurt most by them are the principal LDCs. Many protectionist measures designed to help the older, less competitive industries threaten to cripple America's most competitive and most advanced industries: agriculture, banking, services.

All of the above measures are necessary to deal with the immediate crisis. In order to deal with the longer run problem, namely the risk of a decade of inadequate development in the third world and subsequent loss of U.S. foreign policy gains in the third world, additional measures are necessary:

Capital flows for new development must be restored. A continuation of almost total reliance on commercial banks for third world development funds will be inadequate. There must be revitalization of multilateral aid programs and a reduction of the role of commercial banks in lending for long-term infrastructure development and balance of payments purposes. Allowing the IMF to raise funds from commercial markets would be a major step toward restoring capital flows.

Countries' Responses to the Debt Crisis

The principal borrowing countries have experienced a generation of unusually high growth, typically in the 6 - 10% annual range. This is several

times the historical growth rate of the U.S. economy. Growth and technological development have assuaged nationalist drives by the political leaderships. Growth, particularly in those Asian countries where it has been equitably distributed, has increased popular welfare, funded national transport and communications networks, enabled governments to create stabilizing patronage networks, enhanced the size of the middle class, and in all these ways contributed to the moderation of politics within these societies. Viewed either in terms of the welfare of individuals or in terms of U.S. national or corporate interests in third world political stability, the gains have been immense. The availability of huge volumes of loans at low or negative real interest rates was an essential ingredient in these countries' recipes for success. However, when inflation caused nominal interest rates to skyrocket, this caused cash flow problems. And when subsequent Western disinflation policies caused real interest rates to rise, many countries could no longer raise productivity in line with interest rates.

In this situation, all but a few third world countries are faced with financial embarrassment, austerity programs, unemployment, social polarization, and the resultant risk of political instability. As these difficulties emerge, the political responses of third world countries have varied according to, first, the strength and responsibility of their governments, and, second, the equity and integration of their societies.

Countries with weak or irresponsible governments fear that austerity programs will destabilize them, or believe that they can defer the austerity programs and let their successors deal with them. Governments facing reelection, such as the Mexican government in 1982 and the Nigerian government in 1983, frequently are both weak and irresponsible. In some countries,

irresponsibility derives from economic ignorance, in some from ideology. They continue supporting huge civil service bureaucracies, subsidizing consumer goods and weak industries, and making huge long-term investments despite emerging financial problems. This syndrome characterizes a majority of African countries.

Countries where the government represents only part of the society respond in terms of the interests of the dominant segments rather than in the financial interest of the country as a whole. In Spanish America, frequently a wealthy and powerful elite, based in the political leadership, the senior civil service, the military, and the capital-intensive industries, serves its own interests and ignores the interests of farmers, the majority of industrial workers, the unemployed, and the Indians. Typically, such countries have extremely skewed income distributions, and the poor have benefitted little even when GNP growth has been impressive. Faced with austerity programs, these countries suffer greater polarization and violence and therefore are less dependable in implementing the programs. Moreover, they frequently maintain an extremely overvalued currency, to serve the interest of their elites in foreign goods and foreign travel; this encourages capital flight, which in turn may force rescheduling of debts even though the wealth and foreign exchange of the society are substantial.

At the other end of the spectrum are those countries with strong, aware, responsible governments in relatively integrated societies. Singapore, Taiwan, and South Korea typify these qualities. These countries are far more dependent on international trade and international economic conditions than their Latin American counterparts, but their governments respond to debt problems with austerity programs and currency reforms before crisis hits. Their populations

accept austerity with less unrest because they have benefitted in the past and they know that all of society is sharing in the cutbacks. Their governments' past farsightedness has given them more market-oriented, adaptable, efficient economies, so they suffer less in an adverse environment.

All third world governments reflect combinations of these characteristics. But the problem of weak government has been most pronounced in Africa, the phenomenon of unrepresentative government has been most pronounced in Spanish America, and the relatively strong governments in relatively integrated societies have been most numerous in Pacific Asia.

The Situation of South Korea

Korea is a crucial player in the global financial game. One of the world's most open economies, South Korea is one of the economies receiving the most severe external shocks from global recession, global price declines, and a decline in world trade. As one of the world's largest debtors, South Korea is among the hardest hit by high nominal and real interest rates. With an estimated \$40 billion of total debt in mid-1983, South Korea is the world's fourth largest debtor. The first three, Mexico, Brazil, and Argentina, are financial disasters, and many of those which follow South Korea are in equally serious trouble. South Korea's principal Asian competitors, Taiwan and Singapore, have far less debt both relatively and absolutely. Moreover, South Korea has borrowed some 500% of its IMF quota (about \$1.4 billion). Finally, \$10-11 billion of South Korea's debt is short-term, so it is potentially vulnerable to the short-term fluctuations of the market.

All of this seems at first glance to give substance to periodic reports in the Japanese press and elsewhere that lenders are concerned about South Korea. On the other hand, South Korea has been receiving a steady flow of funds during a period when virtually all Latin American and African and some Asian countries have experienced a drastic curtailment of their access to financial markets. The reason is that, while South Korea faces larger problems from the outside world than many other countries, it also faces them with disproportionate ability to cope. During a three-year period of stagnation in the global economy, and decline of world trade, South Korea's growth rate from 1981 through 1983 has been about 6 percent. (1980, when growth was negative, was an extremely unusual year both politically and economically.) While this impressive growth performance has been achieved, inflation has declined to the area of 7-8% and is likely to remain below 10% for the coming year. The country's current account deficit has steadily from \$5.3 billion in 1980 to \$4.4 billion in 1981 and \$2.5 billion in 1982. Its exports have held up in a time of declining world trade, and it has become clear that South Korea and its neighbors are primary suppliers of world export markets, whereas Brazil and certain other countries are secondary suppliers who are far more vulnerable to a downturn in the world economy. South Korea's public sector deficit has been held to a little over 2% as compared with 6% in the United States, 13% in Sweden, and even higher in Mexico. The ratio of South Korea's debt service to its exports has been declining and is currently under 20%, whereas a number of key Latin American countries exceed 60%.

Perhaps even more important, South Korea has a record of ability to adjust in times of difficulty. It moved quickly to adjust to the oil price rise of 1973, which many observers believed would be financially catastrophic for such

a heavy oil importer as South Korea. Its exports grew steadily during previous recessions. Its quick return to equilibrium after the \$1 billion 1982 curb market scandal compares favorably with the impact, for instance, of the ten times smaller Dewey Dee scandal in the Phillipines, which rocked a very large proportion of the country's most important economic and financial institutions. In the recession of the last three years, South Korea has pursued policies of austerity, price stability, energy conservation, industrial adjustment, and declining protectionism which are much sounder for the long run than those of most other Third World countries and markedly more rational than the policies of such countries as the United States. (The U.S. has run huge deficits, caused high interest rates, and turned strongly protectionist at a time when such policies can only worsen the nation's dilemmas.) Such policies are particularly reassuring to bankers, because they indicate that the banks are performing their proper function of providing a bridge through a difficult period, with strong assurance that there is firm land at the other end of the bridge. Most of the countries in deep trouble have, in contrast, used their funds to increase consumption or to delay the adjustment process.

In a normal world, this would be the end of the commentary. South Korea has a strong, rapidly adjusting, growing economy with relative price stability. A tenuous economic recovery is beginning in the United States, Britain, and West Germany, although extraordinary U.S. budget deficits mean long-term real interest rates will persist at record levels and perhaps even increase, threatening the global recovery. Oil prices have fallen and will probably fall further; South Korea will benefit from this, because the resulting declines in imports and in interest rates, and the more rapid

recovery of Korea's trade partners, will outweigh its construction losses in the Middle East.

But the world is not a normal one. It is a world of global financial crisis and therefore of extremely jumpy financial markets. South Korea's \$10-11 billion short-term debt makes it somewhat vulnerable to the jumpiness of the financial markets. Just as the problems of Argentina and Mexico caused great trouble for Brazil, so the necessity of a major rescheduling in a Pacific Asian country would cause some difficulties for all other Asian countries. Since South Korea's position is so much sounder than Brazil's (South Korea's exports are about the same in size as Brazil's, and South Korea's debt is about half of Brazil's), the result would almost certainly not be any interruption of debt service but rather a few weeks of fast footed financial maneuvers. If one does a worst case analysis, in the manner of military planners, one can imagine an unexpected and severe economic or political shock which would cause a panicky reaction among smaller banks who are less confident of their long-term economic and political understandings and certain others. This could cause a severe short-term squeeze for South Korea. But the important points about this scenario are: first, it is fairly unlikely. Second, the putative financial problems would result not so much from South Korea's objective situation as from the aberrant financial markets. Third, the dynamism of South Korea's economy, its capability for adjustment, and the repeatedly demonstrated confidence that the world's major banks have in South Korean economic management would assure a quick return to liquidity even in this unlikely worst case scenario.

Thus, although South Korea is more exposed to the vicissitudes of an unpleasant global economic situation than almost all the other countries of

the world, its financial situation is much sounder than that of all but a handful of other countries.

The North Korean Situation*

In contrast, North Korea is one of the countries least exposed to international economic difficulties, and one of the least indebted countries of the globe, but it is in more serious financial difficulty, and more persistent financial difficulty, than all but a handful of other countries.

North Korea followed a policy of economic independence, designed to insulate it from all economic dependencies. However, like Poland, North Korea initiated an ambitious industrialization drive in the 1970s. Its motives were to gain greater independence from the Soviet Union and to match the economic growth of the South. Between 1972 and 1973, North Korea's imports from Japan tripled, and between 1973 and 1974 its imports from all non-communist countries doubled from \$335 million to \$786 million. It moved from an \$18 million trade surplus with non-communist countries in 1970 to a deficit of \$107 million in 1973. Like Poland but unlike South Korea, it sought this industrialization in the absence of competitive pressures which would have made its industry efficient. And it lacked the market orientation which would have made its economy flexible in the face of changing economic conditions. Like South Korea, the North faced a huge surcharge when oil prices rose, but

*The author is indebted to Chris Kotowski of Columbia University for research assistance on North Korean debt figures.

it lacked the South's ability to generate additional exports. Its exports were diverted from the non-communist hard currency countries to the soft currency Soviet Union, its major oil supplier. Second, unlike South Korea, North Korea is lucky enough to possess some indigenous raw materials, notably non-ferrous metals, and it planned to pay its debts with exports of these, but was hit hard when commodity prices declined. Third, North Korea's ports seem to have been a bottleneck for its exports.

North Korea's financial problems surfaced very early. Its payments were slow in 1973. In 1974, payments to its principal creditors, Japan, France, and Germany, became erratic and then stopped. In early 1975 it failed to make payments also to Sweden and Finland. Japanese banks cut off letters of credit and West Germany's export insurance organization cut off coverage of exports to North Korea. The North Koreans rescheduled their obligations to European creditors and brought their interest payments current, but fell behind again in early 1976. They paid Japan only \$33 million out of \$73 million owed and stopped payments to all other creditors. These problems were compounded by curtailment of Soviet aid from a cumulative figure of \$725 million between 1970 and 1974 to approximately \$4 million total in 1976.

By this time North Korea was roughly \$60 million in arrears to Japan, owed Moscow about \$400 million on which it was not making payments, and was lucky to achieve cancellation by China of some \$200 million of debt. Its total indebtedness at the end of 1976 was about \$2.5 billion, including \$1 billion to communist countries and \$1.5 billion to non-communist countries. North Korea's financial story since that time has been one of periodic rescheduling, followed by further difficulties. In January 1977, Western European creditors rescheduled some \$1.2 billion, of which \$516 million had been in default for

over two years. In October 1979, North Korea reached agreement with 43 Japanese creditors to reschedule debts of \$360 million. In both cases, there was a grace period followed by payments over a very extended period of time. Likewise, in April 1980 the French signed a rescheduling at a concessional 7.5 percent rate of interest. However, in July 1980, North Korea failed to make payment of 8 billion yen, one of the first payments due under the 1979 rescheduling agreement. On June 17th, 1981, London banking sources disclosed that North Korea had been able to make only one payment on its refinanced European debt. However, by late 1981, North Korea was said to have paid its obligations under the principal rescheduling plans.

North Korea today has escaped from the period of greatest international financial embarrassment. It remains a country of great financial weakness. Its exports are small. Its imports are small. Its economic flexibility is almost nonexistent. It continues to be dependent upon low level exports such as magnesia clinker, cement, and steel materials, along with some machinery products and marine commodities. It has little debt but even less access to international credit. Ironically, it was severely affected by the downturn in commodity prices, but will be slow to benefit from the decline in oil prices or the gradual recovery of the world economy: its oil imports are from the Soviet Union, which is unlikely to reduce its prices, and its narrow range of export commodities will not benefit greatly from the somewhat more dynamic but also much more competitive world economy of the next few years.

Some Conclusions

South Korea is in the position of a rapidly growing, successful corporation, which has enormous capital requirements in order to achieve its

real economic potential. As a result, South Korea has a very large debt, but also has impressive liquidity and auspicious prospects. North Korea, on the other hand, is in the situation of a small, obsolete firm: very little debt, but virtually no liquidity and poor prospects for the future.

South Korea has always run its economy and its finances close to their limits. Given South Korea's extraordinary managerial talent and its past successes, such an approach is laudable. But the experience with over-investment in heavy industry in the late 1970s shows that even South Korea has its limits, and the financial analysis above also suggests that this is an appropriate period for a modicum of caution.

The analysis also suggests that the era of the open, export-oriented economies is not over. Many critics have argued that, with the onset of a global recession, global financial crisis, and declining world trade, the open, export-oriented economies will suffer disproportionately and their model of development will go out of style. To be sure, these economies have suffered lower growth rates as compared with previous periods. But they are still growing faster, adjusting faster, and experiencing fewer financial problems than their more inward-looking competitors. On a relative basis, the analysis suggests the opposite of the critics' argument. It appears that the outward-looking Asian economies will rapidly increase their market share in the world economy as they return to relatively rapid growth, while their more inward-looking Latin American and African counterparts struggle with years of austerity and debt rescheduling.

Finally, the contrasting conditions of North and South Korea suggest that pressures must rise for North Korea to modify its policy of autarky. No aspect of that policy is more important than the goal of insulating North

Korea from external economic pressures. But that is precisely where the policy has failed most miserably. North Korea's alternatives are now starker than ever: it can pursue self-reliance and fall far behind South Korea economically and militarily, or it can open itself somewhat to the rest of the world, a great domestic political risk, and attempt to remain in the competition.