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## **East Asia in Crisis: The Security Implications of the Collapse of Economic Institutions**

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EAST ASIA IN CRISIS:  
THE SECURITY IMPLICATIONS  
OF THE COLLAPSE OF ECONOMIC  
INSTITUTIONS

Stephen J. Blank

February 5, 1999

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## FOREWORD

The financial crisis that began in Thailand in mid-1997 has now become a global one. It has consumed governments, upset defense planning and the regional standing of major powers in Asia, and is forcing us to rethink Asia's entire past and future political trajectory. The security implications go beyond merely the crash of unsound financial systems. Governments have fallen across Asia and in Russia. Civil violence is currently taking place in Indonesia, a key Asian state. Defense research, development, and procurement have been postponed in most Asian countries. The crisis and its reverberations have shaken financial markets and governments as far away as Brazil.

In order to assess the dangers posed by this crisis to Asian and U.S. security interests, the Strategic Studies Institute (SSI) cosponsored a conference with the National Bureau of Asian Research and the Reserve Officers Association in Seattle, Washington, on June 9-10, 1998. This conference represented a unique opportunity to conduct such an assessment since it brought together participants from government, the military, academia, international financial institutions, and Asia.

The discussions were frank, open, and sobering. In fact, the conference raised several issues of great importance for the overall security policies of the United States in Asia. First, defense burden-sharing is less feasible, and military exercise programs have been scaled back. Second, despite widespread hunger and poor agricultural productivity, North Korea continues to maintain its Army on a war footing and is developing new classes of missiles nearing intermediate range. Third, the nuclear tests by India and Pakistan have weakened the leadership of the United States and created a new security dynamic.

Looking at the reaction of financial institutions to the crisis, not surprisingly, there was a strong tone of critique of

the International Monetary Fund's (IMF) forceful actions in Asia. While the critique strongly targeted against the issues of bailing out improvident investors and lenders (moral hazard), and the austerity that ensued as a result of the reforms that the IMF dictated; most presenters did not address the other side of the argument. In effect, this argument in defense of the IMF asks what would have happened had the IMF not imposed its terms. Would those states have been better off than they now are? After all, one can claim that many of the obstacles to healthier economic policy and growth were smashed due to the IMF's forceful, even coercive actions. Furthermore, if the IMF calls for the same reforms that the United States is now urging, how would the latter implement its policies and "lead" the recovery without having a mechanism like the IMF at hand to implement that recovery? As many have called on the United States to adopt a stronger position in Asia as a result of the crisis, depriving it of what has been a reliable instrument does not harmonize with that call for action. Since it is the IMF alone that has the leverage abroad and the financial resources to impose, if need be, the desired reforms, it might be argued, then, that to curtail its powers would be to deprive the global community at large, and not just the United States, of the means to respond promptly to future crises in the global economy.

Further questions pertain to the role of other actors. Mention of Europe was noticeably scarce at the conference. In view of the size of the global economy, the globalization of economic crises' effects upon those not directly affected, and the size of the response that is needed, Europe must play a greater role in resolving future crises. Here the IMF's multilateral composition is a fundamental element of the solution. Should future crises of this scale break out again, a multilateral response will again be needed and a mechanism like the IMF or the IMF itself will have to coordinate the international action to ease the crisis. To improvise a multilateral mechanism of those capable of rescuing afflicted societies during the crisis will necessarily draw out and extend the crisis, perhaps past some societies' breaking point.

Especially as the Euro that began circulation in January 1999 promises to be a major international currency, European participation through existing multilateral institutions is even more essential to preventing crises and then promptly mitigating their impact when they occur. Although China's currency has been central to this drama, China hardly can be the engine of international recovery for Asia, let alone the world. China's economy is fragile, state-owned industries are unproductive, and its banking system is in need of reform. China's currency neither circulates freely abroad nor is it traded freely in world markets. Still, China's restraint during 1998 in not devaluing its currency played an important role in the crisis. Ominously, however, while the rest of Asia has scaled back defense spending and military modernization, China is pouring money into improving its People's Liberation Army. Thus the conference's emphasis on China and exclusion of Europe's role in the crisis and its resolution might bear some rethinking, but is at least understandable.

These are only some of the crucial policy-relevant issues that emerge from a consideration of the effects of this crisis upon Asian and international security. Undoubtedly these and other questions will continue to demand international political attention for quite some time. Precisely because of the continuing importance of these issues to U.S. security policy in Asia and elsewhere, SSI is publishing this summary of the discussions and the issues raised by the speakers. In this fashion we hope to contribute to the ongoing process of devising a U.S. security policy that includes economic help to Asia but goes beyond that to strengthen the possibilities for attaining the vital security interests of the United States in Asia and the Pacific.

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DR. STEPHEN J. BLANK has served as the Strategic Studies Institute's expert on the Soviet bloc and the post-Soviet world since 1989. Prior to that he was Associate Professor of Soviet Studies at the Center for Aerospace Doctrine, Research, and Education, Maxwell Air Force Base, and taught at the University of Texas, San Antonio, and at the University of California, Riverside. Dr. Blank is the editor of *Imperial Decline: Russia's Changing Position in Asia*, coeditor of *Soviet Military and the Future*, and author of *The Sorcerer as Apprentice: Stalin's Commissariat of Nationalities, 1917-1924*. He has also written many articles and conference papers on Russian, Commonwealth of Independent States, and Eastern European security issues. Dr. Blank's current research deals with proliferation and the revolution in military affairs, and energy and security in Eurasia. He holds a B.A. in History from the University of Pennsylvania, and an M.A. and Ph.D. in History from the University of Chicago.





East Asia

# EAST ASIA IN CRISIS: THE SECURITY IMPLICATIONS OF THE COLLAPSE OF ECONOMIC INSTITUTIONS

## Introduction.

Contrary to earlier reports and hopes at the time of the conference, East Asia's financial and economic crisis is spreading abroad and worsening. It has become a global crisis embracing Latin America and Russia and the Middle East oil states. Many analysts now believe and publicly state that it might last at least into the year 2000 or 2001. It already has toppled several governments, devastated virtually all of East Asia's economies, and threatens to cut an even deeper swath through the world economy. By August 1998 Russia had to devalue its ruble, Brazil and Venezuela were rumored to be in line for devaluation. And China had pledged not to devalue and took strong measures in support of its currency.

One sign of the crisis' global impact is the effect it has had on global commodity prices, e.g. energy. Those prices have tumbled as a direct result of the dramatic fall in Asian aggregate demand. Thus states that depend on commodity products for foreign exchange, e.g. Russia, which rely on oil and gas revenues, are undergoing severe economic crises as well.<sup>1</sup> History shows that crises of this magnitude generally lead to major international crises that have a great effect on U.S. security policy and upon our allies. For example, Indonesia is on the brink of chaos and widespread internal violence and famine.<sup>2</sup> Social unrest there has already toppled the Suharto regime and could undermine its successor as well. Likewise, Japan's prolonged structural crisis has profound implications for Asia and the global economy. The consequences of that development or of similar catastrophes in other states are incalculable for both regional and global security.

For that reason the Strategic Studies Institute, together with The National Bureau of Asian Research and The Reserve Officers Association of the U.S. armed forces, organized a conference in Seattle, Washington, on June 9-10, 1998, to assess the crisis' direction and impact. This conference focused on the crisis' domestic and international causes, its current and foreseeable directions, and its implications for international security. The conference brought together a distinguished international group of academic and governmental experts, policymakers, business leaders, and military officers who represented a unique mix of inter-group cooperation and expertise. This report presents a summary of the main points and ideas discussed at the conference.

In general, anxiety and sobriety marked the conference's tone, particularly when discussing Indonesia. There also was considerable general pessimism about Japan's readiness and ability to reform its own system and help pull Asia out of the crisis. Everything that has happened since the conference, especially the newly-elected Japanese government's continuing failure to launch adequate reforms, seems to confirm that negative assessment.<sup>3</sup> Japan's centrality to Asia and its long-term stagnation are major reasons for concern over Asia's future. For instance, any significant depreciation of the yen will instantly undermine China and South Korea's efforts to hold the line on their currency and their ability to export enough goods to keep growing. Beijing has already intimated that in the event of a devaluation of the yen it would then have to devalue the Reminbi, stimulating further distress all across Asia. Foreign observers also well understand the pressure on China's currency.<sup>4</sup> And Seoul is likely to experience the same pressure and follow the same course.

Likewise, there were few signs of optimism for the near term, although most speakers reiterated their conviction that, given proper policy changes, Asia would reform and return to economic health. Only in the case of Russia, one of the many casualties of this crisis and its fallout, did Herbert Ellison voice optimism, mainly on the basis of the installation of the Kiriyenko government and its pledges to carry out a vigorous

reform program. Since then, as well, the IMF has come to Russia's rescue by lending it some \$22 billion on the promise of vigorous implementation of a new reform plan. But even the IMF's rescue efforts could not prevent a full-scale collapse of the Russian government, which, as of November 1998, still had no credible economic recovery plan. At the conference there was some debate over whether this optimism was justified. In the end it is clear that it was not warranted and that Russia's crisis is only in its inception as its leaders now admit. Russia appears to be something of a black hole and nobody really can say with certainty how it can be saved.

Accordingly, financial and presumably political crises may spread throughout the Commonwealth of Independent States (CIS). If that is coupled with a major crisis in Asia, it is not clear whether the international community can cope with such large interactive and simultaneous crises. Finally all the participants clearly understood that however individual governments and states contributed to the crisis and were then affected by it, there is a strong international dimension to its causes and any future resolution.

These features of the conference and the general concern for the future emerged at the outset of the program. Keynote speaker George Russell, CEO of the Frank Russell Company, one of the U.S.' leading institutional investment firms, voiced his fears that the Asian crisis was slipping from recession to depression. This foreboding has also begun to enter into foreign discussions of the crisis as Japan's stagnation and recession betoken a protracted regional crisis and loss of its former preeminence in Asia.<sup>5</sup> Naturally, the word depression evokes memories of the Great Depression, 1929-41, which was instrumental in providing the stage for the crises that led to World War II. Here Russell clearly sought to alert the audience to both the international scale and scope of the challenges now confronting Asia and the world economy. Russell and the other speakers all agreed that efforts at recovery must not assume only a narrow national dimension. Rather those efforts must be international in scale and led by the United States, due to its leadership in world affairs and its own strong economy. Trends since the conference appear to

bear out the rightness of this assertion since no one else has taken or appears ready to take the lead in addressing the crisis in practical fashion.<sup>6</sup> Those U.S.-led international efforts must combine coordinated private and public institutions' activities.

Another theme that emerged from Russell's speech and from the conference in general was considerable skepticism about the IMF's role. There was a feeling that the IMF had placed too much pressure on weak states and undermined them once the crisis began. It failed to foresee the crisis and responded relatively slowly to it. Furthermore, the IMF is vulnerable to charges of defending the big banks that invested abroad rashly. This means it supported the moral hazard of defending unsound lending and investment practices. The IMF is also accused of usurping legitimate state functions, and of imposing an unmerited policy of austerity. While certainly many of the conditions it is imposing for transparency of financial and corporate sectors are needed, it is also the case that the IMF is now seriously compromised as an impartial player and its resources are quite strained should further crises develop. Should that occur, the IMF cannot automatically count on U.S. political support since the last Congress showed itself to be highly reluctant to fund further "bailouts of the IMF." Thus, one of the cornerstones of American international policy since 1945 is steadily being eroded at a time when it is most needed. Because so much of our worldwide security policy rests on the foundation of liberal and flourishing international economic policies and institutions, this development, in itself, may yet have ominous repercussions whether or not one approves of the IMF's policies.

Furthermore, due to the freedom for "hot money" to move in and out of currencies, there is a need, as Russell stated, to examine with an open mind the question of regulating international financial flows. Russell's observation accords with a growing debate over the wisdom of unrestricted global flows of financial credits and instruments. Unregulated flows of money are clearly coming under attack although it is not

clear whether that attack will succeed in restricting the freedom of money to move around the world.

Thus this crisis is already shaking the financial pillars of the current status quo as embodied in the IMF and its more or less uniform approach to such crises. It also is shaking individual governments and the hierarchy of power in Asia because it has transformed the standing of China and Japan vis-à-vis Asia and the United States. Presently, a continuing strong Sino-American relationship has risen in importance relative to the existing U.S.-Japan connection. That development causes some nations to perceive a potential for a tectonic shift in Asian security agendas. China's rise to great power status, some believe, could even eclipse Japan's standing in Asia and may prove to be the most consequential aspect of this crisis. While other participants in the conference acknowledged these trends, they were less sanguine about China's economic future. They cited the fragility of China's banking system and state-owned enterprises. Therefore it is absolutely necessary for the U.S. Government to take a broad strategic leadership role in attacking the crisis and formulating long-term solutions for it. In the financial domain these solutions necessarily involve greater disclosure, transparency, and financial and corporate reforms in Asia. They also should help restrain what might have been called the "irrational exuberance" of lenders and financial institutions here and elsewhere who willingly abetted the Asian boom that went out of control.

Subsequent speakers addressed many of the themes raised by Russell and, in many cases, spoke with regard to specific states and governments. They noted that by the time of the conference South Korea and the most affected Southeast Asian states had suffered an annualized income loss of \$50 billion/year and lost over \$500 billion in market capitalization. Total unemployment will reach at least 20 million people in Indonesia, which must add 3 million people annually to the labor force to prevent an increase in unemployment. Indonesia also faces an imminent famine due to ecological devastation from last year's fires, the enormous devaluation of its currency and the ensuing price rises and the

forced ending of subsidies of basic commodities.<sup>7</sup> And since the conference, conditions there have not appreciably improved, and may have worsened. Therefore one major outcome of this crisis, which will be pervasive but particularly powerful in Indonesia, is the widespread immiseration of large sectors of the Asian population. In the absence of a viable "safety net" in Indonesia and elsewhere, there is a severe risk of widespread social unrest, not to mention humanitarian emergencies that require large-scale, urgent, external intervention, in many countries. For example, labor unrest and labor-management struggles are already daily occurrences in South Korea and Russia.<sup>8</sup> To the extent that austerity must spread, it is quite likely that labor-management strife will intensify. Inasmuch as labor movements historically have been powerful forces for democratic reform or for pushing the establishment over into Fascism as a reaction to pressures for democratization, the prospect of further strife within several unsteady states demands our careful and ongoing scrutiny.

Accordingly, many speakers emphasized that recovery must take place on an international basis and is directly tied to the capacity of governments to implement needed reforms and undertake innovative policies. To the degree that governments fail to do so, stagnation may be the best of several bad alternatives in the afflicted countries. Here there was widespread concern that Japan shows signs of denial, and an inability or unwillingness to reform itself let alone be an engine of recovery for Asia. Unless Japan moves forward quickly, the global economy will undergo further traumatic shocks and a more protracted crisis. China, on the other hand, has played a major constructive role by embarking on a major program of domestic reform and investment and by keeping its currency stable. But for the crisis to end, the industrialized world must here follow the United States and open their markets to Asian exports so that afflicted states can obtain sufficient short-term working capital to revive their economies. Right now we see stagnation and a decline in imports for lack of capital and a concurrent decline in the internal Asian markets because of the liquidity crisis affecting all sectors of the most seriously afflicted economies.

Paradoxically states must take the lead to strengthen their ability to create a framework for their economies yet must retreat from their efforts to protect individual sectors and cronies from competition. Globalization, in the context of a retreat of the state from economic sectors that it cannot effectively control, must be allowed to take place across Asia to a hitherto unprecedented degree in order for those governments to control what they can and must regulate. To the extent that Asian economies have followed the Japanese model (and there is some debate as to whether they have actually imitated Japan's example) they and Japan must now leave that model behind and find a new paradigm of political economy. That does not necessarily mean, as many Americans have written, that they must adopt our model. In many ways they cannot and will not and it is quixotic to hope for that.

Nevertheless they must move in a new direction. Japan, due to its enormous economic power, wealth, and involvement in the Asian economies, must itself overcome the structural barriers to reform at home, including opening the economy to a greater penetration from abroad and moving to a less regulated model of the economy's actual operation. This would entail removing the state from its central role as an actor in the economy to a hitherto unprecedented degree. It also means shattering the cozy ties between the ruling Liberal Democratic Party and the banks, and opening up the political system to more democratic and less bureaucratic forms of control and the representation of economic and political interests. A pro-consumer, rather than the traditional national state perspective of production must come to dominate Japanese economic policy. And it is the magnitude of both political and economic reforms, including much more economic democracy and weakening of the Keiretsu, the Liberal Democratic Party, and the bureaucracy that has led to these sectors' entrenched opposition to such reforms.

Although the acute symptoms of Japan's enduring crisis manifest themselves most strongly in economic recession and stagnation, unpaid bad debts, banks' reluctance to loan capital and a preference for devaluation rather than opening the market to imports, the real illness lies in the realm of



political economy. To most observers, the system is bankrupt but it is precisely that bankruptcy and the novel phenomenon of attacks upon the bureaucracy for corruption, misguided policy, etc. that prevent the bureaucrats and other leading sectors from taking on a new paradigm. It is possible, as Kenneth Pyle thought, that once the Japanese Establishment fastens on that new paradigm that it will move with tremendous speed to institute it.<sup>9</sup>

However, the prevailing sentiment at the conference was that Japan's political system and its major components, parties, bureaucracy, and banks are either in denial, or simply cannot grasp the magnitude of what must be done. Hence the most we can hope for from Japan is muddling along. Unfortunately that is not enough for Asia. Hence Japan's reputation for economic leadership and its actual ability to offer and provide it either in economics or in politics is evaporating almost on a daily basis. Nor is the long-term prognosis for Japan as a leader in Asian economics and politics a particularly optimistic one. Steven Rosefielde's paper pointed to negative trends of decline for Japan in the years to come, a warning that, if heeded in Japan should awake the regime from its torpor. But there is no sign of that happening yet.<sup>10</sup>

## China's Role.

The conference's proceedings made clear that Chinese policies have immediate impacts upon all of its neighbors and a growing importance for and upon the global economy. China has tried to stimulate domestic demand, not just exports, in response to the crisis and has launched a comprehensive reform plan at home that includes major capital projects and reforms. Indeed, it must do so, for its exports have declined considerably during 1998 and otherwise it cannot stimulate sufficient growth to maintain internal stability and development. A major problem that it faces is the increased unemployment that will inevitably ensue and which has already apparently led to sharp infighting as labor-management clashes have begun to occur.<sup>11</sup> Should those clashes escalate, the fears are that they could endanger the

reform plan and lead to a revival of the socialistic elements, or to soft-budget constraints within the economy.<sup>12</sup> Trends toward a return to primacy of the state sector could, of course, resemble the authoritarian solution that might be tried elsewhere, also in response to labor-management strife. At the same time, China's growth is slipping below the targeted figure of 8 percent per annum. Most economists believe that China must achieve this rate of growth as the minimum necessary to achieve real growth in its overall economy. And exports that bring in foreign currency that can defend the Reminbi and Hong Kong's currency are also falling as competition from cheaper currencies and depressed demand in Southeast Asia and Japan eat into China's exports.

Although China has "stood by Asia" and even sent several million dollars in aid to afflicted economies, some analysts are already maintaining that China might have to devalue its currency in 1999 if these adverse trends continue. That could undo all of Southeast Asian states' efforts at recovery and stimulate a round of competitive devaluations that will prevent exporters from sending their goods to Asia because there will be insufficient domestic capital with which to buy them. As it is, East Asian economies are suffering from a credit crunch which could force prolonged recessions or a long-term reduction in the standard of living and growth prospects for the future. Those phenomena could generate unsettling political repercussions and could also stimulate recessions in the advanced industrial economies. A Chinese devaluation would set off competitive devaluations across Asia and a "beggar thy neighbor" competition there that would have devastating economic and political consequences.

There are significant international aspects to China's role as well. In the broadest sense, this crisis and China's thoughtful response to it compared to Japan's paralysis suggest a major transformation of politics in the region. Precisely because Asia as a whole, and indeed, the entire world economy, now depends to a hitherto unprecedented degree on China's ability to stabilize its currency, China has achieved influence very quickly. Not only does China have the relative power to shape outcomes abroad in ways that it never

had previously, it also is restructuring its own economy while continuing a policy of military growth that its neighbors cannot match. Thus it is widely believed that the United States intervened in June 1998 to prop up the yen and keep it from falling in response to Chinese threats to devalue if the yen kept falling. Certainly the widespread perception that Washington moved to support the yen in June 1998 precisely because China warned that its devaluation would lead to a Chinese devaluation and an overall Asian disaster testifies to Beijing's new-found power to influence international economic and political policies.<sup>13</sup> While one should not exaggerate Beijing's power because it too must face very rough economic conditions in 1999, its response in 1998 appeared to be considerably more vigorous and constructive than did Japan's. When juxtaposed to Japan's paralysis, China's standing and power have risen, which may be the most enduring geopolitical aspect of the transformation stimulated by the crisis.

A second aspect of the international political consequences of this crisis is its impact upon the Taiwan issue. Taiwan, like China, seized upon the crisis and its own relative stability to pronounce its willingness to help Asian countries, and to offer aid or new investment. Naturally, Taiwan hoped to exact a political price in the form of greater, and perhaps more overt support for Taiwanese participation in international bodies in its campaign for "international space." Beijing has moved firmly and promptly to denounce and to counter Taipei's efforts. But these moves and countermoves show that the continuing struggle between Taipei and Beijing has effects throughout Southeast Asia. In this case we see the international political "fallout" from the crisis and the ways in which it is exerting and will exert influence upon the direction of Asia's international security agenda. The Sino-Taiwanese division has become an open competition in economics and politics across Southeast Asia and even Oceania.<sup>14</sup>

## The View from International Economic Organizations.

Participants at the conference from the international financial institutions (IFIs) emphasized that the crisis revealed the unsound foundations of Asian financial systems, coupled with unsure foreign lending and risk assessment policies. Once the bubble burst, then, the area has continued to suffer from an enormous outflow of capital. Hence the primary need is to restructure Asian economies to make investment more efficient and transparent, and to encourage the inflow of capital. However, it is not clear that an export led recovery is possible or necessarily desirable. For one, due to the capital crunch, firms cannot now obtain the working capital they need to export or to obtain the necessary imports for earlier stages of the production of goods for the export market. Furthermore, it is entirely possible (and we see signs of this happening relative to Japan, South Korea, and China) that an export driven effort at recovery will only lead to competitive devaluations that will further undermine prospects for overall recovery. Certainly, Japan has not reformed at home and instead has, in practice, sought to export its way to security and build up an even greater export surplus than before.

But even for the representatives of the IFIs it remains unclear how Asian states can stimulate their internal markets to provide for an internally generated growth spurt and capital formation. This may be the weakest point of the IMF-directed austerity programs that threatened to suffocate imports and domestic demand while driving away foreign investors by making the crisis and the regional devaluations larger. Even as the IMF's conditions may have been necessary to prevent the complete collapse of some Asian currencies and economies, the remedies it imposed will clearly lead to a long period of capital austerity and a shortage of investment capital due to falling exports. Imports also will necessarily decline because there will be insufficient capital with which to buy foreign goods. And the balance sheets of many major U.S. firms reflect that sharp drop in U.S. exports to Asia in 1998. It is not surprising that by mid-1998 one could see evidence of

Southeast Asian governments and South Korea trying to reflate their economies by greater domestic spending, albeit through new forms and instruments. Worse yet, in September 1998, Malaysia imposed currency controls and moved decisively towards autarchy and away from economic internationalism. Those efforts clearly represent a questioning, if not critique, of the IMF's programs and outlook and a new possibility for state intervention at home, albeit through new mechanisms of economic regulation and control.

From a political point of view, the continuing failure of IFIs to devise adequate relief measures or to come to grips with the crisis calls into question the ability of all these institutions that underpin Asian and international security to meet the challenges they will face in the future. Whether it is APEC, or the IMF, or the World Bank, none of them alone can do the job. Their discussions seem to have degenerated into a fractious chorus with each agency pointing the finger at the other or at some government. It is hardly surprising that these quarrels often mask deeper interstate rivalries on international economics and security.<sup>15</sup>

While the struggle between governments and the IFIs has stimulated many Asian governments' policies of reflation, states' internal efforts to reflate economies is also a reaction to the desperate domestic situation and stagnation across much of Southeast Asia. As Linda Lim pointed out for Indonesia, once the bubble burst a panicky flight to dollars began and triggered the domino effect of the Rupiah's devaluation. This led to the meltdown of the Suharto system, not economic recovery. The Rupiah under Suharto's successor, President Habibie, has fallen from 9500 to the dollar to 13,000 to the dollar and shows no sign of reversing that decline. Without a restoration of stability and confidence, which Lim does not foresee anytime soon, foreign capital and investment will stay away and IMF programs will fail.

The implications of a continuing devaluation of the Indonesian currency and collapse of the economy are obvious, as Donald Emmerson observed. Continued economic instability means continuing political unrest, violence, and the very strong tendency for the various factions of the armed

forces to be drawn into factional or even ethnic and sectarian violence. As it is, recent revelations strongly suggest that an anti-reform wing of the armed forces and secret police orchestrated the rioting in early 1998. Their goal was to incite an anti-Chinese ethnic pogrom, use that chaos as a pretext to eliminate or undermine the reform wing in the armed forces and elsewhere, politicize the pro-regime faction there and, in effect, use the violence to preserve Suharto's system and Suharto in power.<sup>16</sup> The politicization of ethnic and/or sectarian violence is already leading to apparent quasi-secessionist uprisings in Indonesia. And if famine is added to that, it is not too hard to see a return to 1965-66 when hundreds of thousands, perhaps a million, people were massacred in sectarian and political violence that ended only with Suharto's rise. Liberalism and democracy's future there cannot be considered truly secure. Nor is it clear that Beijing will remain silent if anti-Chinese violence deepens.

Indonesia's collapse or long-term stagnation would have serious international consequences. Jakarta was and is a driving force behind ASEAN and if it cannot act, neither can ASEAN.<sup>17</sup> ASEAN, throughout the crisis has been too conservative to react boldly and has come under great pressure to act, but has taken only minor steps to date. These are probably too little too late. And the pressure for a more wrenching change is surely building up across Southeast Asia. But the inability to respond to this crisis and China's growing power relative to that of ASEAN's members must inevitably force a reassessment of how ASEAN functions to ensure regional stability. If ASEAN cannot adapt to the crisis, and its performance has been less than inspiring, its ability to stand up for the region's interests will erode. This would call into question ASEAN's leadership in the collective process for mediating security issues, the ASEAN Regional Forum (ARF), and the strong influence of the ASEAN Post-Ministerial Conference (PMC) on the other participants would weaken. As it is, Thailand and the Philippines are challenging the rule of "noninvolvement in each member's internal affairs" and the organization is clearly facing a major turning point.<sup>18</sup> Continuing failure in Indonesia will have repercussions across all of Southeast Asia.

Lim's discussion also noted that the Malaysian situation is deteriorating despite official IMF optimism. The reasons are political. Since Kuala Lumpur has (as of June 1998) followed IMF recommendations but without the imprimatur of the IMF, interest rates have remained too low, driving away foreign capital and preserving inefficient capitalists in business. As long as the foreign investment climate is inhospitable and inefficient, and corrupt businesses are preserved without reform, Malaysia, too, will stagnate, if not deteriorate further.

In order to insulate Malaysia from foreign economic pressures and demands for reform emanating from abroad, President Mohammad Mahatir instituted currency controls. To stifle internal criticism, Mahatir arrested his heir and the leading reformer, Anwar Ibrahim, and has clearly turned towards more authoritarian and repressive policies. It is unlikely that policies could achieve anything more than a short-term fix at the expense of the long-term. Moreover, they have created a fissure between Malaysia and its ASEAN partners that can only further weaken regional cohesiveness across a host of issues.

Lim's analysis, coupled with those that preceded her, raise some troubling issues. If the prognosis for individual Southeast Asian states is bad, their international mechanisms for security do not appear to be doing any better. First of all, as Leif Rosenberger pointed out, the crisis has its roots not just in Southeast Asian governments' unsound economic policies; it also was the result of the vulnerability to international currency movements of Southeast Asian governments. China's 1994 devaluation and the reversal of the positions of the dollar and the yen, making the yen a weak currency and the dollar a strong one, meant that just as Chinese competition devastated Southeast Asia's former export markets, imports and debts rose in value as they were denominated in dollars. Moreover, Japan's continuing resistance to imports hobbled the Southeast Asian economies by depriving them of markets for their products. However, it is clear that Japan, until now, has been unwilling to reform and

allow for more imports for political, as much as economic, reasons. As one Japanese analysis states,

Even now, Japan fears that making the yen a global currency will require that domestic policies are connected with the global economy. As an example, if the Yen were treated as a global currency, Japan would be unable to maintain its ultra-low-interest-rate policy. A perception functions herein whereby preference should be given to domestic balance and to bar global influence as a means to preserve Ministry of Finance authority.<sup>19</sup>

Indeed, Japan's Prime Minister, Kezio Obuchi, told the *Washington Post* that Japan had already done everything possible short of a wartime economy to pull out of its trough. Therefore, perhaps a wartime economy may be the only option left to Japan.<sup>20</sup> This shot across the bow was probably correctly interpreted as a warning to Washington to back off its pressure upon the Japanese government, as Obuchi also cited the American recovery from the great depression through military spending and arms exports which are banned in Japan under its interpretation of the Japanese constitution.<sup>21</sup> But threats like these and the outlook cited above have produced the widespread feeling that Japan cannot be relied upon to contribute to Asia's recovery.

When these external, international causes of the crisis are added to unsound internal practices, the result has been devastating and has been compounded by the IMF's imposed austerity packages that have sent all of Asia into recession. The danger, as noted above, is that the international economic system, now based on unimpeded movement of capital across borders which is widely attributed to be one of the causes of the global crisis, will not reform as well. In practice that means Japan will continue to stagnate, and seek to export its way out of crisis while not reforming its unsound economic practices. China will have to devalue and Asian states will be forced into an unwinnable and devastating competition. As each Asian state seeks its salvation in exports, each of them will come under pressure to devalue its currency further, resulting in their net impoverishment as they become progressively unable to import foreign capital or capture



sufficient export markets. Since there is so much excessive production capacity across Asia and governments and businesses are still loath to cut it to a sufficient degree, any strategy based on exporting abroad as the way out of crisis will fail. Even more alarming is the fact that estimates of the capacity that must be destroyed for balance and competitiveness to return to Asian economies ranges from 30-60 percent of governments' manufacturing capacity. Clearly such drastic unemployment, curtailment of investment, and plant slowdowns are politically unacceptable even if deemed to be economically necessary.<sup>22</sup> Since few markets are available to Asian governments and capital sources are also closed given the high risk of investment there, continued stagnation and long-term political crises are the likely result.

This nightmare scenario is not so far removed from reality as to be dismissed out of hand. Russell's warnings suggest a long-term stagnation and contraction: 9 of 13 Asian economies are currently in recession and those that are not are to some degree at risk. If, as Rosenberger and many other critics have suggested, the IMF's response was too little, and, to use a medical analogy, the treatment is killing the patients, then the international financial system is at risk.<sup>23</sup> As it is, due to its bailout of Russia, the IMF's funds are running low and the refusal to date of the Congress to support the U.S. payment into the IMF's coffers before October 1998 only intensified the possibility of its being unable to respond, let alone do so correctly. Fear of the IMF's inability to respond certainly added fuel to the fire throughout the summer of 1998.

But the controversy here has had the following impact. Clearly the IMF's vision of a cure for malfunctioning economies, its innate tendency to reward bad behavior, and the so-called "Washington consensus" of hard money, open markets in trade and finance are all now under severe attack. These conditions are all in need of a sustained and dispassionate review (to the extent that these are feasible). If anything, this crisis has exposed the fragility of the international financial and economic order, and beyond that the political consequences of relying on such flawed mechanisms. Indonesia's case may be the only one where a

state comes utterly apart. But Japan's stagnation, Russia's devaluation and protracted crisis, and China's struggles also signify a profound and long-lasting transformation of the Asian political scene.

Any such reexamination of the principles upon which the status quo now rests will encounter strong opposition. Michael Miller observed that APEC rejects the idea of an APEC bailout fund under the IMF and the notion that liberalization of trade fueled the financial market crisis. Mismanagement, not the uncontrolled movement of "hot money," is to blame. Nor is APEC at fault or to be castigated for not doing enough, according to Miller. But should the crisis continue as forecast, it is unlikely that the status quo can emerge unscathed. And should hot money's flight from an economy cause another collapse, or should the current crisis spread still further, the call for new policies will be much stronger and perhaps irresistible in certain governments.

South Korea.

South Korea's crisis came about due to policy mistakes as well as Taiwan's 1997 devaluation that made it impossible to gradually bring down the value of the ROK's currency, the Won. Lawrence Krause pointed out that efforts to reform the system, though obviously insufficient, were already in place when the crisis broke. But those foreign shocks, combined with the dominance, profligacy, and irresponsibility of its large conglomerates and industrial giants, the Chaebols, precipitated the tremendous crisis that engulfed the country in late 1997. These firms have astonishing debt/equity ratios. And the previous utter lack of control over them and over the financial sector will be the focal point of intense domestic struggles because their unaccountability to investors or to the government represent a major obstacle to the deeply rooted process of democratization. But the same is true for South Korea's rigid labor markets. That rigidity represented part of the trade off whereby government and the corporate sector led by the Chaebols gave labor jobs and wage security in return for labor peace. Since unemployment in South Korea may now go up to 10 percent and the Chaebols and the government are

fighting with each other over the future shape of South Korean capitalism, the end of this "social contract" has already triggered considerable labor unrest.

We may find even more labor-management antagonism and unrest in the future unless the economy turns around and unless labor's demands for more democratization and reforms are resolved. Inasmuch as the recently elected government of Kim Dae Jung owes its political base to the labor movement, even if the economy, as expected, begins to grow again in 1999, intense political struggles will occur. As Krause observed, the Chaebols must undergo restructuring. They are trying to sell off their weakest parts and retain as much of the old system as possible. But the likely price of this obstructionism is their future marginalization in the economy once it resumes growth.<sup>24</sup>

The question is not whether they will be restructured, but the direction and quality of that process. As of now, evidently little has been done other than to shift assets around in the manner best calculated to avoid shutting down production.<sup>25</sup> That, however, is merely a recipe for continued failure and stagnation over a longer-term than is necessary. Firms with hopeless losses must go bankrupt while others must undergo restructuring or perhaps outside or foreign acquisition. Debt must be converted to equity and a climate hospitable to foreign direct investment must be brought into being. Many debts will have to be written off and somehow absorbed by the state. Presumably, as well, bailouts of industries that cannot be allowed to fail will have to take place. But it is clear that a major industrial restructuring must occur that changes significantly the role of the Chaebols and of labor in South Korean economics and politics.

### The Security Dimension for the United States.

These developments must profoundly affect the security relationships within Asia and between Asian states and the United States. Major General Stephen Silvasy, Deputy Commanding General of the U.S. Army Pacific (USARPAC), observed that his command embraces an incredibly diverse

area extending as far as Central Asia and one that is undergoing profoundly rapid transformation. Consequently Asia eludes easy understanding and categorization and cannot be reduced to a single denominator.

Nor can this crisis be so characterized even if we only look at its military dimension. The crisis in Indonesia, for example, is forcing a reassessment of our military-to-military relationship with Indonesia's armed forces.<sup>26</sup> Published reports in mid-1998 gave rise to concerns that, indeed, we had been collaborating with Indonesian forces and training them in operations that were hardly models of democratic civil-military relations.<sup>27</sup> In general we must become more sensitive to the fact that our bilateral and multilateral connection with Asian militaries must now also comprise facilitating their transition to a clearer system of democratic civilian control over a depoliticized armed forces. There are signs that this is happening since no military coup has taken place. Even the suspicion that elements of the Indonesia forces tried this to keep Suharto in power discredited them and strengthened the drive to keep the army out of politics.<sup>28</sup>

At the same time, as both General Silvasy and Sheldon Simon observed, this crisis will significantly reduce readiness, defense spending, all forms of engagements with the United States, exercises of all sorts, weapons procurements, and international military cooperation across the board. Because of the crisis, our Asian partners will have significantly fewer funds for bilateral and multilateral activities with the U.S. armed forces and for military modernization. Clearly the U.S. military engagement across Asia far transcends classical issues of defense readiness and deterrence in its political impact.<sup>29</sup>

When these trends are taken with Japan's inability to move forward, China's uncertain prospects amid a relative and absolute rise in its Asian power position and its standing relative to its neighbors, it becomes clear that the old status quo in Asia is under serious challenge and is fast disappearing. Given the current weakness of almost all the other players, only the United States can provide a framework for cooperative and joint action and a security structure that

other states can accept as legitimate. This applies as much to issues of economic security as it does to political and military security. Thus the United States, for the foreseeable future, must do more in Asia along a series of different azimuths than its present establishment seems ready to accept. One can see the reluctance to act in the utter absence of media or public discussion of the impending Indonesian famine.<sup>30</sup>

The U.S. defense involvement with the area or our role as the ultimate financial and military guarantor of security and defense will increase. President Joseph Estrada of the Philippines has recently stated that his government cannot afford to modernize and reform its armed forces and will have to rely on the United States for defense.<sup>31</sup> This is only one example of a wider regional trend. The increased role that the United States is expected to play is part of the broader consequences or outcomes of this crisis. Certainly it shows that Manila cannot rely on its own or ASEAN's efforts vis-à-vis China or other future security challenges. Recent analyses that postulated a Southeast Asian ability to stand China off on its own are in danger of becoming history.<sup>32</sup>

Other areas of international involvement with Southeast Asian security will also be affected. Japan may lose its role as number one foreign aid donor this year and in any case has shown itself both unimaginative and paralyzed in confronting this crisis. The fears or hopes expressed earlier in this decade of a yen block or of a Japan that was ready to take the lead in Asia have proven illusory.

As Steven Rosefielde pointed out, the demographic, economic, and investment projections for Japan's future are all rather pessimistic. It does not seem likely that an aging society and sclerotic political system can take the lead in shaping Asia. This pessimism rightly applies even more strongly to Russia, which will continue, in Rosefielde's analysis, to be marginal to Asia. And in fact it may become still more marginal. Yet his figures are optimistic for China and the United States, bearing out the notion that a restructuring of the Asian security system according to those two states pride of place in it is occurring.

As this analysis has maintained, the current crisis not only highlights the quite responsible and responsive role that China has played but it marks China's real arrival as a great power. The fact that Asia's economic-political health now depends in no small measure on the stability of China's currency signifies its arrival as such a player because only great powers' currency commands such attention. Admittedly this is a paradoxical situation because China is not a member of the WTO and its currency is not freely traded abroad. Yet already the prospect of a major economic-political crisis in China due to the global crisis and its own incomplete reforms frightens governments everywhere. One may compare the intense scrutiny of the Reminbi compared to the relative disinterest outside the CIS with the fate of the ruble. Hence the United States and China are likely to become the two key powers for Asian security and the states whose mutual relationship largely shapes Asia's agenda. While this may be unjustified in terms of reality and comparative strength of the United States and China; it is not unjustified based on perceptions across Asia.

This dynamic process also appears in the regional defense agenda. As Simon noted, every state is cutting back on its defense spending and procurements. It is not inconceivable that the military gap between China and its neighbors will open more widely and contribute to a growing disparity between Chinese power and that of its neighbors. They, in turn will increasingly have to turn to the United States as the balancer even as Washington finds itself under pressure to retract its investment and presence in Asian security. In short, this crisis confronts Washington with the necessity to reformulate its Asian agenda and stop relying simply on economics and freer trade to work their magical charm. Washington must now actively lead in the resolution of Asian issues and the promotion of a new Asian order. It cannot evade the choices inherent in its position.

But how is Washington to respond to the challenges being foisted upon it while it is caught up in its own self-imposed political crisis and faces an elite that is loudly skeptical about the IMF, "bailouts" or extensive military-political foreign

engagement at a time of no visible threat. Donald Hellmann observed that much of the U.S. analysis and commentary about this crisis has been one of rejoicing that the Japanese model has fallen and the simplistic refrain that Asia's economies now must become or are becoming more like ours. It is an enduring source of comfort to the official mind of Washington that others are becoming more like us, but is that true? Given the IMF's refusal to reconsider its current model of sound policy, APEC's refusal or inability to act, and our own refusal to create new institutions to replace those that emerged out of World War II, like the IMF, can we truly say that the Pax Americana is succeeding? And given the fact that the IMF's remedies have only globalized or internationalized recessions, slumps, and crises, it is hardly satisfying to state that the IMF's programs, many of which were made in Washington, have answered these states' needs. Those boasts and triumphalism about the American economic and political system may yet come to haunt us if the crisis continues.

As Hellmann suggested, much of our analysis is based on myth. If the United States, which occupied Japan and had total power over it, could not change it materially from its pre-1945 structural and ideological proclivities, how can we expect the IMF to change South Korea successfully? Likewise, given the structural challenges to effective international leadership that confront any American president, how can this Administration, scandal-plagued and now suffering from plummeting credibility at home and abroad, effectively lead Asia and overcome those domestic U.S. coalitions that oppose the actions needed to overcome this crisis and restructure Asia peacefully?

Robert Zoellick captured many of the issues noted above as he sought to outline a program where the United States takes a visible but not insensitive lead on reform. Zoellick called for the United States to engage in further dialogue with Chinese reformers over the question of reforming banks to make them more accountable and transparent and to guarantee their depositors. We should also parallel our offers of support for democracy and political-economic reforms with material help to open markets on both sides to lower Asian governments'

costs of reform. And while we seek to move Japan to more reform, we should consolidate our military and intelligence collaboration with it under the new Strategic Guidelines to the Mutual Defense Treaty.

Zoellick also outlined a comprehensive series of steps that Washington might take with its Asian allies and partners to help rescue them. We would begin by outlining priorities for the reform agenda in Asia and international economics. Then we could go on to help stabilize their currencies and launch revival by a third step of confidence-building measures in economics that remove impediments to investment and trade by also improving competition and open markets. He also encouraged American investors to invest in markets throughout Asia, not just within Japan.

Zoellick also strongly addressed issues of Asian security. ASEAN's weakness and the recent Indo-Pakistani nuclear tests have undermined regional confidence. Washington must help ASEAN to recover its capability to be the regional spokesman for security and its ability to face up to new challenges like those discussed above. In this context he criticized the U.S. failure to move on trade liberalization because it signifies a weakened Administration, a recalcitrant Congress, and a refusal to coordinate investment policies through the IMF with freer trade. Since our trade deficit must grow as our customers falter and they must export to us more, attacks on open markets will grow and the Administration has little ammunition with which to defend itself. The U.S. failure to press APEC on following its own commitments to freer trade or to undertake its own initiatives in this regard are telling. But they reflect an unwillingness to spend political capital at home. So, too, the failure to press harder to bring China into the WTO is for Zoellick a telling sign of the times.

Zoellick also cited the failure to gain IMF replenishment funds as a failure to defend the internationalist vision at the heart of American foreign policy and to provide institutional buttresses for weakened Asian and other states. If the IMF becomes a whipping boy for all of its and others' faults, it will be unable to function and we will have lost a valuable resource needed to effectuate "financial peacekeeping." This



observation tallies with Hellmann's observations that we have not created new institutions to meet present challenges but are apparently busily destroying existing organizations' ability to meet current crises.<sup>33</sup>

## Conclusion.

Zoellick made the point that this crisis highlights the fragility of the previous Asian order and represents a crisis of transition to an as yet undefined order. In the future we may encounter a China that will play a greater role, a Japan that remains unable and unready to act, and a U.S. whose policy is adrift. Obviously, if that is the future, it will not suffice to meet any or all of Asia's concurrent security challenges. The economic or financial crisis is not an isolated event. The Indo-Pakistani nuclear challenge, China's rise as Russia collapses, the lack of money to support the 1994 deal on North Korean proliferation, like the economic crisis, all betoken a structural crisis of the old order. Indeed, Pyongyang already has threatened to revoke the 1994 agreement unless it gets its money soon and Washington will have to find a solution to that crisis, too.<sup>34</sup> Meanwhile, North Korea shoots missiles over Japan, upping the ante in the security arena.

Drift is not the answer. Past history and much current writing on world affairs tell us that economic-political failure and a resort to violence are generally related. Worse yet, if that failure is due to liberalism, then liberalism will be repudiated and anti-liberal forms of political order will emerge. In this connection, it is noteworthy and worth remembering that much writing on Japan points out that Japan's economic organizations and ideology derive from authoritarian, nationalist, Listian, and even Marxian ideas, not Adam Smith's liberalism as in the United States.<sup>35</sup> Given the popularity of such non-liberal, or even anti-liberal ideas in Asia over many years, continued liberal failure will give them a new respectability among a new generation of disaffected Asian elites. Therefore a prompt and comprehensive solution to the economic and financial crisis is essential. Economic challenges to security cannot be isolated from political and

ultimately military ones. As Australian scholar Andrew Butfoy wrote in 1997,

In the Asia-Pacific moves towards cooperative security gathered considerable, if patchy, momentum in a manner which suggested a growing sense of regionalism, and in ways that cut across the divide between strategy and economics. Indeed, in places like the Asia-Pacific it was difficult to disentangle efforts to build cooperative security from the parallel evolution of international capitalism. Here attempts to explore the potential for security regimes need to be seen within a complex context. This context was dominated by inter-locking patterns of world trade and investment, the burgeoning of global communications networks, a dawning (though incomplete) appreciation of the security dilemma, and an unfolding (but contested) sense of Asian identity.<sup>36</sup>

The challenges to the United States and to its armed forces are numerous and highly significant. Moreover, we must begin to address them now even if other institutions cannot or will not do so with us. Those crises comprise ASEAN's decline as a meaningful security provider, Russia's collapse, Japan's stagnation, South Korea's unresolved democratic transition in economics and politics, Seoul's and Tokyo's inability or growing reluctance to support the 1994 nuclear accord with North Korea, the danger of an unforeseeable crisis emerging in North Korea, and most of all the rise of China with nobody but the United States to counter or balance it. The challenge confronting the United States and its allies involves nothing less than the creation of a new, legitimate order in Asia. That order must be shaped and created very much by the leadership of the United States in all fields of national power: diplomacy, economics, trade, investment, finance, defense, and culture. But doing so requires a strong U.S. leadership that will tie all these elements of power together in a comprehensive, politically persuasive vision, and the fortitude to implement them at home and abroad.

Absent that response, drift, stagnation, enduring crisis, and probably violence will mark Asia's alternative reply. Perhaps these crisis phenomena will occur to varying extents and not in all states or not to an irretrievable degree in any one

state. But unless our firm leadership manifests itself soon, it is almost certain that we will see a crisis-ridden Asia and maybe other areas as well for some time to come. But from today's vantage point can we truly say that we see the strong American leadership that Asia and we need to move to a new international order there?

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