ANALYSIS

Volume 9, Number 4

The East Asian Crisis: Implications for U.S. Policy

Strategic Studies Institute, U.S. Army War College
The National Bureau of Asian Research

ISSN 1052-164X

Printed in the United States of America.

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Funding for this publication was provided by the Henry M. Jackson Foundation.

Publishing and production services by Laing Communications Inc., Redmond, Washington.

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This is the thirty-ninth *NBR Analysis*.

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THE NATIONAL BUREAU OF ASIAN RESEARCH

4518 University Way NE, Suite 300
Seattle, WA 98105
Tel: (206) 632-7370
Fax: (206) 632-7487
Email: nbr@nbr.org
http://www.nbr.org

FOREWORD

On June 9–10, 1998, The National Bureau of Asian Research (NBR) and the Strategic Studies Institute of the U.S. Army War College convened an extraordinary group of government, business, academic, and military leaders to address the political, economic, and security implications of the East Asian financial crisis. Participants included: officials from the Clinton and Bush Administrations, senior executives of major U.S. and Asian corporations, World Bank officials, partners of some of the nation's most prestigious law firms, leading specialists on East Asia, and military officials responsible for developing strategy in the Asia-Pacific. They analyzed the sources of the crisis and the multidimensional challenges that lie ahead. The essays in this issue of the *NBR Analysis* were prepared for the conference and emphasize a recurring theme of the meetings: The United States must continue to exercise economic, diplomatic, and military leadership in the Asia-Pacific region.

The first essay is an adaptation of a speech given by Robert Zoellick, NBR board member, president and CEO-designate of the Center for Strategic and International Studies, and undersecretary of state during the Bush Administration. Mr. Zoellick discusses the impact of current economic problems on the future political and security order in Asia, and offers policy recommendations for the United States to guide the region through the current turmoil and coming transitions smoothly. He points out that the American response to the crisis will mold the impressions of an entire generation of East Asians. Therefore it is crucial that the pursuit of U.S. interests in open markets, greater transparency (especially of financial institutions), and democratization be accompanied by concrete assistance from the government and private sector. Active U.S. engagement in the region will also help manage changes in the regional security environment that are likely to result from the shifting economic landscape.

In the second essay, Kenneth B. Pyle, NBR president and professor of history and international studies at the Henry M. Jackson School of International Studies at the University of Washington, analyzes Japan's post-Cold War immobilism and the failures of its once highly praised political-economic system. In a succession of crises, including its recession and banking crisis, Japan has exhibited an indecisiveness that has paralyzed its policymaking. There are several fundamental causes of the indecisiveness, including the entrenched interests and institutional practices that remain from the century-long efforts to "catch up" with the West; and the exclusive concentration on economic growth since World War II that left many political-strategic institutions underdeveloped. Immobilism also results from the difficulty of consensual decision-making in Japan in times of great uncertainty. Dr. Pyle concludes that the U.S. must continue to prod Japan to make decisions that its system resists.

The final essay addresses the political and economic impact of the East Asian crisis on Russia at this crucial stage in its post-Soviet transition. Herbert Ellison, NBR's director of Eurasia Policy Studies and professor of history and international studies at the Henry M. Jackson School of International Studies, outlines the steps taken by the Russian government to deal with the crisis and evaluates the ability of the new government to handle urgent problems. Dr. Ellison asserts that President Boris Yeltsin's March 1998 decision to dismiss the cabinet of Prime Minister Viktor Chernomyrdin was not capricious, as many have asserted. Rather, the decision resulted from the recognition that bold reforms would be needed to keep the crisis from worsening. From the crisis has emerged "the most promising reform government of the Yeltsin era," led by the new prime minister, Sergei Kiriyenko. Dr. Ellison argues that the $22.6 billion IMF-led package of loans to Russia, agreed to in mid-July, was awarded not only in recognition of the country's strategic importance, but also as an expression of confidence in the young government.

Funding for the "East Asia in Crisis" conference was provided by the Reserve Officers Association, Frank Russell Company, The Boeing Company, the Strategic Studies Institute of the United States Army War College, and the Henry M. Jackson Foundation. The Bell Harbor International Conference Center provided in-kind support, and cosponsoring organizations included the Henry M. Jackson School of International Studies, the Japan-America Society of the State of Washington, the National Center for APEC, the Washington Council on International Trade, and the World Affairs Council.

Richard J. Ellings
Executive Director
The National Bureau of Asian Research

The Political and Security Implications of the East Asian Crisis

Robert B. Zoellick

This essay discusses the impact of current economic problems on the future political and security order in Asia, and offers policy recommendations for the United States to guide the region through the current turmoil and coming transitions smoothly. The author points out that the American response to the crisis will mold the impressions of an entire generation of East Asians. Therefore it is crucial that the pursuit of U.S. interests in open markets, greater transparency (especially of financial institutions), and democratization be accompanied by concrete assistance from the government and private sector. In addition, the author calls for U.S. economic and political support to back East Asia's reforming democracies—especially in Thailand and South Korea. If these governments fail, further openings are likely to prove illusory. Active U.S. engagement in the region will also help manage changes in the regional security environment that are likely to result from the shifting economic landscape.

Political Orders in Transition

Exactly a century ago, in June 1898, the political order of East Asia faced a transformation. A month before, Commodore Dewey's Asiatic squadron of the U.S. Navy had methodically destroyed or captured, over the course of seven hours, all eleven ships of a Spanish fleet in Manila Bay. Within seven months, Spain had ceded the Philippines to the United States. A new power had a place in Asia.

Equally important for America's future in the Pacific, the events of early 1898 had revealed the strategic value of Hawaii for the U.S. Navy's capability to project power. President McKinley had not been able to convince two-thirds of the Senate to support his treaty annexing Hawaii, so on July 7, 1898, he used the war to persuade a majority in both Houses of Congress to vote for a joint resolution to secure the valuable islands.

Nor was the United States the only new power to challenge the Asian order. In 1894–95, a rapidly modernizing Japan had surprised the world by defeating China, annexing Taiwan, eliminating Chinese influence in Korea, and making a bid for the southern tip of Manchuria. Within a decade, in the war of 1904–05, Japan's imperial navy would crush two Russian fleets. After

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Robert B. Zoellick is the President and Chief Executive Officer-designate of the Center for Strategic and International Studies in Washington, D.C. Mr. Zoellick served as undersecretary of state in the Bush Administration. His recent publications include: "Economics and Security in the Changing Asia-Pacific," *Survival* (Winter 1997–98) and "China: What Engagement Means," *The National Interest* (Winter 1996–97).

This essay is based on a luncheon address delivered by Mr. Zoellick at the "East Asia in Crisis" conference, sponsored by The National Bureau of Asian Research and the Strategic Studies Institute of the United States Army War College, June 9–10, 1998 in Seattle.

mediation by America's President Theodore Roosevelt, Russia and Japan concluded a peace treaty which confirmed Japan's new status, but sought to preserve a regional balance of power. The fruits of Japan's victory included new territory in Manchuria, the southern half of Sakhalin island, and dominant rights in Korea, which Japan annexed and occupied militarily five years later.

China's Qing dynasty, in contrast, continued to lose ground to foreign powers. Britain, Germany, France, Russia, and Japan each claimed new territories, posts, or privileges in China, prompting some Chinese to fear that their country was about to be "carved up like a melon." Partly in response, the Boxers United in Righteousness, as they called themselves, emerged as a force in 1898, only to be crushed by foreign troops two years later.

Although 1898 might have appeared to affirm the vigor of the nineteenth century imperial order in East Asia, in fact the age of European colonial power was beginning its slow decline. The United States signaled its preference for a different set of rules by pressing for an "Open Door" policy toward China in 1899. After World War I sapped the strength of the European colonial empires, the United States tried to institute its model of international cooperation in East Asia through the arms control of the Washington Naval Treaties, Open Door commercial policies, and Dollar Diplomacy. Yet this first American system for East Asia would collapse because of the Great Depression and the clash of visions with the other rising power—Japan.

After World War II, and with the onset of the Cold War, the United States created another order in Asia, one designed to counter communism, end colonialism, and promote Asian economic growth. Over 100,000 Americans lost their lives in Asia to fulfill U.S. commitments. Their sacrifice contributed to an American system for the Asia Pacific that was strikingly successful. But with the end of the Cold War, observers saw more changes on the horizon. The Asian economic success prompted discussion of Asian miracles, Asian values, and even of a coming Asian Century.

The Asian economic crisis of 1997–98 has prompted a reevaluation of the early post-Cold War hypotheses. How will these economic events affect the next political and security order in Asia? This paper will address that question by reviewing the effects of the East Asian economic crisis on: (1) the relative influence of the large powers; (2) East Asia's internal politics; (3) cooperation, competition, and conflict within the region; and (4) the politics of international capital markets and institutions.

It is generally felt that Japan has failed the test of leadership, while China, so far, has advanced its stature.

The Effects on the Relative Influence of the Large Powers

Japan and China

One of the striking features of Asia's economic crisis has been the different responses of Japan and China. It is generally felt that Japan has failed the test of leadership, while China, so far, has advanced its stature. If these conditions persist, the financial crisis may have signaled a change in relative long-term influence of the two great Asian powers.

Japan's stumbling performance has been particularly disappointing for those who had hoped Japan could play a complementary leadership role with the United States in the post-Cold War world. This crisis has occurred in Japan's home region and might have been countered through Japan's special competence: economics. Moreover, the actions Japan needs to take to lead regional recovery are consistent with Japan's domestic interest. But Japan's political system has been paralyzed.

Indeed, the events of 1997–98 have revealed problems in Japan that are far deeper than a failure to pursue sensible stimulative policies in a timely fashion. First, Japan's controlled network of banks and corporations has broken down. For decades, that system channeled low-cost savings to corporate capital investment despite modest profits. The primary goals for Japanese companies were to maximize sales and manufacturing employment, not earnings. But Japanese banks have incurred such severe losses on assets that they can no longer sustain the cross-shareholding structure that insulated corporate management from demands for better governance and profitability. As a result, Japanese corporations are under pressure to restructure at a time when banks are wary of lending and consumers have lost confidence. The liberalization in Japan's financial markets, and especially the new competition in fund management, will reinforce the pressures to change the banking-corporate relationship.

Second, the Japanese public has lost confidence in the elite government bureaucracies that have guided Japan's economic performance since World War II. Japan's poor economic record in the 1990s made the bureaucracy vulnerable. Then the wave of government corruption scandals severely discredited the world of officialdom. The staffs of the ministries, in turn, feel victimized and uncertain. As a result, the traditional engine of Japanese economic management is sputtering.

Third, the political leaders of Japan have not yet adjusted to these fundamental shifts. Neither stimulation policies nor bureaucratic expertise will be sufficient to reestablish Japan's eminence, although expansionary programs are important to avoid even greater downside risks. At some point, a group of Japanese political leaders will need to agree on a broad-based program of structural change, as they did in the past during the Meiji Restoration and after World War II. Perhaps a new generation of Japanese business executives will be able to contribute to this shift, because Japan still enjoys incredible industrial capabilities—especially in manufacturing, technology, and a talented workforce—that can assist the country's remobilization. But no one can predict how many years it will take to launch this revitalization process.

In the meantime, the Japanese public's cynicism and loss of confidence makes standard economic policy responses far less effective. Unemployment is increasing. Asset prices are depressed. Savings rates are up as people prepare for more trouble. The monetary stimulus is ineffective because weak banks are afraid to lend and consumers prefer to hold cash because they believe interest rates can only go up (a liquidity trap). Tax cuts would be saved by consumers, not spent. Investors and consumers are skeptical about the expansionary effects of spending packages because the government's six prior announcements of new spending since 1992 were insufficient or unreliable. As a result, only radical policy options are now likely to be credible. These conditions raise the serious risk of further yen depreciation that could generate another wave of financial contagion and competitive devaluation in the region.

After its striking defeat in the upper house elections, Japan's ruling Liberal Democratic Party should finally be aware of the public's dissatisfaction with the country's economic performance. Yet the selection of a new prime minister and cabinet, combined with the jostling to assemble an effective coalition that can pass the government's legislative package, will take time. Ultimately, I expect Japan to enact the "bridge bank" and other measures to begin cleaning up the banking sector, as well as further fiscal stimulus legislation. However, the financial sector provisions must then be implemented, no small challenge. Although Japan might now act to avoid further slippage in its economy, one should not expect Japan to lead a turnaround for the region.

The current economic problems in Japan may be exacerbated by a fundamental shift in public psychology. The Japanese seem keenly aware that their population is aging. The generations that rebuilt Japan in the face of tremendous adversity now seem fearful of the future. For the first time, their successors appear to question whether the tried formula of hard work and discipline will revive the country. These factors are likely to make Japan exceedingly cautious about assuming new roles in the Asian and global systems.

China, in striking contrast to Japan, has enhanced its influence over the past year. It established a constructive posture by committing not to devalue the yuan in 1998, resolving to support the Hong Kong dollar peg, and contributing $1 billion to the Thai bailout. U.S. Treasury officials have been impressed by their discussions with senior Chinese officials on how to address the financial crisis.

On the home front, the Chinese have faced up to the economic challenges by speeding up internal reforms. Prime Minister Zhu Rongji's team is trying to combine serious economic restructuring with a steady growth of output and employment. To counter the slippage in external demand, officials have pushed the funding of domestic projects.

Nevertheless, China's economic reformers still face staggering challenges. Like the economies in trouble, China suffers from corruption, cronyism, and state direction of investment. The banking system is weighed down by enormous bad debts to inefficient state-owned enterprises. Foreign investment, which has been critical for China's export industries, is likely to slip as capital from overseas Chinese dries up. China's exports will face tougher competition from other East Asian economies.

China's Communist Party also will have to face the question of political legitimacy. While communist ideology seems left behind by China's modernization, the party has retained the old structure of authority. Economic growth and nationalism have substituted for voluntary public consent as a justification to rule. If China's growth slows considerably, it is likely to postpone structural reforms for fear of the social and political consequences. If unemployment rises, there is a danger that China will turn to a mix of inflationary monetary policies and currency depreciation to maintain social stability.

China is also watchful of Taiwan's efforts to capitalize on financial problems in Southeast Asia. Having come through the crisis in relatively good shape, Taiwan is seeking to convert its success into stronger economic and political relationships in the region. China can be counted on to resist these moves. China's sensitivity regarding Taiwan is likely to remain a stumbling block to closer U.S.-China security relations: the Chinese cite differences with the United States over Taiwan to justify their unwillingness to join the Missile Technology Control Regime and their strong reaction against the new U.S.-Japan Defense Guidelines. This resistance, in turn, will strengthen the concerns of Americans who believe the United States has been too accommodating to China.

To date China has shrewdly recognized that the success of its economic reform strategy depends on a healthy economy in the region. If China can continue to balance the demands of its internal transformation with support for the region, it will emerge from this period both stronger and more respected. Relative to Japan, a struggling Indonesia, and the rest of the Association of Southeast Asian Nations (ASEAN), China's power will increase. This shift in the regional balance of power will increase the worries of some of China's neighbors.

American Influence

The events of 1997–98 have also reminded the region and the world of the depth of America's power and the extent of U.S. influence. No other country seems capable of organizing coalitions to provide financial support to countries in peril. America's market must be the source of purchasing power that will help the Asian economies revive. And America's dynamism and adaptability stand in stark contrast to Asia's problems. When combined, these attributes seem to give the United States an unparalleled ability to reassure or censure. Moreover, in the eyes of many, the United States uses its strength to direct the policies of the key international financial institutions, especially the International Monetary Fund (IMF) and World Bank.

[East Asian] impressions of America for years to come are likely to be molded by U.S. conduct today. . . .

The United States, however, needs to be careful about its use of power and attentive to regional perceptions. This economic crisis could be the epic event in the lives of a generation of East Asians. Their impressions of America for years to come are likely to be molded by U.S. conduct today, just as America's actions in Europe after World War II provided the foundations for a lasting trans-Atlantic relationship.

American crowing is likely to generate enduring resentment. Asians will also be sensitive to actions that appear to take advantage of their weakness. And the United States should seek to avoid statements or behavior that make America appear to be the source of Asia's pain. A sense of victimization is on the rise in Asia, and the United States does not want to be the one blamed. A new Malaysian book, *Hidden Agenda: In the Eyes of the Tiger*, is reportedly promoting a conspiracy theory of manipulation of Asian economic forces by the Western media and Hollywood—the usual suspects.[1]

To avoid these dangers, U.S. policy needs to combine guidance with empathy and support. America's promotion of democracy, political openness, and economic reforms should be backed by concrete help. To ease the political costs of reforms by Asian leaders, where appropriate, the United States might propose mutual steps toward trade and market liberalization. Words and actions need to be suited to publics as well as governments. For countries in severe straits, and in Indonesia in particular, President Clinton should mobilize America's historic commitment to humanitarian relief for those most in need. Effective communication will include symbolic conduct. Actions by private parties, especially U.S. businesses, might be particularly helpful.

In dealing with the other major powers, the United States should embrace China's constructive behavior without casting Japan aside. More specifically, the United States ought to intensify its dialogue with China's economic reformers. The Chinese have expressed interest in America's experience with the Resolution Trust Corporation to handle problem loans; they could also benefit from greater exposure to experts on U.S. accounting standards, financial systems, and financial supervisory mechanisms. To coordinate and stimulate these and other reform contacts, the Treasury Department should revitalize the Joint Economic Commission with China and staff an ongoing, in-depth effort. Over time, these arrangements may prove as effective in opening up China's markets as traditional trade negotiations.

These reform relationships might also offset increasing tensions with China stemming from transfers of missile technology, differences over proliferation policies, and investigations of political funding allegations.

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[1] Lim Kok Wing, Robert Ho You Chair, and Yee Mee Fah, *Hidden Agenda: In the Eyes of the Tiger*, Lingkokwing Integrated, 1998.

Contacts with Japan should not suffer just because America enhances its links with China. Indeed, given the uncertainties in the region, Asian frustrations with Japan (especially on the part of Korea as the yen depreciates), the enhancement of China's relative strength, and Japan's own self-doubts, the U.S.-Japan alliance has become even more critical. Despite its current problems, Japan still accounts for about two-thirds of Asia's economy. Japan remains a close democratic ally; it will be an important partner in the future.

Therefore, America's pressure on Japan to undertake structural reforms needs to be complemented with statements and actions that focus on both America's appreciation of the fundamental relationship and the strategic objectives for the alliance. Some steps might be shorter-term and symbolic. For example, President Clinton should have visited Japan as well as China this summer. The United States could also emphasize points of commonality in foreign policies with Japan.

Other steps need to focus on the longer-term. The United States should continue to work with Japan to revise the bilateral security relationship, thus moving towards greater mutual responsibility and integration of military forces. To support a closer political-security partnership, both sides ought to cooperate more closely in gathering and exchanging intelligence and work together on nonproliferation and counter-terrorism. Japanese and U.S. forces should strive for interoperability, just as the United States does with its European allies. Given the great risk of missile proliferation to Japan and the United States, it would serve the interest of both countries to jointly fund, develop, and deploy a theater-missile defense system.[2]

These closer security links should support common interests with third parties. The United States, Japan, and Korea ought to build a trilateral security relationship that could help deal with a collapse of North Korea and survive a unified Korea. The U.S. and Japan should also seek a three-way security dialogue with China.

The Effects on East Asia's Internal Politics

The ramifications of the economic crisis will of course extend far beyond the relative positioning of the large powers. In countries large and small, the events of 1997–98 will transform domestic politics as well. These changes will have security implications, both for internal cohesion and relations with neighbors.

The extraordinary economic growth in the region has bolstered the process of building nations, and the legitimacy of regimes and leaders. Over past decades, economic success has been a key ingredient in making countries out of colonies that encompassed diverse ethnic, linguistic, and religious groups. The economic targets involved building assets, achieving development objectives, and strengthening specific ethnic groups—not maximizing profit.

Malaysian companies borrowed heavily to advance Prime Minister Mahathir Mohamad's plan for a new industrial society that would empower the Muslim majority that lived alongside an economically influential Chinese minority. In Indonesia, overseas Chinese and local elites borrowed heavily to develop rich local resources, because they assumed President Soeharto's new order would maintain stability. Korea was targeting a goal beyond high growth: It leveraged and allocated capital as part of a national strategy to become an industrial power worthy of global recognition.[3]

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[2] For a fuller discussion of the logic behind, and action plan for, a new U.S.-Japan Security Agreement, see Robert B. Zoellick, "Economics and Security in the Changing Asia-Pacific," *Survival*, vol. 39, no. 4 (Winter 1997–98), pp. 29, 45–47.

[3] David Hale, "The IMF after the Asia Crisis," statement before The Bretton Woods Committee, Feb. 13, 1998, pp. 5–6.

The successes of these plans fed publicists for supposed Asian models of political order, government-business relations, and even cultural superiority. These accounts conveniently overlooked Asia's great diversity, just as today new critics are painting East Asia with broad-brush criticism.

It is natural, however, that the economic shocks have prompted serious questions about political problems and the corruption that accompanied these national strategies. Moreover, the groups in Asia who appear to be paying the biggest price for the calamity are not the ones who apparently caused the misfortune. The devastation of the middle class weakens these societies. And the countries have weak social safety nets to support those most in need. Asian publics' frustration and loss of faith raise the question of whether governments retain the legitimacy and support they need to restore business confidence and recovery.

The East Asian democracies have been able to install new governments by drawing on their peaceful procedures for transferring power. In Thailand, the new Prime Minister, Chuan Leekpai, not only instituted a new government of respected technocrats, but also managed to change the constitution as part of a political reform. The new Korean President, Kim Dae Jung, also transformed his election into a broader mandate for reform. Across the region, Asian citizens are calling for greater openness to expose the perfidious behavior of elites who did extremely well while claiming to do good.

Yet it is far from clear that these new governments will succeed with either their immediate economic or longer-run political agendas. Economic conditions remain grave. East Asia suffered a twin crisis—involving currencies and domestic financial systems at the same time. So far, most adjustment in Asian trade accounts has occurred through cutting imports, not by increasing exports. Weakened banking systems have led to severe domestic credit crunches, even for relatively healthy borrowers. Unfortunately, severe problems in financial systems take many years to clean up, even for wealthier, developed economies.

As the early sense of relief about financial stabilization in some countries has worn off, Asians and foreigners have been growing more concerned about prospects for recovery. For example, the yield spreads on Korea's successful bond issue have widened; equity markets have lost the ground they had regained.

The economic conditions will have political effects. In Thailand, opposition politicians have begun to challenge the reformers' plans. South Korea's conglomerates (*chaebols*), at first set back by the shock of events, will resist major restructuring that threatens their power. The Korean unions are growing restive as the economic effects of unemployment and bankruptcies follow the financial turmoil. Their first marches may help President Kim overcome his opposition, but before long the public will hold the new president responsible if there is no upturn. In the Philippines, President Estrada will have to meld his populist themes and nationalist rhetoric with economic policies that preserve investor confidence. Democracy has given these countries a new beginning, but it will not, as Europe observed in the 1930s, ensure the vital mixture of leadership, sound policies, and public support.

Indeed, Singapore and Hong Kong have reminded us that economic success and resilience depend on good governance and respect for the rule of law, not just free elections. Although one usually associates these attributes with established constitutional democracies, the connection is not foreordained.

Indonesia presents a very special problem. Economic revival is critically dependent on restoration of political confidence. Fortunately, the country skirted a blood bath, and the process of Soeharto's departure revealed some important positive attributes. The result depended on opposition leaders and students who exercised restraint when demonstrations risked violence, army leaders who recognized this restraint, and ultimately Soeharto's willingness to exit quietly without a long and painful final act.

But Soeharto's departure has launched a longer and larger transition. President Habibie has adopted the students' cry against "corruption, collusion, and nepotism," but he is an unlikely leader of reform.

Indonesia's future depends heavily on the army—whether it will accept significant roles for new actors on the stage, whether it fears that protests will threaten national cohesion, and whether the army itself can remain united. I suspect the army's answers depend in part on whether the reform movements can retain public legitimacy, which will require them to avoid association with riots or ethnic violence. The answers depend as well on whether the opposition forces can coalesce, offering a reasonable alternative to authoritarian rule under a new guise.

The greatest danger to the continuation of the political reform process stems from severe shortages of food, medicine, and other necessities that could precipitate a social explosion.

Unfortunately, some countries—Vietnam, Burma, North Korea, perhaps China—are likely to draw very different political guidance from Indonesia's turmoil. From their perspective, the lesson is to maintain strong central control backed by intimidating military force.

The internal political challenges throughout the region are of great importance for the United States. Up to now, the reform movements have combined a series of causes welcomed by the United States: sound fiscal and monetary management; increased market competition; enhanced openness for trade and investment; reliance on the rule of law and clean government; and the promotion of democracy. But there are many uncertainties about the best means for the United States to support these ends. And mistakes could backfire both for people in the region and for America. The United States' unwillingness to contribute to Thailand's stabilization package will be remembered for a long time in that country—an ally that supported many U.S. causes in decades past.

It certainly makes sense for the United States to back reforming democracies—Thailand and South Korea in particular—both economically and politically.

It certainly makes sense for the United States to back reforming democracies—Thailand and South Korea in particular—both economically and politically. Indeed, the United States should be looking for ways to reinforce the new leaders as they encounter the inevitable troubles that will slow their initial momentum. Positive visits to the United States, and return visits by American officials, can help signal ongoing U.S. engagement and alert the U.S. government to relatively small actions that might resonate. The United States should constantly keep in mind that the audience for messages now includes foreign media, business people, parliamentarians, and students, as well as officials in ministries. Therefore, symbolic communication will matter a great deal.

Furthermore, the United States would be prudent to discuss and prioritize with its friends their economic reform agendas. The first priority should be measures to maintain financial stabilization and launch economic revival. Next should be removal of structural impediments to investment and market confidence. And the third objective should be to increase competition and open markets. In pursuing these goals, the United States should be careful not to overload newly elected governments that are facing tremendous economic and political challenges. If these governments succeed, they are likely to move their countries in the direction the U.S. seeks; if they fail, further openings are likely to prove illusory.

The most important political signal might flow from business decisions: announcements by U.S. and other foreign firms to buy or invest in Asian companies. Although foreign investors are seizing some buying opportunities, their primary focus seems to be on Japan, not the less developed economies.[4] Some U.S. firms have reported that Korean executives still have not accepted the reality of new valuations; other Americans are concerned about Asian governments' follow-through on commitments to open up for foreign investment. The U.S. government should quickly identify these problems by staying in close contact with potential investors and then actively trying to resolve the obstacles. An ongoing series of investment announcements will pay dividends far in excess of the particular dollar amounts involved.

The United States, the European Union, and Japan must continue their financial support for Asian exporters. Given the collapse of banking systems, export credits and even working capital are critical.

The U.S. government should also encourage private American groups, especially businesspeople, to consider immediate actions that might promote long-term interests. For example, the U.S.-ASEAN Business Council has instituted an aid program to help Asian students. For countries seeking to strengthen the rule of law, accounting standards, or other aspects of good governance, the United States should offer exchanges, technical cooperation, and comparative experience; these projects should involve U.S. universities, foundations, and private groups, as well as the government. Some might be multilateral, sponsored by the Asia-Pacific Economic Cooperation (APEC) forum or other groups.

Indonesia will present the most sensitive case. The United States should be starting, right now, to organize massive humanitarian relief, principally food supplies, both to assist Indonesia's people and signal America's support for their plight. To help achieve political legitimacy, the United States needs to encourage the new government to keep faith with its own statements, because the government must have public support to succeed. Given the key role the army will play, the U.S. should be expanding its ties to officers—according them respect, but also cautioning that crackdowns will cut Indonesia off from vital international support. At the same time, the U.S. ought to strengthen contacts across Indonesia's broadening political spectrum because this process of change will be ongoing.

Cooperation, Competition, and Conflict in East Asia

The economic crisis will affect the external politics of countries in East Asia as well as their internal politics. In Europe in the 1930s, crushing economic burdens doomed designs for cooperation and converted competition into destructive conflict. So far, East Asia has avoided this dangerous downward spiral. But one cannot foreclose the possibilities of competitive currency devaluations, increased trade barriers, and antagonistic ethnic politics. If the first round of reforms fails to reverse the downturns, governments may be tempted to adopt more nationalist postures to shift the blame and divert domestic opponents.

Increased democracy and freedom are, unfortunately, not a panacea for distressed countries. In fact, participatory politics might increase tensions within countries or with neighbors.[5] India's and Pakistan's nuclear tests have reminded us that countries are ready to ignore economic self-interest to capitalize on the internal political appeal of assertive external policies.

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[4] See, e.g., Duncan Hughes, "US bargain-hunters spend $36b in Asia," *South China Morning Post*, May 31, 1998 (Money Section, p. 1).

[5] This was the view of Alexander Hamilton, who believed that popular assemblies were just as "subject to the impulses of rage, resentment, jealousy, avarice, and other irregular and violent propensities" as were monarchies. See Hamilton, *The Federalist*, No. 6, New York: The New American Library, 1961.

Indeed, the responses of China and North Korea to the nuclear tests, and the subsequent behavior of India and Pakistan, could combine with current political insecurities in the region to trigger new instabilities. The nuclear breakouts have heightened the combustible nature of proliferation politics. In order to steady nerves, the United States will need to reassure East Asian countries, starting with America's allies, of its ongoing commitment.

The U.S. presence is especially important because of ASEAN's troubles. Economic problems have slowed ASEAN's forward momentum. ASEAN cannot move without Indonesia, and Indonesia cannot move. As a result, the association has had difficulty influencing its new members—Vietnam, Laos, and Burma. ASEAN's Free Trade Agreement is also likely to suffer. And ASEAN has been less able to forge common foreign policies, for example toward Cambodia or the conflicting claims in the South China Sea. China has shrewdly agreed to discuss South China Sea issues within the ASEAN Regional Forum, but has meanwhile been taking a series of small steps to strengthen its territorial claim; ASEAN has been unable to develop a response. Without a sturdy Indonesia, ASEAN will not be able to pursue its subtle diplomacy of posing a prospective counterweight to China in the event China would take threatening actions.

The crisis has also pointed out more fundamental limitations of the so-called "ASEAN way." Its hands-off attitude toward internal matters has left ASEAN incapable of responding to a crisis that involves internal economic and political weaknesses in its own members. Although a number of nations in South East Asia are seeing the spread of NGOs and deeper civil societies, the ASEAN preoccupation with state-to-state relations has failed to tap these developments. So these groups either do not care about their governments or tend to oppose them.

When the ASEAN nations begin to recover, it may not be easy to resume cooperation from the pre-crisis posture. Indonesia's approach will loom particularly large. Soeharto was willing to subsume Indonesia within a group of smaller partners and to keep his country's role limited, thereby reassuring others. His successors, perhaps pressed by active electorates, may assume more unilateral but not necessarily constructive roles. Alternatively, Indonesia's internal demands may absorb all its resources—human and financial—restricting the country's outward orientation.

Regional and global trade liberalization movements are also in distress. Initially, the countries of the region signaled their ongoing commitment to open markets by subscribing to the World Trade Organization's (WTO) financial services agreement and endorsing the Vancouver APEC summit's trade agenda. The APEC announcement of November 1997 designated 15 sectors for early liberalization; it sought agreement on detailed plans for 9 sectors (totaling over $1.5 trillion in global trade) by the middle of 1998, with implementation in early 1999. Economic realities have put this pledge into question. Malaysia, the host for APEC's summit in 1999, is an unlikely candidate to invigorate the group.

The Asian events have led to a modest increase in trade barriers elsewhere. The countries of the Common Market of the South (Mercosur)[6] increased their common external tariff by 25 percent (from 12 to 15 percent) to avoid contagion effects. Russia has been badly buffeted by events. As the full impact of Asian devaluations and recessions is felt in other markets, protectionist sentiments will be on the rise.

In this context, the absence of U.S. trade liberalization initiatives is telling. President Clinton's failure to press effectively for fast-track trade negotiating authority, particularly with his own party, has imposed a heavy cost. The U.S. Treasury Department's concentration on the IMF replenishment legislation—and the decision not to connect financial and trade strategies—may be understandable, but passed up the opportunity to receive the trade negotiating request as part of a larger

[6] Argentina, Brazil, Paraguay, and Uruguay.

U.S. plan for Asia. As the growing U.S. trade deficit becomes a domestic political target, President Clinton is likely to find himself increasingly on the defensive. Given America's obvious self-interest in opening markets abroad and the country's extraordinary strength, the inability of the United States to follow through on its trade rhetoric raises understandable doubts in other countries.

At a minimum, the U.S. government should be pressing the APEC nations to follow through on the November 1997 commitments. The APEC approach is particularly valuable because it links internal reforms to trade liberalization in a multilateral context. The mutuality of internal and external actions could reinforce reforming governments by enabling them to point to a common approach, shared efforts, and benefits won from others. The agenda takes the offensive against protectionists, instead of ceding the initiative to opponents of open markets.

To establish a supportive global context, the G-7 should pledge not to impose any new trade barriers as Asia rebounds.

To establish a supportive global context, the G-7 should pledge not to impose any new trade barriers as Asia rebounds. The U.S. government should in fact do more—by proposing free trade agreements with Singapore, New Zealand, and Australia. The United States also should state that it would be open to other free trade agreements in the region if countries follow through on their reforms. By throwing its weight behind free trade, the United States would offer incentives, reinforce the will of reforming governments, and signal America's ongoing strategic commitment to the region. This course would necessitate an effort by the Administration to promote the benefits of liberalization at home. The President needs a far-reaching vision, backed by the prospect of tangible gains, to motivate business and other supporters of open markets. Without such an effort the inevitable friction of special interests will grind away to protect against competition.

The corollary of this strategy is to agree on a process to bring China into the WTO. This plan would provide an external complement to China's internal reforms. It would strengthen the forces in China promoting markets and private property. It could create incentives and disciplines.

I have written elsewhere how such an accession plan for China might be structured, incorporating China's acceptance of core WTO principles, a "downpayment" of liberalizing actions, and a timetable for implementing China's full set of obligations.[7] To maintain leverage during the transition, China's trading partners could apply specific safeguards if Beijing failed to implement its obligations. Those who would prefer to delay China's accession to the WTO, ostensibly to press China to meet high standards, should recognize that China is free to trade without the WTO, and China's leverage to negotiate WTO terms is not likely to diminish over time. It is in America's interest to expand China's exposure and commitment to international rules—and to broaden the interests of private Chinese businesspeople—while maintaining America's ability to withdraw benefits if China does not comply with the rules.

In Korea, economic events will change the context for North-South relations. South Korea's new president has signaled his preference for reconciliation to achieve his goal of "gradual system transformation." Kim Dae Jung's strategy has been to propose a series of North-South initiatives, without giving the North the opportunity to block the overtures by rejecting any one proposal. South Korea's economic difficulties, on the other hand, limit President Kim's ability to afford northern problems.

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[7] For a fuller discussion of this proposal for China's accession to the WTO, see Robert B. Zoellick, "Economics and Security in the Changing Asia-Pacific," pp. 44–45.

Despite speculation to the contrary, U.S. officials have not seen evidence that North Korea is more open to overtures because of the South's economic troubles. Instead, North Korea has continued its odd past practices of testing its opponents through hard demands and then insisting on gifts. Any perceived failure by the United States, South Korea, and Japan to deliver on the terms of the nuclear framework accord will trigger more threats from the North. Meanwhile, living conditions in North Korea seem to be getting worse.

The United States will need to proceed cautiously with North Korea, operating in close cooperation with South Korea. Kim Dae Jung's policies are making this cooperative approach easier. But if Kim Dae Jung's support fades because of a delayed recovery, his ability to navigate the dangers could be weakened.

Continued hard times would also complicate the combined efforts of the United States and South Korea to work with Japan, China, and Russia to arrange the external context for possible unification. If the regional powers remain unprepared for Korea's unification, North Korea's collapse could destabilize regional as well as peninsular security. In particular, if Korea and its neighbors do not agree that the United States should retain a military presence in a unified Korea, Korea might build up its capabilities and Japan might question why it should host U.S. forces. In short order, the stabilizing factors of 50 years could change drastically.

As for North Korea's future, I am skeptical about its willingness to undertake serious reforms. Moreover, if North Korea begins to open up, the fresh air may well lead the old body to disintegrate. If North Korea does not open up, it is also likely to expire. Therefore, the key transitional issue is likely to be whether China, the United States, and South Korea decide to prop up the North for a time while South Korea recovers and if so under what terms.

The Politics of International Capital Markets and Institutions

The fourth political dimension of East Asia's economic turmoil pertains to international capital markets and institutions.

As Martin Wolf of *The Financial Times* has pointed out, between 1996 and 1997, the net supply of private capital invested in Thailand, Indonesia, Malaysia, the Philippines, and South Korea fell by about 10 percent of their combined pre-crisis GNP.[8] Impartial observers might reasonably ask whether such a swing reflected sensible economic decisions both before and after the crisis. Or one might wonder whether Indonesia's errors warranted a currency depreciation of about 80 percent. Moreover, it is clear that China's relative success has been dependent at least in part on the non-convertibility of China's capital account.

The risks of open capital markets are likely to be magnified by certain trends. David Hale has noted three developments in particular.[9] First, advances in computer and communications technology will continue to greatly reduce the costs of capital mobility. Second, the savings behavior of aging societies is likely to further expand global capital flows through securities markets. And third, the growth of derivatives and other highly leveraged forms of trading will spur more aggressive financial intermediation. These risks and trends make the adoption of open capital markets a very uncertain proposition, especially for smaller economies.

The standard response to these anxieties is that countries must improve their domestic policies: They need prudent macropolicies; stronger and better supervision of financial institutions;

[8] Martin Wolf, "Global Capital Flows and Emerging Economies: Lessons of the Asia Crisis," speech before the Trilateral Commission 1998 Annual Meeting, Berlin, March 21–23, 1998, pp. 2–3.

[9] David Hale, "The IMF After the Asia Crisis," p. 7.

broader ownership of financial institutions, including by foreigners; greater transparency; and incentives to attract more stable capital flows. Each of these ideas make sense. But one must expect that deviations from the creed will incur wrathful punishment. Moreover, once market retribution has begun, and confidence is lost, it will be hard to limit the scope and severity of the destruction.

Herd behavior and panics are endemic to markets, and they can lead to inefficient allocations of capital and mispricing of risk for a time. So we should expect countries to explore approaches to insulate themselves from extreme market swings. Some may try to regulate the flows of short-term capital through limits or disincentives. Others may regulate foreign currency assets and liabilities more closely, especially for banks. Some may build large reserves.

It would certainly be prudent for the larger, wealthier economies to guide these adjustments in ways that enable developing countries to benefit from open capital markets while achieving some protection from panic. One approach is to make it easier to renegotiate debts without choking off business operations and growth, perhaps drawing on experience with domestic bankruptcy procedures. Unfortunately, the Birmingham G-7 Economic Summit did not lead the way in addressing these critical questions.

Any consideration of global capital markets naturally leads to an inquiry of the IMF's role and performance. In the United States, the first salvo of IMF critiques focused on its policies for the countries of East Asia. These debates examined the mix of stabilization measures, how the IMF handled the closing of financial institutions, the IMF's requirements for structural reforms, and the IMF's early inattention to the need for debt rescheduling.

The second round of IMF commentary struck deeper at the institution's core mission. Those concerned with the moral hazards of interventions in markets asserted that the IMF perpetuated bad policies by countries and made investors less cautious because neither paid fully for their mistakes. The populist version of this criticism attacked the IMF for spending taxpayers' money to bail out banks.

All of these criticisms raise an even more fundamental point for the IMF: Can it retain political legitimacy within the G-7 countries that have sponsored and guided it?

By way of contrast, the recent vote in the U.S. Senate to enlarge NATO was more than a vote on three new members. In effect, through this vote, 80 U.S. Senators endorsed America's commitment to a Cold War institution in a new environment. Although NATO faces important challenges pertaining to its future mission, capabilities, and organization, it can now proceed with the goodwill of the vast majority of the Senate, including many senators elected after the end of the Cold War.

The IMF has also been working to redefine its mission. After the transformation of the Bretton Woods financial system that the IMF was created to serve, the Fund moved on to new challenges: Latin American debt in the 1980s, the restructuring of the old Soviet bloc in the 1990s, and then the Peso and East Asian crises. David Hale has coined the term "financial peacekeeping" to describe the IMF's newest function—a label that highlights the unpopular nature of these activities, at least in the United States.[10] And, like the new military peacekeepers, the IMF's blue helmet brigade is learning through trial and error.

It is not clear that the Clinton administration realized these long-term political dimensions of Congressional debate over IMF replenishment. President Clinton passed up an opportunity early this year to shape the discussion of the IMF's future and to explain how the IMF supported

[10] David Hale, "The IMF After the Asia Crisis," p. 1.

America's security, political, economic, and trade strategies. The Birmingham Summit offered a second missed opportunity. By concentrating on tactical moves, the President has left it to others to shape the strategic context of the IMF argument.

Unfortunately, the outlook for congressional passage of the IMF's replenishment has worsened. A strong Senate vote reflected senators' anxieties about the economic risks of Asia's breakdown. But the Administration then passed up a chance to secure House passage by refusing a watered-down version of an extraneous amendment. As action on the replenishment legislation slipped, critics on both the right and left raised objections about the IMF's core mission and functions. Now the vote on the IMF is becoming a vehicle for congressional representatives to express their unhappy sentiments about globalization. Without additional resources, the IMF may be incapable of responding to another round of this crisis—whether in Asia, Russia, or other emerging markets.

Conclusion

The events of 1998, like those of 1898, might augur a new political order for the Asia Pacific. So far, the rush of affairs has been perceived largely in a piecemeal fashion, as the datelines of crisis reports have jumped from country to country, and domestic and foreign repairmen have rushed to reverse the reactions of unforgiving markets. But one can begin to perceive some of the far-reaching political and security implications that might flow from the daily accounts.

The potential influence of the distant, stabilizing power—the United States—has been heightened, but the consolidation of this opportunity will depend on what America does next.

The new conditions and responses to them are shifting the region's balance of power. China has advanced; Japan and ASEAN have slipped. The potential influence of the distant, stabilizing power—the United States—has been heightened, but the consolidation of this opportunity will depend on what America does next.

The paralysis of the nascent institutions of regional cooperation—ASEAN, APEC, and the ASEAN Regional Forum—has revealed their considerable limitations. Nevertheless, their critical test may still be to come: They can perform a vital service if they dampen tensions and help avoid conflict among Asian countries struggling to overcome extraordinary economic and political stresses.

Once the countries of the region begin to recover, ASEAN in particular will need to reconsider its ends and means. Indonesia, ASEAN's cornerstone, will probably be preoccupied with rebuilding both its economy and a new political system. Other ASEAN countries will be passing from a generation of dominant founding leaders to more complex and open polities. New civic and nongovernmental groups will be seeking influence within countries and transnationally; the recognition of governments' fallibilities will embolden these forces. At the same time, the ASEAN countries will need to adjust to a changed external environment, with a stronger China and rising proliferation risks.

The hopeful notion that increased economic interdependence will prevent international strife will also be tested again. As Europe learned in the promising year of 1914, and also during the downturn of the 1930s—and as South Asia is demonstrating today—economic interest and integration cannot ensure peace.[11] The current American strategy toward China is predicated on the assumptions that economic interdependence will make China more cooperative and that the development of internal markets will lead to increasing political liberalization. At the regional level, if there is an additional cycle of decline, support for reforming governments will wither and tensions could spill over internationally.

Further economic troubles will be particularly trying for relatively new countries that have built their states upon the foundation of healthy growth. The democracies offer the support of public legitimacy for difficult reforms, but they are fragile structures, and will be subject to severe strains.

The people of Asia are certainly making judgments about a host of important ideas concerning political governance; combinations of economic and political power; openness and corruption; the benefits and risks of markets; the key components of cohesive societies; and the potency of global forces that range beyond the control of any government.

This generation of Asians will also be watching to see who helps them in this hour of need. Well-intentioned interventions alone will not ensure a favorable appraisal.

Indeed, the shock of events and difference of perspectives may be triggering a political clash of cultures, but in an ironic fashion very different from the one forecast by Professor Samuel Huntington.[12] For East Asians, America's role looms especially large today, whether through U.S. actions or inaction. This viewpoint has led Asians to call for U.S. support while simultaneously worrying that U.S. involvement will strengthen American dominance. In contrast, important groups in the United States, including in the Congress, not only do not want to dominate Asia, but seek to avoid having anything to do with it. These Americans neither want the IMF to be the Lender of Last Resort, nor America to be the Leader of First *or* Last Resort.

This U.S. ambivalence reflects attitudes with old origins. Today's debate evokes some of the arguments about America's interests and ideals in the Asia Pacific that one might have heard a century ago. So it is important today, as it was then, that the President shape the public's conception of America's role in the world, through words and deeds.

Today, America's security commitment to the region is firm. The challenge will be for the United States to adapt its security relationships in the face of changes sure to come. Most important will be the overhaul of the U.S.-Japan security agreement, an alliance with Korea that will last beyond unification, and a framework with China that encourages cooperative ties but can safeguard against a China that might choose a more confrontational path.

The U.S. economic commitment in Asia reveals a more complex picture. On the one hand, America's companies are deeply involved; they are actively seeking investment and trade opportunities throughout the region where host countries create openings. I also suspect U.S. markets are likely to remain relatively open to Asian goods, despite increasing protectionist pressures, as long as the U.S. economy does not suffer a serious downturn.

On the other hand, the United States may have missed an opportunity to shape the Asia Pacific trading landscape for decades to come. And the tactical response to great upheavals in international capital markets and to questions about the IMF's role have left the IMF adrift in stormy seas.

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[11] For a discussion of the history of the hope that economic integration and free trade would end war, see Robert B. Zoellick, "Economics and Security in the Changing Asia-Pacific," pp. 29–31.

[12] In *The Clash of Civilizations and the Remaking of a World Order* (New York: Simon and Schuster, 1996), Samuel Huntington predicts a new era of clashes between civilizations—most notably between the West and an alliance of Islamic and Confucian cultures.

America's political vision of democracy, individual rights, and constitutional limits on government has been given at least a temporary boost by events. But the final votes on the model in Asia will be cast by the Asians who are struggling with these great changes.

The same point is true for all dimensions of Asia's future. Unlike the world of 1898, and despite the present trials, Asians are now the subjects, not the objects, of policy. The United States can play a major role in shaping the choices by promoting a possible future of stability, economic openness and prosperity, and political freedom. But ultimately, the political, economic, and security future of Asia will depend on decisions by the people of Asia. ■

Japan's Immobilism

Kenneth B. Pyle

This essay analyzes Japan's post-Cold War immobilism and the failures of its once highly praised political-economic system. In a succession of crises, including its recession and banking crisis, Japan has exhibited an indecisiveness that has paralyzed its policymaking. There are several fundamental causes of the indecisiveness, including the entrenched interests and institutional practices that remain from the century-long efforts to "catch up" with the West; and the exclusive concentration on economic growth since World War II that left many political-strategic institutions underdeveloped. Immobilism also results from the difficulty of consensual decision-making in Japan in times of great uncertainty. The author concludes that the U.S. must continue to prod Japan to make decisions that its system resists.

The stunning rebuke that Japanese voters gave the ruling Liberal Democratic Party in the July 12, 1998 upper house elections, the resignation of Prime Minister Hashimoto, and the resulting disarray among political leaders exacerbated what had already become the greatest political-economic crisis Japan has faced since the end of World War II. It is a systemic crisis. The Japanese system, which once worked so well under the unique circumstances of the Cold War and which only a decade ago was widely expected to provide world leadership, is foundering. The Japanese ship of state is adrift.

A veritable tide of troubles has swept over the country in the 1990s. In the face of these troubles Japan has shown a bewildering lack of purpose and direction, a pattern of immobilism in its policymaking, and a deeply dismaying absence of leadership. The problem is not simply the recent Asian financial crisis, nor is it the prolonged economic slump, the uncertain progress of deregulation, and the unresolved banking crisis. Rather, in a succession of crises since the end of the Cold War, Japan has exhibited a peculiar pattern of passivity, indecisiveness, and failure to come to grips with the problems facing the nation. As a consequence Japan has suffered a dramatic diminution of its international stature.

One is struck by the contrast between the confident expectations of the 1980s and the dismal realities of the 1990s. During the previous decade it appeared that the tide of history was with Japan. It was the hallmark of the Nakasone years (1982–1987) that Japan must increasingly play the role of leader in the international system and set forth its own objectives and principles.

Kenneth B. Pyle is president of The National Bureau of Asian Research and professor of history and international studies at the Henry M. Jackson School of International Studies, University of Washington. His recent publications include *The Making of Modern Japan* (2d edition, 1996); and *The Japanese Question: Power and Purpose in a New Era* (2d edition, 1996).

This essay served as the basis for Dr. Pyle's testimony before the Subcommittee on Trade of the Ways and Means Committee, U.S. House of Representatives, July 15, 1998. An earlier version of the paper was prepared for the "East Asia in Crisis" conference, sponsored by The National Bureau of Asian Research and the Strategic Studies Institute of the United States Army War College, June 9–10, 1998 in Seattle.

"Having 'caught up' [with the Western nations]," this dynamic and colorful prime minister said, "we must now expect others to try to catch up with us. We must seek out a new path for ourselves and open it up ourselves."[1] The Japanese believed that they were destined to become the world's economic, scientific, and technological leaders in the next century. The belief that Japan would lead a new wave of revolutionary change in the twenty-first century was widely held, and Prime Minister Nakasone's circle argued that economic leadership in the world would require political leadership as well.

Nakasone had an impressive grand design to prepare for Japanese global leadership that entailed reforming Japan's institutions, restoring national pride in Japan's modern history, and above all adopting an active role in strategic affairs. He aimed to replace the country's politically passive policies with an activist foreign policy that envisioned a Japan engaged in international strategic issues, participating in its own defense, and possessing its own goals and values. In photo sessions at G-7 meetings, Nakasone pushed to the center and stood tall, chatting affably with Ronald Reagan and Margaret Thatcher. The Ron-Yasu era was a heady time and the rest of the world was duly impressed. The cover jacket of Paul Kennedy's best selling *The Rise and Fall of the Great Powers* showed a jaunty Japanese carrying the Rising Sun, mounting the stage of world history as a tired Uncle Sam followed an aged John Bull off the stage.

. . . the post-Cold War period has brought Japan a tsunami of troubles that has utterly frustrated the expectation of an activist Japan as a world leader.

In a truly startling reversal of fortune, the post-Cold War period has brought Japan a tsunami of troubles that has utterly frustrated the expectation of an activist Japan as a world leader. Consider this succession of troubles in the 1990s and the peculiar immobilism of Japan's leadership:

(1) At the beginning of the decade the Persian Gulf War revealed a paralysis of policy in which Japan, unable to muster coherent support for the international coalition (despite the fact that 70 percent of its oil came from the Persian Gulf), ended up writing checks for $13 billion for which it got little thanks and much derision.

(2) In l993, when the Liberal Democratic Party (LDP) was overthrown after 38 years of uninterrupted government, many observers thought that the end of one-party rule and the passage of electoral reform legislation in 1994 would bring to power new faces with new ideas and a new sense of national purpose. Since then, however, politics have been in a rudderless state. Parties have experienced a dizzying display of realignments. In the ensuing three years there were three changes of government, five prime ministers, and the sharing of power by eleven political parties. The opposition parties proved even less able than the LDP to provide decisive leadership. Today, even after its losses in the July 1998 upper house elections, the LDP is back in power again, the opposition parties are fragmented, the reformers in disarray, and the electorate so alienated that in recent polls fully half the voters respond that they support no party.

[1] Quoted in Kenneth B. Pyle, *The Japanese Question: Power and Purpose in a New Era*, 2d ed., Washington, D.C.: The American Enterprise Institute, 1996, pp. 89–90.

(3) In 1994, when a showdown with North Korea over its nuclear weapons program made war appear imminent, the U.S. command in Japan asked the Japanese government to contribute fuel and material for American forces, to provide ships and planes for sweeping mines and gathering intelligence, and to cut off financial flows to North Korea. Japanese officials were unable to respond whether or not they could provide such assistance. If conflict had ensued and American forces had not had access to Japanese bases, Defense Secretary William Perry later said, "it would have been the end of the alliance."

(4) In 1995 an earthquake devastated the major port city of Kobe, and in its aftermath the prime minister and government demonstrated appalling incompetence in crisis management. Self-Defense Forces were dispatched slowly and got lost in a traffic jam that kept them from efficient rescue operations.

(5) In the same year the Aum Shinrikyo cult released nerve gas into Tokyo subways, killing a dozen people: its biological work was meant to be thousands of times more devastating. We now know that Aum had previously carried out at least nine biological strikes: its targets were the Diet; the Imperial Palace; the surrounding city; and the American naval base at Yokosuka. The attacks failed because Aum never got hold of germs of sufficient virulence. Japanese authorities knew nothing of the attacks until long after they had occurred.

(6) In 1996 the 126-day hostage crisis at the Japanese ambassador's residence in Lima, Peru, revealed a startling lack of resoluteness, crisis management, and determination to take a principled stand. Prime Minister Hashimoto made it clear that his concern was not with resistance to terrorism. Peruvian President Fujimori acted decisively on his own to resolve the crisis knowing that the Japanese government, if informed, would pressure him to try alternative solutions. Japanese commentators subsequently reflected on what they called Japan's "cowardice" in dealing with terrorism.

(7) Throughout the 1990s Japanese leaders have failed to lay to rest the burdens of the nation's militarist past, at great cost to Japan's international standing and its own self-respect. This was particularly evident on the occasion of the fiftieth anniversary of the end of World War II. At that time, the Diet deliberated at great length and without success on a resolution of apology meant to express a commitment to peace based on the lessons of history. Issues of the "comfort women," germ warfare experiments, the Nanjing massacre, etc. continue to fester.

. . . Japan's continuing economic problems diminish in important ways the country's capacity for regional political leadership.

(8) In the Asian financial crisis Japan has displayed policy paralysis once again. The burst bubble and prolonged economic slump have presented the world with a picture of immobilism and disarray and exposed Japan to a chorus of criticism. Coming after several years of economic stagnation, uncertain progress in deregulation, and the unresolved problems of banking debt, Japan's failure to stimulate economic recovery has threatened to exacerbate the regional contagion and has exposed Japan to a chorus of criticism not only from America and Europe but from other Asian countries. President Clinton's effusive praise for China's "great statesmanship and strength . . . [which serves] the entire region by maintaining the value of its currency" contrasts sharply with Washington's impatience with Japan's policymakers. Isolated, self-absorbed, and resentful of foreign hectoring, Japan is in danger of bearing the blame should the Asian crisis deepen.

Moreover, Japan's continuing economic problems diminish in important ways the country's capacity for regional political leadership. First of all, Japan is cutting its Overseas Development Assistance (ODA) budget by 10 percent in 1998. It is likely that this year Japan may lose its position as the number one donor of foreign aid, a position it has held for the past seven years. A new study by a blue ribbon committee advising the government calls ODA "Japan's principal foreign policy tool" and recommends that if Japan is to retain public support it must be deployed in a much more focused manner to serve Japan's strategic self-interest. Most foreign commentators thought Japan was already doing this, but, as a result of Japan's economic problems, it is likely that Japan's overseas assistance will be more sharply focused in its strategic purposes. Keidanren, the business association of elite corporate leaders, is calling for a return to tied loans.

Second, economic constraints led Japan to cut its defense budget in 1997 and it is likely to be cut again. There is also increasing talk about the need to cut back on so-called host nation support for the U.S. military bases in Japan. Beginning in 1978 the Japanese government, some would say without any legal basis, began paying part of the allowances of Japanese civilian workers at U.S. bases. Officials explained that Japan was offering the contribution as a "sympathy" outlay to show its consideration for the U.S. forces. Over the years it has grown to 44 times the original sum. Today it is close to $6 billion annually and covers 70 percent of the cost of stationing U.S. troops in Japan—including housing and welfare facilities, utilities, land rent, etc. In a 1998 *Foreign Affairs* article, former Prime Minister Hosokawa advocated an end to all host nation support when the present agreement expires in the year 2000. Citing Japan's "serious financial crisis" as well as the diminished threat in the post-Cold War era, he concluded that "the U.S. military presence in Japan should fade with the century's end."[2] To combat such sentiment, former Prime Minister Nakasone, who had always favored a more autonomous Japanese defense system, defended provision of host nation support, but did it in terms that would make Americans wince, telling a Japanese audience that it was a good thing that Japan "provides money to the United States, allows its troops to be stationed in Japan, and uses them as watchdogs." The reference to "watchdogs" (*banken*), which carries the connotation of mercenaries, was startling because the term has been used before by Japanese politicians in derogatory reference to American troops stationed in Japan.[3]

Third, Japan's financial difficulties will increase the reluctance with which it supports the Korean Energy Development Organization and its lukewarm support for Korean reunification, since the latter will undoubtedly be enormously costly and strategically problematic for Japan. The depreciation of the Korean *won* had made it appear that Japan's share (20 percent) of the cost of light-water reactors for North Korea could be reduced. After initially resisting U.S. entreaties, the Japanese government decided—again reluctantly—to stick to its original commitment, perhaps fearing that in the aftermath of nuclear testing in South Asia North Korea might change its mind about suspending its nuclear program and seek help from Pakistan. It is also possible that the recent nuclear tests in South Asia may have made the Japanese somewhat more receptive to joining theatre missile defense programs with the United States—a decision which they have long delayed—but it is more likely that cost as well as technological and political considerations will cause them to continue to defer a decision.

Fourth, the financial crisis will weaken Japan's "Asianist fever" and take a good bit of the momentum, at least for the time being, out of its fundamental Asian strategy, which has placed great reliance on a combination of trade, investment, and aid to establish Japanese political-economic leadership in the region.

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[2] Morihiro Hosokawa, "Are U.S. Troops Needed in Japan?" *Foreign Affairs*, vol. 77, no. 4 (July / August 1998), pp. 2–5.

[3] *Asahi shinbun*, October 5, 1997.

Lastly, the crisis has tarnished the value of the Japanese model of economic development, which the Japanese had regarded as an essential ingredient of their capacity to give leadership to Asia.

(9) There is one more element in the string of troubles which outweighs the others in many respects and is the most perplexing and problematic for Japan's harried leaders—the rise of China in the 1990s. Nothing has been so psychologically jarring to those Japanese who think about their future strategic role and their aspirations for leadership in Asia. Taken together with all the other troubles enumerated above, the rise of China has greatly diminished the Japanese self-confidence that was so irrepressible in the l980s. The potential size of China's economy, the uncertainty about its future power and purpose as a nation, the potential magnitude of its environmental degradation, competition for resources, and possible political and social turmoil have all justifiably alarmed the Japanese. Perhaps equally jarring has been the way in which world attention has turned from the Japanese miracle to fascination with China. President Clinton's extended trip to China was closely watched by the Japanese, who are increasingly wary of the potential for change in the triangular relations among China, Japan, and the United States.

Partly as a result of American dissatisfaction with Japan's response to the Gulf War and to the confrontation with North Korea, and partly as a result of the Taiwan Strait crisis in March 1996, Japan has reluctantly agreed to U.S. insistence on a revision of the guidelines for the U.S.-Japan security treaty. These revised guidelines provide for an increased but still modest role for Japan in the event of a regional crisis and seek to draw Japan into a tighter, more integrated, more reciprocal, and therefore more effective operational alliance.

Once again, however, one is struck by the slow and limited way in which Japan has dealt with this issue. There is, as many observers point out, a "mountain" of legislation required to initiate these guidelines. The government is moving slowly and deliberately with this legislation and it is likely to be some years before this new, limited role is operational. Above all, Japanese leaders have yet to deal with the unresolved issue of "collective self-defense" and to involve the Japanese people in the solution. The government continues to maintain the curious position that while all nations under the UN charter possess the right of collective self-defense, Japan cannot exercise this right. So long as this position is maintained, Japan will contribute little leadership in the strategic issues facing Northeast Asia.

How are we to account for the paralysis of Japan's political leadership in this decade? For each of the nine crises cited there are, of course, a number of proximate causes for vacillation. For example, with regard to economic policy there are conflicting concerns among policymakers that tax cuts and stimulative spending would worsen already substantial government deficits and undermine the fiscal discipline required to deal with Japan's rapidly aging population.

If we look, however, for fundamental causes of the overall pattern of immobilism, they are partly to be found in the legacy of the policies and institutions that remain from the catch-up period and the unique role that Japan played in the international system during the Cold War. The century-long campaign to catch up with the Western industrial economies left many deeply entrenched interests and institutional practices, especially the iron triangles among bureaucracy, industry, and ruling party, which are resistant to change and reforms. Moreover, the postwar exclusive concentration on economic growth left many political-strategic institutions undeveloped. The weak prime ministership, the lack of crisis management practice, and the inexperience of deploying armed forces are glaring examples.

Another fundamental cause of immobilism is the nature of Japanese decision-making in circumstances of uncertainty. The late Professor Kosaka Masataka, an astute observer of Japanese political behavior, stressed the government's difficulty reaching consensus in situations of great uncertainty. "Consensus is obtained without great difficulty when the nature of the task is clear. Often, for instance, the Japanese have been good at adapting to strong, decisive pressures from outside. But when the situation is blurred, they are in trouble."[4] From his own experience with Japanese diplomatic methods, Henry Kissinger writes of the "painfully—and sometimes maddeningly" slow consensual decision-making process. He anticipates therefore that Japan will accommodate to the new post-Cold War circumstances in a cautious and cumulative fashion. "The role of Japan," he writes, "will inevitably be adapted to these changed circumstances, though following their national style, Japanese leaders will make the adjustments by the accumulation of apparently imperceptible nuances."[5]

Such consensual decision-making is ponderous in times of uncertainty. In Japan's post-Cold War environment there are developments that raise huge uncertainties, including the globalization of capitalism, the rise of China, and the prospect of Korean unification. Historically, in such times of uncertainty, Japan has moved with circumspection. Japan is not disposed to international leadership. It is typically adaptive to its environment, opportunistic and pragmatic in its pursuit of the national interest. Japan has a dominant conservative tradition—it is no less strong than America's liberal tradition—which prizes social obligation and solidarity. Most Japanese policymakers are deeply resistant to American-style market-led reforms, which they believe are too disruptive and unpredictable in their social consequences. Many policymakers, such as Sakakibara Eisuke, a key Ministry of Finance official in international economic matters (sometimes known as "Mr. Yen"), still have faith in a Japanese-style capitalism.

If we look at the last 150 years of Japanese foreign policy, a recurrent pattern of behavior stands out. Japan has tended to accommodate to major changes in its international environment. The common approach during periods of fundamental transition in the international system like the current one has been to hold back, watch and wait for trends to clarify, and then to adjust to the new international environment when it is clearly established. A good illustration of this approach comes from an interview with Kato Koichi, a likely future prime minister who is better versed on Sino-Japanese relations than any other politician. His attitude toward issues with regard to China is: let's wait and see. China will not be a threat for another generation. He is a master of ambiguity. As Morita Minoru, one of Japan's leading political commentators, says, Kato is a classic LDP politician in his approach. "Regardless of the issue, he takes a passive stance—he waits for events to develop before making a decision."

Today, while uncertainty prevails in so many ways in the country's external environment, Japan will not make fundamental decisions.

Japan has been guided throughout its modern history by pragmatic nationalism rather than by fixed principles. An opportunistic adaptation to international conditions in order to enhance the power of the state has been characteristic of Japanese foreign policy. Some observers of Ja-

[4] Masataka Kosaka, "The International Economic Policy of Japan" in Robert A. Scalapino, ed., *The Foreign Policy of Modern Japan*, Berkeley: University of California Press, 1977, p. 222.

[5] Henry Kissinger, *Diplomacy*, New York: Simon & Schuster, 1994, pp. 827–829.

[6] I have developed my argument in the 1997 Edwin O. Reischauer Memorial Lecture reprinted in the *International House of Japan Bulletin*, Summer 1997.

pan today feel that the Japanese are in the midst of a great debate about their international role and that once they arrive at consensus, Japan will change.

I do not see it that way. My argument, in short, is an outside-in one.[6] The Japanese have been shaped by and have adapted to changes in their international environment. Moved by a keen pragmatic sense of national interest, Japan has repeatedly accommodated to fundamental changes in the structure of international politics. It has repeatedly allied itself with the dominant, ascendant power (Great Britain, Germany, the United States). Moreover, it has tended to make fundamental changes in its domestic institutions as part of its process of adjustment to a changed international system. Today, while uncertainty prevails in so many ways in the country's external environment, Japan will not make fundamental decisions. It will move very slowly and cautiously. However, once the structure of its external environment becomes clear, Japan will accommodate itself to this new order of things. Moreover, it will accommodate with a speed that will surprise those who look only at the present immobilism.

What this all adds up to for the foreseeable future is a protracted period of drift and instability in Japanese politics, making Japan a difficult and uncertain partner for the U.S. in world affairs. Despite the fact that many of its fundamentals are good (foreign currency reserves, savings rates, overseas assets, manufacturing base, etc.), there is little prospect that Japan will muster the leadership to quickly stimulate its economy, boldly reform its financial institutions, and thereby strengthen the yen and help lead Asia out of the regional contagion. Accordingly, this combination of systemic gridlock and characteristic strategic caution in the politics of our principal ally in the region enhances the imperative for American leadership and a clear strategic vision. The United States will have no choice but to continue prodding Japan both bilaterally and, when possible, multilaterally to take steps its system is resisting. While there is widespread Japanese resentment of U.S. hectoring, fortunately, as a result of America's restored economic and political influence in the world, Japan has a renewed appreciation for the indispensability of the alliance. ■

RUSSIA: CRISIS AND REFORM

Herbert J. Ellison

This essay addresses the political and economic impact of the East Asian crisis on Russia at this crucial stage in its post-Soviet transition. The essay outlines the steps taken by the Russian government to deal with the crisis and evaluates the ability of the new government to handle urgent problems. The author asserts that President Boris Yeltsin's March 1998 decision to dismiss the cabinet of Prime Minister Viktor Chernomyrdin was not capricious, as many have asserted. Rather, the decision resulted from the recognition that bold reforms would be needed to keep the crisis from worsening. From the crisis has emerged "the most promising reform government of the Yeltsin era," led by the new prime minister, Sergei Kiriyenko. The author argues that the $22.6 billion IMF-led package of loans to Russia, agreed to in mid-July, was awarded not only in recognition of the country's strategic importance, but also as an expression of confidence in the young government.

A Bear Is Not A Tiger

Russia was an incidental victim of the East Asian economic crisis. It was not a booming emerging market economy of the pre-crisis Indonesian or Thai variety, distinguished by a massive influx of foreign investment and spectacular growth rates. It was a former communist command economy engaged in a protracted and painful transition to the market. Instead of an Asian boom it had experienced eight years of relentlessly shrinking gross domestic product (GDP), with investment—domestic and foreign—in desperately short supply. Rather than a structure of politically controlled banks investing huge sums in everything from freeways to high-rise office buildings, it had an infant banking system, collectively no larger than a single American regional bank. Russian banks had invested in government short-term bonds at phenomenal interest rates, and in privatized state assets, but had avoided commercial lending. Individuals and companies gaining wealth in the rough and tumble of the post-communist transition were transferring billions of dollars abroad and operating offshore to avoid the tax collector and the uncertainties of the Russian currency and market. Nor was Russia an emerging economy. It was a developed industrial economy in a country with a highly educated and technically skilled population that was nearly 80 percent urbanized.

Despite these differences, the East Asian economic crisis has had a powerful impact on Russia since the fall of 1997. By lowering world oil prices the crisis reduced already inadequate state

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Herbert J. Ellison is professor of history and international studies at the Henry M. Jackson School of International Studies, University of Washington and director of Eurasia Policy Studies at The National Bureau of Asian Research (NBR). His recent publications include: "The New Russia in Asia: 1991–1995," *NBR Analysis* (June 1996) and "Russia in Crisis: Toward a New Realism," *The World and I,* (May 1995).

An earlier version of the paper was prepared for the "East Asia in Crisis" conference, sponsored by The National Bureau of Asian Research and the Strategic Studies Institute of the United States Army War College, June 9–10, 1998 in Seattle.

revenues; and by undermining confidence in emerging market investments in general, and exposing the frailty of the Russian financial situation, it reduced both Russian and foreign investment. The climax of the process came in June and July of 1998 with a severe stock market decline and a run on the ruble that threatened the most impressive financial reform achievements—a stable and convertible ruble and relatively low inflation. More broadly, it threatened the stability of the new Russian market economy and the democratic order that depended on it.

Beginning the process as an incidental victim of the Asian crisis, Russia appears to have emerged, under a determined and tested reform leadership, with renewed hope and opportunity.

The thesis of the present analysis is that the Russian leadership, especially the new government installed in April, responded energetically and competently to the impact of the crisis, but only barely avoided a major financial and political catastrophe. It could not have done so without a major loan by the International Monetary Fund (IMF), supported and pressured by the United States. Beginning the process as an incidental victim of the Asian crisis, Russia appears to have emerged, under a determined and tested reform leadership, with renewed hope and opportunity.

To understand the impact of these events, and the prospects for Russian recovery, it is helpful to begin by looking first at the Russian domestic political and economic situation when the crisis initially struck in the autumn of 1997,and then at its progress through the summer of 1998.

How It All Began

When the East Asian economic crisis began in July 1997 with the devaluation of the Thai baht, the first repercussions were felt in Malaysia, the Philippines, Indonesia, and the Czech Republic. By October the impact had reached Hong Kong, Brazil, and Russia, and generated anxious discussion about the stability of South Korea, Taiwan, and Japan.

The impact on Russia dashed the hopes of economic growth that had been encouraged by promising trends in 1997. After declining 43 percent between 1989 and 1996, Russia's GDP experienced its first modest growth in 1997, and the stock market soared—rising 285 percent in 1997 alone.[1] Thanks mainly to exports of oil, gas, and metals, Russia enjoyed a 1997 merchandise trade surplus of $18 billion. By June interest rates on the bonds (GKOs) that the government used to finance much of its deficit were down 200 percent to 19 percent. Banks were beginning to shift funds from government bonds to business loans, though the much lower rate on bank deposits (7.4 percent) and concerns about the security of deposits continued to discourage expansion of ruble savings as a source of loan capital. Another positive sign in 1997 was a steady rise in federal revenues as a share of GDP—up to 13.1 percent in April 1997 from 8.8 percent a year earlier. These developments, combined with hopes of Duma passage of a tax law that would significantly increase government revenues, reduce borrowing, and lower interest rates, encouraged the belief that Russia was poised for economic recovery and growth.

Beginning in November 1997, however, the government's financial situation turned negative rapidly. Foreign and domestic investors, perceiving Russia as yet another unstable "emerg-

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[1] In preparing this paper, I have found *Russian Economic Trends, Monthly Update*, published by the Russian European Centre for Economic Policy, to be the most convenient and informative source of information on trends in the Russian economy.

ing market," began to flee the stock and bond markets, sending stocks down 20 percent by the end of the year and forcing interest rates on GKOs up to 40 percent.

As the first phase of the Asian impact was felt, the government sought to hold GKO interest rates down by a costly intervention in the market, a move that sharply reduced gold and hard currency reserves. By cutting expenditures and spending huge sums of foreign currency to sustain the ruble, a semblance of stability was achieved by the end of the year. The interest rate on GKOs was down to 29 percent, but this was still nearly double the pre-crisis level and an obstacle to lending. It was also more than double the 12 to 14 percent GKO interest rate on which the 1998 budget was predicated. At the planned level the interest obligation would have been 4.4 percent of GDP, creating a total deficit of 4.7 percent when added to a modest primary deficit (deficit excluding interest obligations) of .3 percent.

In fact, interest rates remained high throughout the first five months of 1998. Other negative signs included: a steep decline in new construction and equipment, declining export earnings (projections suggested a drop of $7 billion for 1998 because of reduced oil prices), and a continued heavy proportion (48 percent) of consumer sales of imported goods. Meanwhile, the Duma opposition continued to block a proposed tax law designed simultaneously to increase revenue and to remove barriers to investment (though it did finally approve a government-supported 1998 budget to reduce the deficit substantially from the previous year).

During the first four months of 1998 the federal government ran a deficit (IMF-defined) of 4.4 percent of GDP, down from 8.5 percent in the first four months of 1997. The performance showed a primary surplus of 0.5 percent of GDP. The deficit reduction was accomplished by lowering spending from 18.9 percent of GDP in 1997 to 15.3 percent in the first four months of 1998. Federal revenue for the first four months was 10.9 percent of GDP, 0.5 percent above the level for the same period in 1997, but below target.

The government's revenue shortfall manifested itself not only in heavy—and risky—dependence on short-term financing, but in socially dangerous arrears in payment of wages and pensions. Arrears in wage payments had been much reduced in late 1997, but began to rise again in 1998, reaching a total of 608 billion rubles ($99 billion) by the end of April—8 billion of which was attributable to the state sector, the rest to the private. There were also reports of delays in pension payments in March, and by the end of that month 88 billion rubles were owed to the state pension fund. The chronic failure to get control of these arrears was one of the main factors leading to President Boris Yeltsin's dismissal of Prime Minister Viktor Chernomyrdin's government.

Problems and Possible Solutions

The two most urgent problems confronting the government in March and April of 1998 were a renewed rise in wage arrears and continuing shortfalls in tax collection. The consideration of a new tax law, which was needed to improve revenue, was postponed until early 1999. Hence the government faced an enormous shortage of funds for wages and pensions at the same time that a shortfall in tax revenues and declining oil and gas revenues threatened a fiscal crisis that could require expanded government borrowing, with its negative impact on interest rates and investment.

One possible short-term solution to these problems was the profitable sale of state-owned shares in key enterprises, and the enhancement of revenues from those (especially the main electricity supplier, United Energy Systems) that were to be retained. This course was opposed by erstwhile Yeltsin supporters (such as prominent businessmen Boris Berezovsky and Mikhail Khodorkovsky), and the Duma retained an anti-privatization majority. Yeltsin's main agent in earlier privatizations, Deputy Prime Minister Anatoly Chubais, had been severely compromised by attacks from Berezovsky and by the widespread public perception that his privatization programs had unfairly transferred vast wealth to a few. Moreover, Prime Minister Chernomyrdin was widely regarded as having received great wealth from the Gazprom privatization, and worse still he now perceived himself as a viable presidential candidate (despite considerable evidence to the contrary) and had begun to spend much time cultivating his candidacy.

With the government's financial situation deteriorating, Yeltsin was also very concerned about the impact of an economic reversal on the 1999 parliamentary elections and the presidential election in 2000. He had little time left to improve government performance by increasing revenues to meet the backlog of wages and pensions and to reduce the indebtedness that blocked investment and growth. Moreover, he needed an instrument of his policies—a prime minister who was an effective administrator, who had no hint of private interest or corruption on his record, and who could head a reinvigorated reform program.

A common complaint of both Russian and Western critics of Yeltsin's dismissal of the government on March 23, 1998, was that it was hasty and impulsive, and that it risked rather than supported the reform process. In this view, the economic decline had finally bottomed out, the "Asian flu" had been resisted, there was increasing dialogue between the executive and legislative branches of government, and the phlegmatic Chernomyrdin was ideally suited to maintaining the course.

Escaping A Trap

However, the critics failed to note Yeltsin's central dilemma. On the one hand, the opposition blocked tax reform, land privatization, and other reforms needed to complete the transformation of the Russian economy: and on the other, the country was drifting toward a financial crisis in which the persistent deficit threatened social and financial stability. Even some of his supporters among the *Semibankirshchina* (seven bankers group) blocked efforts to gain revenue from competitive sales of shares in state industries, while entrenched bureaucrats blocked management reform of enterprises still owned by the state.

So what was the answer? As he has done in the past, on March 23 Yeltsin moved to break up the logjam in the stream of reform. The dismissal of the entire cabinet enabled him to get rid of obstructionists and build a reform team under new leadership. He lost Chubais as deputy prime minister, but Chubais had become a highly visible symbol of the negative features of earlier privatizations. And he could be useful on the board of United Energy Systems (UES). The task was to find a prime minister who could replace the cautious Chernomyrdin, reinvigorate the government's reform initiatives, and possibly develop into a future presidential candidate.

Critics of Yeltsin's choice for prime minister, Sergei Kiriyenko, sought to discredit him on grounds of youth and inexperience, ignoring his promising record. His career began with a conventional engineering training and Communist Youth League activism in Gorky (now Nizhny Novgorod). Military service and a stint as a shipyard foreman were followed, at the opening of the post-communist era, by training in finance in Moscow and then a bank chairmanship and the presidency of the large Norsi oil refinery. After Nizhny Novgorod Mayor Boris Nemtsov moved to Moscow to become minister of fuel and energy in March 1997, Kiriyenko followed to become deputy minister of fuel and energy in May, and then minister in November. It was from this position that he was asked to become Yeltsin's nominee for prime minister in March 1998. Successful in business and government, he had acquired a reputation for honesty and independence.

Kiriyenko stressed his commitment to the fundamental economic policies of the government, but also noted the government's need for broader public support. From the beginning he stressed the importance of rebuilding Russian industry, of combating poverty, and of putting an end to delays in payment of pensions and public sector wages. Commenting on recent economic policy, he stressed the success in achieving a stable ruble and controlling inflation, as well as the huge expansion of the private sector and the halting of the slump in output. On the negative side, he talked about unrealistic budgets, the underestimation of growing state debt, weak government control of state monopolies, and the slowness of tax reform.

At an early stage, Kiriyenko won the confidence of trade union leaders and began to work with the heads of state committees, who are not cabinet members but play a major role in such matters as management of state monopolies, support of small businesses, management of bankruptcies, and relations between federal and regional agencies. He also proved to be appealing to regional leaders, who have become enormously important in Russian politics. In short, he defined a very practical and important work agenda and showed every sign of being an effective manager.

Following approval of his appointment by the Duma on April 25, Kiriyenko proceeded to form the strongest reform cabinet of the post-communist era. Particularly notable was the Government Council—the core of a much down-sized cabinet whose members, like Kiriyenko himself, have extensive experience in private business, government, or both.

This was not the first time that Yeltsin had surprised the Russian political leadership by placing a very young appointee in high office. Anatoly Chubais was even younger than Kiriyenko when he took responsibility for state property in 1991, and eventually for the largest privatization in history. Deputy Prime Minister Boris Nemtsov and Former Prime Minister Yegor Gaidar were still in their thirties when they joined the government. There are many other examples—including Andrei Kozyrev, the first Russian foreign minister—that document Yeltsin's preference for representatives of the young generation who bring radically new ideas into the Russian leadership. President Yeltsin has made excellent use of the talented young reformers. The rejection of Kiriyenko by the communist leader Gennady Zyuganov on the grounds of his youth and inexperience was a predictable and unconvincing complaint.

The second phase of the East Asian Crisis . . . precipitated a financial crisis [in Russia] that, without the support of the IMF and the World Bank in mid-July, might well have brought the collapse of the economy and the government.

There was much Russian and foreign criticism of Yeltsin and Kiriyenko for their alleged failure to negotiate compromises with Duma leaders in order to secure votes for Kiriyenko. In fact, both Yeltsin and Kiriyenko had good reason not to allow Duma leaders to name members of the new cabinet. Yeltsin's nominee was approved without other concessions or compromises on cabinet membership or policy that would prevent him from doing his job. The wisdom of this course would be clear when the new prime minister and his colleagues, an extraordinarily talented and ideologically cohesive group, confronted the second phase of the East Asian Crisis—their baptism by fire.

Russia and the Asian Crisis: Act II

The second phase of the East Asian crisis, between May and July, had a far greater impact on Russia than the first, and precipitated a financial crisis that, without the support of the IMF and the World Bank in mid-July, might well have brought the collapse of the economy and the government. Its opening coincided with the renewal of strife in Indonesia and the fall of the Soeharto government on May 21. Combined with the downgrading of Korean banks and rumors of American and German interest rate increases, these developments increased investor concern about Russian stability and the security of Russian investments.

In May the ruble came under greater pressure than at any time since Black Tuesday in October 1994.[2] Since the government established the currency corridor in 1995, the ruble had been the symbolic anchor of the economy, discouraging inflationary expectations and encouraging foreign investors to lend to the Russian government, companies, and banks. By committing to the corridor, the government constrained the printing of money by the Central Bank and assumed responsibility for financing deficits by borrowing on the domestic and international financial markets. It was by this means that inflation was reduced from 200 percent at the beginning of 1995 to a current annual rate of 7.5 percent.

Though the system was a good one, it was used excessively during the two years after its introduction, causing the GKO holdings to rise from 3.5 percent of GDP at the end of 1995 to 13.5 percent two years later, a large debt with an average maturity of less than a year. The Kiriyenko government's vigorous efforts to lower government spending greatly reduced the need for new financing, but the excessive borrowing of the past imposed the necessity of raising an average of 8 billion rubles ($1.2 billion) each week as existing debt matured. When investors were less willing to hold ruble-denominated bonds, the government was obliged to raise interest rates, which simultaneously increased the debt burden and doubts among investors about its ability to pay.

The Russian stock market was down in early May, but the bond market held steady for two more weeks. Investor concern increased following: (1) candid statements from the head of the Central Bank about his fears of a debt crisis; (2) the prime minister's announcement that tax collections were 26 percent below plan; and (3) reports of conflict between the Russian government and the IMF over policy for dealing with a growing fiscal crisis.

The Russian crisis accelerated rapidly on May 18. Foreign investors sold off Russian government bonds and securities, Russian banks failed to fill the gap, and interest rates rose rapidly to 47 percent. Bank liquidity had been greatly reduced by the elimination of tax offset certificates, which were used by banks to reduce their taxes, and by the termination of commercial bank handling of government payments. Both were parts of a broader reform program that, ironically, was being implemented just as the crisis appeared.

As the Russian stock market plummeted (off 17 percent for the week ending May 20, 1998 and 40 percent from January 1, 1998), the Central Bank raised the refinancing rate for GKOs held by private banks up to l50 percent and spent $1 billion in two days to defend the ruble. During the same week the fact that representatives of the IMF visited Moscow without announcing plans for a resumption of payments on the $9.5 billion loan to Russia was taken as a negative sign by investors. During the following week the GKO passed the 50 percent mark and on Wednesday, May 27, the government failed to sell enough to pay upcoming obligations. Stocks

[2] On Black Tuesday, Oct. 11, 1994, the ruble's value plunged 25 percent in a single day after the Russian Central Bank failed to intervene to support it.

dropped 11 percent in a single day, and only a dramatic (and temporary) increase of interest rates to 150 percent restored the market.

The crisis had arrived in earnest, with a serious threat of a run on the ruble. Devaluation was not an option, since inflation and other consequences would shake the confidence of the population and because it would do severe injury to Russian banks heavily burdened with short-term foreign currency debt. As the Central Bank had already spent heavily trying to prop up the ruble, and greater dependence on short-term debt would only increase the concern of foreign investors, the government's options had narrowed dangerously. At the same time, the huge rise in interest rates had further reduced hopes of economic recovery.

The aggressive and skillful management of this harrowing crisis during the ensuing eight days was impressive testimony to the abilities of the talented young Russian leaders. Investors were demanding 80 percent on bonds, and even a slight devaluation would have started a run on the ruble. One of the remaining hopes—that the sale of the last state-owned oil company, Rosneft, would bring substantial revenue—was disappointed on May 27 when no bids were submitted. Meanwhile the IMF was providing no help—neither talking of new aid nor acting on the delayed payment on the existing Russian loan.

The following eight days were key to the management of the crisis. Anatoly Chubais was sent to the West to seek support, and the prime minister met with foreign investors. On May 29 the IMF announced that it would disburse $670 million on the existing Russian loan. But despite a somewhat vague call for further Western aid by President Clinton on May 31, the stock market dropped an additional 10 percent on June 1, imposing further strain on banks heavily invested in the market and obliging the government to place one of the main banks, Tokobank, in receivership. On the same day, the government reassured markets by announcing plans to hold a second Rosneft auction at a price reduced by half a billion dollars. The success of the June 3 bond auction by the Russian Central Bank, which sold $1.25 billion in bonds in twenty-five minutes, provided some encouragement, but many of the bonds were for terms as short as seven days, and subsequent auctions throughout June and early July brought steadily rising interest rates on government bonds, reaching 120 percent in early July (up from 80 percent in late June).

It was clear that only major debt restructuring—the conversion of short-term debt to long-term—and drastic measures to reduce expenses and increase revenue, could prevent further deterioration of the financial situation. Plans were quickly prepared for aggressive reduction of state expenditures—an effort that proposed to pare expenses by an amount equal to the revenue deficit. Another important initiative was the appointment of the brilliant financier Boris Fyodorov to head the tax service. Fyodorov, a former World Bank representative and finance minister, and the successful manager of Russia's 1993 inflation crisis, was given a mandate to use firm measures to deal with tax evasion, rebuild the collection system, and push for the long-delayed tax law. This was doubtless the most reassuring initiative for the IMF and World Bank, which had long pressed for the matter of tax collection to be made the first priority of government fiscal reform.

Restructuring the state debt presented a formidable challenge in the crisis environment of mid-1998. The total debt was $200 billion, or 45 percent of GDP, a very moderate figure by international standards. Of that total, $130 billion was inherited from the Soviet era and had already been restructured, with annual interest payments of $7.2 billion, which comprised only 1.2 percent of the current GDP. The immediate problem was the short-term debt in GKOs. Of the total of $70 billion, $45 billion was held by state banks which would continue to hold them, leaving the $25 billion held by Russian private banks and foreign investors.

From mid-May through early July the Russian government managed to meet the cost of turning over its short term debt, but the relentless rise in interest rates, which reached 80 percent in late June and passed 100 percent in early July, was putting the ruble under heavy pressure and draining reserves.

The Crisis Program

Both the seriousness of the situation and the deep frustration of the leadership were evident in Boris Yeltsin's June 23 speech announcing the government's "anti-crisis program," which was designed to restore confidence in Russia's financial markets. Presented at a cabinet session to which many parliamentary deputies and business leaders were invited, the program's central feature was a series of previously announced measures to reduce the expenditures of the federal government by 42 billion rubles ($6.8 billion). The plan included heavy cuts in government employment and reduction of subsidies to industry, agriculture, and transportation. The program also proposed to bring off-budget funds, including the pension fund, into the federal budget, and to introduce revenue increases totaling $20 billion per year. New revenue was to be obtained by increasing the powers of the tax authorities, raising the land tax, and increasing penalties for illegal production of alcohol (which challenges the state monopoly and reduces revenue significantly).

The plan was obviously designed to make absolutely clear to the financial markets and the IMF that the Russian government was determined to reduce expenditures and increase revenue in order to restore confidence in Russian markets and protect the ruble. Yeltsin underlined his commitment by a veiled threat to use the presidential decree power if the Duma failed to pass the enabling legislation before the summer recess. The response from Zyuganov was to press forward his efforts to impeach the president. In previous weeks Zyuganov had stressed not only the impeachment plan, but the end to cooperation with the government, as well as support for strikes and other popular actions aimed to isolate and weaken the government. He balked only at the proposal of Viktor Ilyukhin, the communist chairman of the Duma Security Committee, on June 20 to use any means, "including illegal ones," to remove the Yeltsin leadership.

In this tense environment the announcement that the IMF had decided to release the delayed $670 million tranche of its loan was encouraging. But Russian leaders stressed the need for a $10 to 15 billion loan under the IMF's Supplemental Reserve Facility Program to stabilize the financial markets and to facilitate the reduction of government bond rates. Without this change, they noted, it would not be possible to reduce interest payments, encourage foreign and domestic investors and domestic saving, and reduce the huge gap between ruble and foreign-denominated lending rates

The final stage of negotiations began at the end of June and concluded with an agreement on July 12 in an atmosphere of increasing and dangerous crisis. As the negotiations proceeded, the interest rate on GKOs rose to 120 percent, and the stock market continued to fall, reaching 25 percent of its October level. The long-delayed project for selling the state-owned oil company, Rosneft, had failed for lack of investor confidence in the Russian economy, and the Central Bank was spending huge sums from its dollar reserves to defend the ruble. Rumors circulated about a probable uncontrolled devaluation, a bank collapse, dangerous social and political conflict, and the extension of the crisis to Ukraine and Kazakhstan.

Help Arrives

The protracted negotiations with the IMF delegation in Moscow were accelerated by the growing sense of crisis in early July. The Central Bank's hard currency reserves were increasingly being consumed as interest rates on treasury bills passed 100 percent and the fear of a massive devaluation of the ruble and collapse of the banking system, followed by renewed inflation and spreading social unrest, created a growing sense of crisis. Certainly the Western leaders had grown accustomed to financial crises over the previous year, but the strategic importance of Russia, and the concern about both the economic and political fallout from a financial collapse, created a special sense of urgency.

The precipitating event was the collapse of the GKO market on Wednesday, July 8, when even a 120-percent interest rate failed to secure adequate sales, a signal of pending financial collapse. Under pressure from the U.S. Treasury, the IMF moved quickly to negotiate a vast package of financial support that surpassed even the earlier Russian requests. The announcement came on July 13.[3]

Under the new program, Russia was promised a total of $22.6 billion in loans from the IMF, the World Bank, and Japan during 1998–1999—$14.8 billion in 1998 and $7.8 billion in 1999.[4] Of the total, $15.1 billion was to come from the IMF, $6 billion from the World Bank, and $1.5 billion from Japan. The United States agreed to loan the IMF $2.1 billion, and the remainder of the money came from Japan, Germany, France, and Saudi Arabia.

Anatoly Chubais, the responsible Russian negotiator, acknowledged both the length and arduousness of the negotiations, but proudly claimed the outcome as a sign of "restoration of faith in Russia's ability to overcome its difficulties."[5] The outcome was also the result of vigorous American support for IMF action which included a recommendation to double the financial package and a commitment of American funds.

After the success with the IMF, there remained the crucial question of the willingness of the Duma to approve the legislation required to implement the government's austerity program—the measures for reducing expenditures and increasing revenue. The extraordinary two-day session, which began just two days after the IMF announcement, proved immensely encouraging. The Duma rapidly approved key provisions of a new tax code and reduced the corporate tax rate to improve tax compliance. At the end of the first day of the two-day session foreign financial specialists appeared confident that a combination of new legislation and, as necessary, presidential decrees, would meet the requirements of the IMF Board meeting scheduled for July 20. The second day brought further progress, with the passage of a large number of laws suggested by the government's anti-crisis program, and further concessions to the government's position on sales and income taxes. Meanwhile, the dramatic rise of the Russian stock market (up nearly 20 percent in the five days following the IMF announcement) and the decline of bond interest rates indicated the positive view of events among Russian and foreign investors.

Where from Here?

How can one summarize the impact of the East Asian crisis upon Russia during the past nine months, and what are the prospects that the international support will be used to achieve financial stability and economic growth?

The impact of the East Asian crisis was to derail an incipient economic recovery and to precipitate an exceedingly dangerous financial crisis that threatened the major political and economic achievements of the Yeltsin era and exposed major weaknesses in the new system. It

[3] *New York Times*, July 14, 1998, p. A1.

[4] The loan package combined about $17 billion in new credit and more than $5 billion in already negotiated loans. *Radio Free Europe-Radio Liberty Newsline*, July 14, 1998.

[5] Ibid.

is exceedingly unlikely that the rapidly accelerating financial crisis of early July could have been halted, or the devastating consequences of a runaway ruble devaluation, bank collapse, and inflation avoided, without the major international financial aid announced on July 13. One might well ask, as recent critics have done, why IMF action was postponed so long, or why, without American pressure, it seemed likely to be inadequate.[6] At a minimum, there would appear to have been an inadequate assessment either of the seriousness of the crisis, or of what could realistically be expected of the terms the Russian government could meet, or both. It would be hard to find fault with the efforts of the Kiriyenko government.

It is indeed ironic that Prime Minister Kiriyenko and his cabinet received far more jeers than cheers from both the Russian and the Western press from the time of their appointment to their successful resolution of the financial crisis. Even in late May *The Economist* asserted that "Russia's biggest problem may well be a government that is incapable of solving problems even when it recognizes them."[7] The article goes on to describe the Russian government as "ineffectual" and "obstructive," adding to the already impressive list of deprecations of President Yeltsin in its pages. It should be clear by now that the removal of the Chernomyrdin government in March was both necessary and wise, and that the new government, particularly its core "government Council," is the most talented, and the most consistently reformist in membership, of any government since 1992. It should be equally clear that the package of loans recently provided to Russia, as well as the skillful management of the financial crisis during the long period of waiting for outside support, were the result of clear-headed analysis and planning by the government. Certainly the substantial resources awarded Russia were a recognition of its enormous strategic importance, but they were also an expression of confidence in its government.

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The tasks ahead—the completion of the financial stabilization and the creation of an environment favorable to domestic and foreign investment, the reduction of the size and cost of the state apparatus and budget, extensive tax reform, the meeting of wage and pension obligations, and many others—are still daunting. But while many problems remained to be solved, there are also major advantages in the Russian situation. In comparative terms the state debt is relatively small, and Russia, because of its enormous store of natural resources, can be assured of a continuing and substantial merchandise trade surplus. Once the reformed financial system is operative, interest rates are realistic, and investors can be confident of favorable taxation and legal protection of their investments, there is certain to be a rapid expansion of the Russian economy. Another advantage is the large sums of money available by trimming the state budget. The vast state bureaucracy alone—doubled since the end of the Soviet period—readily lends itself to considerable reduction.[8]

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[6] The controversy on this issue has just begun to appear in the press (see, for example, "The Bailout of the Kremlin: How U.S. Pressed the I.M.F.," *New York Times*, July 17, 1998, p. A1). Critics of the IMF point out that the response to the Russian crisis was slow, that the crisis was allowed to run without adequate response to the brink of financial collapse, and that investors' perception that it was not going to act decisively aggravated Russia's debt marketing problems. They also argue that the cost of the bailout was larger than it would have been if a strong response had come earlier.

IMF representatives have insisted that their tenacity in negotiations gained needed commitments from the Russian government to reforms designed to avoid a future crisis.

[7] *The Economist*, May 30, 1998, p. 70.

[8] There is a very thorough treatment of this issue in *Russian Economic Trends, Monthly Update*, July 2, 1998, published by the Working Centre for Economic Reform, Government of the Russian Federation, Russian European Centre for Economic Policy.

On the negative side, the Duma majority continues to oppose the government's efforts to secure private property in land, some key revenue measures, and many measures needed for expansion of foreign investment in the Russian economy. The latter was evident in its July 16 amendments to a law on production sharing agreements that restricted foreigners to acquisition of no more than 20 percent of Russian natural resources through such agreements, and no more than 20 percent of so-called "strategic natural resources." Legislative restrictions were also increased by mandating approval of production sharing agreements by regional legislatures as well as federal agencies, and requiring special laws for production sharing agreements on important national resources. The Duma also passed a resolution calling for submission of all of the bailout agreements to the parliament for ratification, a requirement the government is most likely to reject. Critics noted that such measures were certain to deter rather than attract foreign investors, which is certainly the aim of most of their sponsors. During the weekend following the Duma session, however, President Yeltsin signed measures that quadrupled tax on most land. He also vetoed parliamentary laws that would have lowered tax revenues by billions of rubles, and restored 60 percent of the revenue that had been cut.[9]

Despite the inadequacy of the Duma actions, the board of the IMF, in an unusually long session on Monday, July 20, endorsed a $17 billion allocation to Russia, of which the IMF is responsible for $11.2 billion.[10] The decision contained a warning for the Duma, however, by reducing the first payment to $4.8 billion from $5.6 billion. The difference was to be delivered when the Duma provided the tax and tax collection measures stipulated in the original IMF commitment. Additional pressure on the Duma was provided by the need to meet these requirements for delivery of the second $5.6 billion loan installment, due in September. Even before the IMF action, the exchange of $6 billion in short-term ruble treasury bills for dollar-denominated longer-term bonds had begun.

The lack of Duma cooperation in meeting the IMF demand is, of course, consistent with other obstacles that body has created for the completion of the Russian conversion to a modern market economy, and it will continue to be a major factor in the Russian political-economic equation. It is an expression of the ideological legacy of the past that has greatly complicated the years of economic transition, adding to the already heavy burdens upon the Russian population.

The impact of the Asian economic collapse has extended and increased those burdens, and Russian voters—like voters everywhere—tend to blame the sitting government for their problems, a habit opposition politicians are only too willing to exploit. With parliamentary elections due in 1999, and a presidential election in 2000, there is little time left to provide tangible evidence that the government's policies can produce economic recovery. For what is at stake is not just the replacement of one government by another sharing broadly similar commitments to an established political and economic system. The overwhelming majority of the political opposition in the Russian Duma is not a "loyal opposition" in the Western democratic sense. The communist and ultra-nationalist leadership of that group, which has so consistently blocked or deformed the policies of the Yeltsin government, seeks an electoral mandate radically to modify, or to reverse, those policies.

The IMF and the World Bank, supported by the United States and other states, have been both generous and wise to support of Russia's leadership in the current crisis. And while it is true that the extended impact of the East Asian economic crisis thwarted an earlier economic turnaround, and created a very dangerous Russian economic crisis, it is also true that from the crisis has emerged an extraordinarily strong and cohesive reform leadership with greater understanding and support from its proper international partners. In that important sense the incidental victim of the East Asian economic crisis has emerged a victor in a major battle, but others lie ahead. ■

[9] Michael R. Gordon, "Parliament in Russia Fails to Pass Bills Tied to Loans," *New York Times*, July 18, 1998, p. 4.
[10] David E. Sanger, "IMF Backs $17 Billion for Russia, but Delays First Payment," *New York Times*, July 21, 1998, p. A3.