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Asian Financial Crisis: An Analysis of U.S. Foreign Policy Interests and Options

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ABSTRACT

The sharp fall in the currencies and stock markets of a number of East Asian economies since July 1997 has the potential to damage a range of U.S. regional and other foreign policy interests, in addition to the expected detrimental effects on U.S. economic growth and the trade deficit. The principal focus of this report is on the foreign policy ramifications of the Asian financial crisis and U.S. options for addressing them. Other CRS products address the economic situation in the affected countries and impact on the U.S. economy, specific issues concerning the IMF programs, and the proposed IMF quota increase and New Arrangements to Borrow (NAB.) This report tracks and analyzes the efforts of the most seriously affected Asian countries to deal with their economic and financial problems, and their interaction with the International Monetary Fund (IMF), the United States, and other major sources of financial support and policy advice. It also addresses the implications of the crisis for such U.S. interests as regional stability and the prevention of conflict, trade liberalization, and U.S. regional and global leadership, and discusses the principal factors that could influence the duration and severity of the crisis. A final section considers options for Congress in the context of various criticisms of the IMF's stabilization programs and the operations of the Fund itself. The report also includes a discussion of the pending FY1998 supplemental appropriations request for the IMF's New Arrangements to Borrow (NAB) and quota increase, as addressed in **H.R. 3114** (authorization), **H.R. 3579** (Senate-passed appropriations), and **H.R. 3580** (House-reported appropriations.) The report will be updated in response to major developments or the accumulation of lesser developments that materially affect the analysis.

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Summary

The sharp fall in the currencies and stock markets of a number of East Asian economies since July 1997 has the potential to damage U.S. regional and other foreign policy interests, in addition to the expected detrimental effects on the U.S. economy, including slower growth, falling exports, and a rising trade deficit. As of mid-April 1998, the currencies of the most affected Asian countries appeared to have stabilized at about 60%-70% of their mid-1997 values against the U.S. dollar, with the exception of the Indonesian rupiah, which continues to hover at about 25%-35% of its pre-crisis value. Although some observers also see the crisis bringing potential benefits in the form of economic reforms and pressures for more democratization, even the most optimistic analysts agree that the process will a long term one, at best.

One of the most important non-economic impacts on U.S. interests could be a rise of political instability in countries whose leaders have largely based their legitimacy on promoting rapid economic growth and an expanding economic "pie." If growth continues to decelerate, existing social class, regional, ethnic, and religious fissures may widen in a number of countries. These developments may be exacerbated by austerity and economic reforms required by the International Monetary Fund (IMF) in return for financial rescue packages, leading to a nationalist backlash against economic globalization as well as a rise in anti-American feeling. Alternatively, some analysts express hope that the crisis may provide an opportunity for "creative destruction," i.e., the adoption of much needed structural reforms, including greater accountability and transparency in banking systems, and more open markets. Most, however, agree that economic distress in a number of countries will cause at least temporary setbacks for regional trade liberalization.

While the crisis does not appear to pose direct risks to U.S. regional security interests, a prolonged economic decline could fuel nationalism, undermine regional cooperation, and foster confrontation over long-standing territorial and other disputes. More than half of Persian Gulf oil shipments pass through key Southeast Asian straits and the disputed Spratly Islands, and the region is also a major oil and gas exporter in its own right. South Korea's economic problems could significantly complicate U.S. efforts to resolve Korean Peninsula issues. Some also see the crisis working in the longer term to enhance China's status and influence.

Congress has addressed the issue primarily through hearings and a pending FY1998 supplemental appropriations request for new IMF borrowing authority and a quota increase, totaling \$17.9 billion. Members tend to be divided between those who emphasize the importance of containing the crisis and using the IMF's leverage to promote economic reforms and market opening, and those seek to make the availability of U.S. funds contingent on the adoption of specific reforms, on the part of both the borrowing countries and the IMF itself. As of early April 1998, the most restrictive of two supplemental appropriations bills — that reported to the House — contains limitations on the release of funds for the IMF that the Administration views as unworkable. The IMF funding measure may also become burdened by an anti-abortion amendment that the Administration says will lead to a veto.

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Asian Financial Crisis: An Analysis of U.S. Foreign Policy Interests and Options

Background to the Crisis

The Asian financial crisis began last July when foreign bankers, investors, currency speculators, and market analysts lost confidence in Thailand's ability to cope with a deteriorating balance of payments situation and a growing international debt that had reached 50 % of Gross Domestic Product (GDP.) After depleting its hard currency reserves to counter speculative attacks on the baht, which had been pegged to the U.S. dollar, the Thai government had little choice but to let the currency find its own level. The resultant plunge in the baht set off a wave of currency devaluations that soon swept through Indonesia, Malaysia, and the Philippines, and to a lesser extent, Singapore.



On August 20, 1997, Thailand entered into an agreement with the International Monetary Fund (IMF) for an emergency stand-by credit of about \$3.9 billion under the Fund's Emergency Financing Mechanism in exchange for the adoption of stringent fiscal austerity and a range of structural reforms, starting with the financial sector. Additional loans from the World Bank and the Asian Development Bank, and credits from Japan, Australia, China, Hong Kong, Singapore, and other Asian trading partners boosted the total package to as much as \$17.2 billion. The United States initially treated the Thai problem as primarily a regional concern and decided not to participate directly.¹

¹Paul Blustein, Thailand Seeks IMF Bailout to Shore Up Its Financial System. *Washington Post*, July 19, 1997: A11; Michael Vatikiotis, Pacific Divide. *Far Eastern Economic Review*, Nov. 6, 1997: 14-16; CRS Report 97-1021, *The 1997-1998 Asian* (continued...)

The sharp fall of South Korea's currency in October 1997 set off a second wave of devaluations in East Asia, including the free fall of the Indonesian rupiah, which initially had remained relatively stable. South Korea and Indonesia joined Thailand in seeking assistance from the IMF and back-up financing from major economic partners, including Japan, the United States, and Singapore.

In the face of mounting bankruptcies on the part of companies and financial institutions in Southeast Asia and South Korea, and alarming disclosures about the extent of private sector short-term foreign borrowing, foreign investors dumped regional stocks and foreign lenders stopped rolling over their short-term loans. Companies and individuals throughout East Asia rushed to exchange their local currency for dollars to cover foreign debts and protect their savings. The unchecked decline of Asian currencies and asset values compounded the crisis by effectively multiplying the burden of foreign debt service obligations.

By mid-December, the chain reaction of collapsing currency and stock prices in Asia appeared to be on the brink of spreading to the broader international financial system. In late December and early January, however, the risk of contagion appeared to abate — for the time being at least — as the result of an accelerated transfer of \$10 billion to South Korea from the IMF, the United States, Japan, and other sources, and a tentative agreement by major western and Japanese banks to roll-over some of the short-term loans to South Korean companies that were at risk of default.

Economists and financial analysts differ somewhat over the exact causes of the collapse of currency and stock values and the likely severity and length of the setback for East Asia's much vaunted economic dynamism. While each economy's situation is distinct, most explanations for the crisis center around a combination of factors, the most important being (1) an over-reliance on short term foreign borrowing by business enterprises and banks; (2) over-investment in real estate; (3) inadequate supervision of financial institutions; (4) politically influenced allocations of credit to unsound companies; and (4) declining terms of trade for countries whose currencies have been pegged closely to the U.S. dollar, which has been strengthening against the Japanese yen during the past year.²

Unlike past crises affecting Mexico and Latin American countries, the Asian crisis was not the result of runaway government spending or unmanageable public debt, but primarily one involving the private sector. Government complicity lay largely in policies that encouraged the allocation of bank credit to politically favored companies and other variations of state-centered "crony capitalism," and the failure to adequately regulate the financial sector.

¹(...continued)

Financial Crisis, by Dick K. Nanto. Updated March 6, 1998:7.

²For more details, see CRS Report No. 97-1021 E., *The 1997-98 Asian Financial Crisis* [by Dick K. Nanto]. Updated March 6, 1998. p. 16-31.

Consequences of the Freer Flow of Capital

Many of the excesses on the part of Asian banks, finance companies, corporations, and governments would not have been possible except for the comparatively recent globalization of capital markets. By one estimate, 90% of international transactions were accounted for by trade before 1970, and only 10% by capital flows. Today, despite a vast increase in global trade, that ratio has been reversed, with 90% of transactions accounted for by financial flows not directly related to trade in goods and services.³ Most of these flows have taken the form of highly volatile portfolio (stocks and bonds) investment and short-term loans.

Credit is a vital lubricant of every modern economy and companies everywhere gain leverage by using borrowed funds to finance investments in productive assets. In East Asia in recent years, however, businesses, banks, and finance companies unwisely piled up short-term foreign debt on the unfounded assumption of never-ending growth and over-confidence in the ability of their central banks to maintain stable exchange rates. This phenomenon was facilitated during the 1990s by the liberalization of previous controls on foreign exchange transactions and private international borrowing in most Asian countries, and by the existence of a significant differential between the relatively low interest rates charged by U.S., European, and Japanese lenders, and the comparatively high domestic interest rates for local currency borrowing. The interest rate gap encouraged Asian banks and finance companies to borrow low cost foreign currency and re-lend the funds in local currency at comparatively high rates of interest, thereby profiting from the spread, but exposing themselves to exchange rate risk.

In general, financial sector liberalization in Asia was not accompanied by the creation or strengthening of domestic institutions to monitor and regulate banking systems. More often than not, the vast inflows of investor funds and bank loans from Japan, Europe and the United States totaling hundreds of billions of U.S. dollars were plowed into speculative property development and excess manufacturing capacity. When profit expectations were undermined by adverse developments such as a glut of office space and hotel rooms, growing competition from lower cost production in China, or the collapse of computer chip prices, business bankruptcies soared and foreign lenders and investors withdrew their funds.⁴

The foreign debt problem was aggravated in several countries by a mountain of non-performing domestic debt. In magnitude, the non-performing Asian domestic debt has been estimated by David Hale, Chief Global Economist at Zurich Kemper Investments, in Chicago, at 20% to 25% of outstanding bank loans in Thailand, 10% to 20% in South Korea, and 5% to 10% in other regional countries, not counting

³James A. Kelly, *East Asia's Rolling Crises: Worries for the Year of the Tiger*. Center for Strategic and International Studies (CSIS) Pacific Forum, PacNet #1, Jan. 2, 1998.

⁴In testimony before the House Banking and Financial Services Committee on November 13, Federal Reserve Chairman Alan Greenspan noted with understatement that "In retrospect, it is clear that more investment monies flowed into these economies than could be profitably employed at modest risk." Testimony before the House Banking and Financial Services Committee, Nov. 13, 1997.

Japan. Chinese banks also suffer from bad-loan problems in the range of 20% or more of total lending, mostly owed by money-losing state-owned enterprises (SOEs), but China's currency is not readily convertible, and most of its foreign debt is long-term. Despite recent adverse trends, China still has a substantial current account surplus and sizeable hard currency reserves.⁵

Crisis Partially Made in Japan

Taking a long view, some analysts see the current crisis as the outcome of a failure by Japan to effectively address the root cause of its own economic and financial problems. In a sense, it is argued, an economic "bubble" that built up in Japan in the late 1980s and burst in the early 1990s, reemerged in the rest of Asia as a result of the failure of the Japanese Ministry of Finance (MOF) and the Bank of Japan (BOJ) to take the necessary steps to liquidate hundreds of billions of dollars worth of non-performing loans. Rather than forcing Japanese banks to sell assets to cover their losses or take the politically unpalatable step of using public funds for a financial system bailout, as the United States did to deal with its savings and loan crisis of the 1980s, the MOF in effect made it possible for banks to disguise the decline of their assets and to continue to make profitable but risky loans to the fast growing Asian economies. By one account, Japanese lending to Asia alone rose from \$40 billion in 1994 to \$265 billion in 1997, much of it for speculative property investment and other doubtful purposes.⁶

Similarly, some analysts also judge that the Japanese finance ministry has aggravated the problem with an expansionary monetary policy that generally has kept the yen undervalued and exports and resultant trade surpluses at a high level. In particular, it is argued, the decline in the official discount rate from 6% in 1991, to 0.5% at present, made it compellingly attractive to Japanese banks in effect to recycle the country's export-generated surplus dollars to the fast growing Asian economies.⁷ Other analysts find the Japanese connection circumstantial at best, and note that European and American banks were also large lenders to Asia.⁸

The problems of Southeast Asian countries also were exacerbated by economic growth differentials between the United States and Japan, which had contributed to a year-long appreciation of the dollar against the yen. Since Southeast Asian currencies were "pegged" within a narrow band to a basket of currencies dominated by the dollar, their exports became comparatively more expensive. By the summer of 1997, foreign investors began to have doubts about the ability of Thailand and other Southeast Asian countries to repay their loans and maintain the existing value of their currencies. These concerns sparked a flight from the Thai baht and other

⁵Estimate by Brookings Institution Fellow, Nicholas R. Lardy.

⁶Ron Chernow, Grim Reckoning in Japan — and Beyond. Op Ed, *New York Times*, Nov. 17, 1997: A29.

⁷Martin Feldstein, Japan's Folly Drags Asia Down. 6 Wallstreet (online service), Nov. 26, 1997.

⁸Douglas Ostrom, Japan and the Asian Economic Crisis: Part of the Solution or Part of the Problem. Japan Economic Institute, *JEI Report*, No. 8A, Feb. 27, 1998: 3-6.

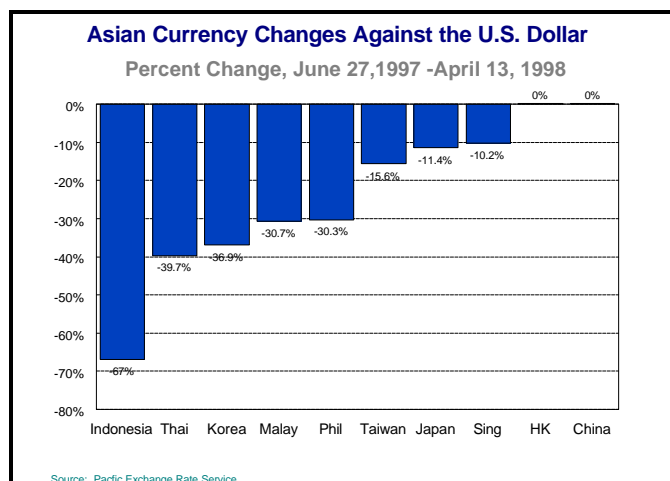
Southeast Asian currencies, and a reluctance on the part of foreign banks to roll over loans or advance new credit to governments and private industries in economies that were increasingly strapped for foreign exchange.

Impact of Competition from China

Competition from China also played a significant role in the weakening export growth of the newly industrializing Southeast Asian countries. By about 1992 China had become the hottest target for Japanese and other foreign investors due to its comparatively high skilled, low cost labor force, and its extensive investments in economic infrastructure. China's rising attractiveness to foreign manufacturing investment pitted it in direct competition with other Asian producers for the same export markets. A devaluation of China's currency, the renminbi, in 1994 directly undercut the exports of the newly industrialized countries of Southeast Asia, especially Thailand, Malaysia and Indonesia, putting steadily increasing pressure on their balance of payments and foreign exchange reserves.

Scale and Scope of the Crisis

The sharp decline in currency and stock prices has affected almost every Asian country, but thus far has fallen hardest on South Korea and Southeast Asia's newly industrializing economies (NIEs) — Thailand, Indonesia, Malaysia and the Philippines. South Korea's brush with financial collapse in mid-December sent a new round of shock waves and currency devaluations through Southeast Asia. By the end of 1997, the currencies of South Korea, Thailand, and Indonesia had lost half of their value against the dollar as measured against June 30, 1997 exchange rates, while the currencies of the Philippines and Malaysia had dropped by about 35%. Most currencies rebounded somewhat in the first three months of 1998, stabilizing at about 60%-70% of their pre-crisis values, except for the Indonesian rupiah. The Indonesian currency has continued to hover erratically at about 25%-35% of its former value amidst growing political turmoil and resistance by the Suharto government to the IMF's reform program.



Currencies in Asian countries with larger reserves of hard currency and/or better regulated financial systems have suffered significantly less, but their economies are nonetheless under stress from declining rates of export and economic growth, rising bankruptcies, and depressed real estate and equity markets. Hong Kong has thus far successfully defended its

dollar against speculative attack, but the necessary rise of interest rates has caused a sharp fall in property and stock prices. Taiwan, which has strong exports and large reserves of hard currency, has seen its currency drop by about 15%-16%, while Singapore, with strong regulation of banks and property investment, has suffered a 10% currency decline as of mid-April 1998.

Continuing Uncertainty and Instability in Indonesia. Since early 1998 Indonesia has emerged as the principal locus of international concern. As of early April, the Suharto government had concluded its third successive agreement with the IMF and had only begun to address the two most critical challenges — stabilizing the banking system by closing unsound banks and strengthening sound ones, and promoting an orderly rescheduling or write-off of some \$74 billion in private debt.

The confidence of both foreign and domestic lenders and investors has been severely shaken by a rearguard action by President Suharto to fend off many of the conditions that the IMF attached to its \$43 billion rescue package, especially macroeconomic policy targets that were to be achieved largely by suspending or terminating major state-dominated infrastructure projects, and other conditionality aimed at curtailing domestic trade and import monopolies and cartels identified with the President's family members and friends, and eliminating costly subsidies of basic commodities.

In effect, the Suharto government has confronted the Fund and its main supporters, the United States, the European Union and Japan, with a difficult choice between simply providing liquidity to Indonesia, with the risk that the funds would fail to suffice for want of necessary reforms, or holding out for strict adherence to the agreed-upon reforms at the risk of an escalating political and domestic economic crisis that could spread to the rest of Southeast Asia. As of mid-April 1998, the IMF had largely stood its ground, but with certain concessions aimed at alleviating the effects of severe problems of unemployment, soaring inflation, and serious food shortages.

Long time Indonesia hands see the Indonesian president's recalcitrance as not just a matter of personal stubbornness or excessive nationalism, though both of these are factors. It has also been seen as stemming from unrealistic expectations that the original agreement with the IMF would lead to the immediate restoration of foreign confidence, as well as a realistic appraisal that the reforms demanded by the Fund and major economic partners attacked the very basis of the regime's political support. Once the President realized that simply agreeing to the IMF's program would not restore confidence in the rupiah, the agreement with the IMF seemed like a bad bargain.⁹

The battle with the IMF was joined with President Suharto's 1997-1998 draft budget, which he unveiled in early January 1998. The plan substantially exceeded the IMF's current account and budget surplus targets, even with unrealistic economic assumptions that it used, and failed to reduce fuel and certain food subsidies

⁹This is the gist of arguments made by a number of Indonesian experts at two round table discussions at the annual meeting of the Association for Asian Studies (AAS) in Washington on March 27 and 28, 1998.

(excluding diesel oil and rice, which had already been exempted.) Instead of austerity, the budget provided for a 32% increase in spending, including funding for 12 major infrastructure projects that the government had earlier agreed to cancel or suspend.

President Suharto appeared to give way in mid-January after a showdown in Jakarta with the IMF's Deputy Managing Director, Stanley Fischer, Deputy Treasury Secretary Lawrence H. Summers, and other IMF and U.S. officials, and phone calls from President Clinton and other world leaders. Suharto and IMF Managing Director Michel Camdessus signed a revised letter of intent on January 15, 1998. The Indonesian president reluctantly amended the draft budget to bring it in line with the revised IMF program, and agreed once again to cut off funding for 12 infrastructure projects associated with his family and friends.

The revised Indonesian program contained a number of concessions to criticisms that the IMF's original program was too severe. It allowed the government to run a one-percent central budget deficit instead of the one-percent surplus required in the original letter of intent. It also put more emphasis on accelerating structural reforms and strengthening the banking system, and allowed a more gradual phasing out of fuel and electricity subsidies, with the exception of kerosene and diesel fuel subsidies, which were already exempted. The revised program allowed not only the maintenance of essential social safety net programs, already permitted in the first program, but also the expansion of community-based rural work programs in areas of severe drought, and other measures to promote a cost-effective expansion of rural infrastructure and employment, and expanded education and medical care.¹⁰

Despite the IMF's concessions, Suharto again threw down the gauntlet by proposing a highly controversial currency board system and firing his well-regarded, American-educated, central bank governor, who reportedly opposed the plan. The currency board plan would have tried to peg the rupiah at 5,500 to the dollar — to be maintained by central bank currency exchange transactions and a rigid requirement that the money supply expand and contract in proportion to hard currency reserves. The reported brainchild of Johns Hopkins economist Steve Hanke, a consultant to the Indonesian president, the proposal drew immediate criticism from nearly all quarters as wholly unworkable given the current parlous state of Indonesia's hard currency reserves, and potentially disastrous to the economy.¹¹

Suharto also disturbed foreign and many domestic analysts by selecting Research and Technology Minister, B. J. Habibie, a long-time confidant who is sometimes described as the president's "seventh child," as his vice-presidential running mate. Habibie has been the moving force behind many of the government's more visionary industrial projects, such as the expensive effort to develop a national aircraft industry,

¹⁰International Monetary Fund, Statement by the Managing Director on the IMF Program with Indonesia. News Brief No. 98/2, Jan. 15, 1995

¹¹David E. Sanger, Risking I.M.F. Aid, Suharto Dismisses Central Banker. *New York Times*, Feb. 18, 1998: A1, D5.

and he reportedly holds highly unorthodox economic views that tend to reinforce the president's own drift towards economic nationalism.¹²

The test of wills between the IMF and Suharto intensified in early March during the 11-day session of the a special expanded parliamentary body that meets every five years to elect a president. Although there was not the slightest doubt that the largely hand-picked People's Consultative Assembly would reelect him, the President seemed determined to bolster his image and restore his prestige by appearing to stand up to foreign pressure. Judging that the Indonesian government was moving too slowly to implement reforms, the IMF decided on March 6 to delay until at least April the disbursement of a pending \$ 3 billion, second tranche of its credit program, originally scheduled for March 15. Reportedly, the IMF had decided to await the President's reelection and designation of a new cabinet before reengaging with him on the issues in dispute.¹³

The People's Consultative Assembly duly reelected President Suharto to his seventh term on March 11, amidst non-violent anti-government demonstrations at the main universities in Jakarta, Bandung, and Yogyakarta, and spreading food riots. The President reportedly demonstrated his customary purposeful and confident demeanor during his acceptance speech, but struck a somber note, telling Indonesians that they would never again enjoy the rapid growth that had taken place during the past 25 years.¹⁴

As if to underscore his disdain for both domestic and foreign critics, Suharto named an ethnic Chinese golfing partner and head of the timber cartel, Mohammad "Bob" Hasan, as trade minister, and made his daughter "Tutut" (Siti Hardiyanti Rukmana) as social affairs minister. The appointment of a close confidant Faud Bawazier as finance minister, replacing a well-regarded technocrat, reinforced the impression that the president was gearing up for further confrontation with the IMF and foreign creditors.¹⁵

In early April the Indonesian government and the IMF came to terms on a revised program. Reportedly, the plan allows Indonesia to run a higher budget deficit than previously planned, in order to cover the cost of socially stabilizing food and fuel subsidies, but it also requires extraordinarily high interest rates in order to bolster the value of the rupiah. According to press accounts, the Indonesian government has agreed to move more quickly to restructure the banking system, including the closure of some banks controlled by his family and close associates, and to enter into talks with foreign banks regarding the rescheduling of the private sector debt. Unlike past

¹²John McBeth, Soaring Ambition. *Far Eastern Economic Review*, Jan. 29, 1998: 14-16.

¹³Sander Thoenes, Rupiah Falls As IMF Delays \$3 bn Credits for Indonesia. *Financial Times*, March 6, 1998: 22.

¹⁴Seth Mydans, Tighten Belts, Suharto Tells His People, It's All Over. *New York Times*, March 12, 1998: A8.

¹⁵Indonesia's New Cabinet May Deepen IMF Rift. *Wall Street Journal*, March 9, 1998: A1, A14.

agreements, the new accord provides for the release of IMF stabilization funds in small monthly increments, based on the fulfilment of commitments by the Indonesian government.¹⁶

South Korean Currency Collapse and Subsequent Stabilization. South Korea, the most industrialized among the affected countries, has been battered by numerous bankruptcies among major banks and industrial conglomerates (*chaebol*) and a devastating drop in its currency and stock market. In late December the Korea Development Bank abruptly withdrew a \$10 billion bond offering after rating services lowered its sovereign debt to “junk bond” status,¹⁷ and concerns mounted in international financial markets that default by South Korean companies on more than \$100 billion in short-term loans would destabilize the global financial system. Initial installments from a multi-year, \$57 billion IMF rescue package, the largest ever organized for any country, appeared inadequate to cover South Korea’s needs.

The situation appeared to abate at the end of December as a result of a hastily organized “Christmas present” of \$10 billion in accelerated funding from the Japan and the United States, and an agreement by major U.S., European, and Japanese banks — reportedly orchestrated by the Clinton Administration — to roll over about \$15 billion in loans that were coming due within the next month.¹⁸ Foreign and domestic confidence also gained a boost from the victory of opposition leader Kim Dae Jung in mid-December elections, and his vigorous efforts to persuade the South Korean population of the need to carry out sweeping reforms, however painful these might be to both the *chaebol* and unionized workers.

As of early April 1998, South Korea still appeared on a recovery path, but analysts have pointed to continued medium and long term challenges. At the end of January 1998 foreign lenders agreed to reschedule \$24 billion in pending short-term loan repayments, giving the South Korean government some breathing space and reducing the risk of default, but still leaving companies with seemingly unmanageable short-term debt levels.¹⁹ Essentially, the rescheduling only covered about one-sixth of South Korea foreign debt, leaving open the question of whether the country and its companies can attract new foreign capital. Also, while the trade balance improved dramatically during the last quarter, the gain was based on a slump in imports, including items critical to export manufactures. Moreover, with 45% of its past exports to similarly distressed Asian countries, the overall prospects for an export-based recovery remained questionable. Although South Korea posted its largest ever monthly trade surplus in March 1998 — \$3.7 billion — the good news for the country’s hard currency reserves was based on export growth of only 7% and a

¹⁶David E. Sanger, After Compromises, Indonesians Reach 3rd Pact With I.M.F. *New York Times*, April 8, 1998: A1, A8.

¹⁷Steve Mufson, South Korea Takes Three More Punches. *Washington Post*, Dec. 23, 1997: C1, C2.

¹⁸Paul Blustein, \$10 Billion in Loans Rushed to S. Korea. *Washington Post*, Dec. 25, 1997: A1, A32.

¹⁹Charles S. Lee, Aftershocks Rumble. *Far Eastern Economic Review*, Feb. 26, 1998: 56.

decline in imports of 35.8%. Some question whether this pattern will be sustainable, since South Korea must import many of the raw materials and components that go into its exports.²⁰ Private investment and economic research institutions have predicted an absolute decline in economic output for 1998, a punishing departure from recent growth rates averaging 8% per annum.

While his show of leadership and self-confidence impressed has both his compatriots and foreign observers, South Korea's new president, Kim Dae Jung, still faces a host of difficulties. On the plus side, President Kim successfully negotiated a historic "grand national compromise" with labor unions that gave companies more flexibility in dismissing workers in return for expanded union organizational and political rights.²¹ On the negative side, the chaebol continue to resist government efforts to reform and restructure their operations, including consolidations aimed at promoting more specialization and greater transparency in their financial operations, and still benefit from preferential bank lending.²²

These problems notwithstanding, many South Koreans took heart from a highly successful sale of \$4 billion in government bonds in early April. Even though the South Korean bonds are still judged as less than investment quality, actual orders totaled \$12 billion — three times what was offered. Analysts viewed the response to the offering constituted a vote of confidence by investors in South Korea's reform efforts.²³

Japan On the Edge. Japan's problem is not primarily with its currency — which many judge has been deliberately undervalued as a result of Japanese monetary policy since 1995 — but a massive overhang of non-performing debt in its banking system that has kept the economy in the doldrums for most of the decade. Apart from a short-lived growth surge in 1996, Japan has averaged less than one-percent real GDP growth since 1991. An unofficial reestimate of the problem loan situation by the MOF and the BOJ on December 5, 1998, indicated that the combined total of shaky and bad loans could amount to as much as \$790 billion at prevailing exchange rates — nearly three times the long-standing official figure.²⁴ The ministry subsequently released an official figure, calculated on a different basis, of \$575 billion. Even these figures are doubted by private analysts due to the lax standards for

²⁰*Japan Digest*, April 2, 1998: 2-3.

²¹Charles S. Lee, Kim Turns Up the Heat. *Far Eastern Economic Review*, Feb. 19, 1998: 61.

²²Ryusuke Hashimoto, South Korean Chaebol Saying "No Deal." *Nikkei Weekly*, Feb. 16, 1998: 18; Stephanie Strom, Foreigners Buy Korea Stock but Not Companies. *New York Times*, April 17, 1998: C1.

²³Kenneth N. Gilpin, Investors Snap Up Korea Bonds in a Big Vote of Confidence. *New York Times*, April 9, 1998: D1, D6.

²⁴Jon Choy, Japanese Banks to Restructure, *Japan Economic Institute (JEI) Report*, No. 46B, Dec. 12, 1997: 4-8.

reporting and the various ways that problem loans can be disguised by weak banks.²⁵

The total bad loan problem is significantly larger than the U.S. savings and loan problem both in absolute terms and as a share of GNP.

Japanese banks are the largest holders of Asian debt, both performing and non-performing. Although some of this exposure reportedly has been reduced in the months before the crash, Japanese banks held \$83.9 billion in debt from Thailand, Indonesia, and South Korea, the three most ailing economies, as of the end of 1996. In all, Japanese banks had loaned \$265 billion to Asia, or 40% of their total foreign lending, as of 1996.²⁶

Despite extraordinarily low interest rates of less than one-percent, the precarious situation of the banking system has inhibited the ability of Japanese banks to make new domestic loans, creating a condition popularly called *kashishiburi* (roughly translates as “credit crunch.”) The squeeze has especially affected small businesses and helped push male unemployment to the highest level (3.7%) since records were kept.²⁷

Out of concern that a liquidity crisis would drive otherwise sound businesses to bankruptcy, the Japanese Ministry of Finance (MOF) in late December 1997 postponed temporarily the imposition of new capital requirements that were intended to bring Japanese banks into line with international capital adequacy standards as established by the Bank for International Settlements. The postponement of the new standards only applies to domestic banks, which can continue to maintain a 4% capital/assets ratio. Banks that are active internationally still have to meet the new 8% requirement. While this move may alleviate a growing credit crunch, it further undermines the faith of international investors in the ability of the MOF and the political leadership to make the hard decisions that are required to deal with the banking system mess.

During February and March 1998 the Japanese government took a number of steps to recapitalize the banking system and protect depositors’ assets, but the initiatives have received mixed reviews from foreign and domestic analysts and commentators. A bill proposed initially by a ruling Liberal Democratic Party (LDP) panel in mid-December 1997, and passed by the Diet with unusual speed on February 16, 1998, earmarks some \$250 billion to recapitalize weak banks and protect depositors’ funds. Nonetheless, many have expressed concern that Japan has not yet dealt with the underlying causes of its banking sector problems, and that instead of relying on the market to work through the problem, the government has greatly

²⁵Reportedly, the Ministry of Finance found it necessary to release more realistic figures to persuade the Diet (parliament) to go along with an unpopular plan to use public funds to bolster the banking system. Sandra Sugawara, Japan’s Lawmakers Get Stabilization, Tax Cut Proposals. *Washington Post*, Jan. 13, 1998: D1, D2.

²⁶Eric Altback, The Asian Monetary Fund Proposal: A Case Study in Japanese Regional Leadership. *JEI Report*, No. 47A, Dec. 19, 1997. P. 5; Appendix Table 3.

²⁷*Japan Digest*, March 2, 1998: 5.

increased its already strong role and shut out both would-be foreign and domestic investors.²⁸

Implications for U.S. Regional and Foreign Policy Interests

The Asian financial and economic crisis has implications for a range of U.S. regional, foreign policy and international economic interests, and potentially for U.S. regional security interests. Some argue that these are actually more significant than the still modest domestic economic impact of the crisis.²⁹ In a larger sense, the U.S. response to the situation is likely to have a direct bearing on perceptions of American leadership and U.S. standing in Asia.

U.S. Interests in Regional Stability and Democratization

The Asian economic crisis has significant potential for negative impact on political stability in East Asia. Most Asia governments, regardless of their political systems, have come to depend on delivering rapid economic growth as the main underpinning of their legitimacy. For Southeast Asian governments, rapid growth has helped find jobs for a fast growing urban population and satisfied the material aspirations of the burgeoning and politically important middle classes, thus maintaining an uneasy social and political stability. By one accounting, Indonesia needs 6 % annual growth to absorb 2.7 million new entrants into the labor force every year, whereas the economy is likely to undergo an absolute decline in 1998, with a sharp rise in unemployment and attendant social strains.³⁰ Predictably, food riots and anti-Chinese demonstrations, as well as university-based anti-government protests have steadily grown during the first three months of 1998.

For emerging democracies such as South Korea and Thailand, growth averaging 8 % per annum in recent years has generally dampened serious regional and other socioeconomic fissures, kept a lid on labor unrest, and expanded the ranks of the middle classes. A sharp fall from past growth rates may heighten regional and social class tensions, and undercut democratic institutions.

Political instability need not be an inevitable consequence of the financial meltdown, but scenarios for unrest are not difficult to imagine. In several Southeast Asian countries, instability could take the form of retribution against Chinese ethnic

²⁸Douglas Ostrom, Tokyo Unveils Two-Part Bank Rescue Plan. *JEI Report* No. 1B, Jan. 9, 1998: 1-4; _____, New Bank Program Progresses Amid Rising Criticism, *ibid.*, No. 10 B, March 13, 1998: 1-3.

²⁹Teresa Wysomierski, Recalculate the IMF's Value. *Journal of Commerce*, April 1, 1998: 7A. For further information on the possible impact on the U.S. economy see CRS Report 98-284 E, U.S.-East Asian Economic Ties: Impact of the Asian Financial Crisis. March 20, 1998 [by William H. Cooper.]

³⁰G. Bruce Knecht, Asia Shudders at "Normal" Growth. *Wall Street Journal*, Dec. 5, 1997: A13.

minorities, which make up a small part of the total population, but control the vast bulk of the wealth and commercial enterprises. Violence between the majority population and the Chinese minority wracked Indonesia in 1965, at the cost of hundreds of thousands of lives — mainly ethnic Chinese. Malaysia experienced serious ethnic rioting in 1969 following a contested national election outcome, which spilled over into Singapore, with its predominantly ethnic Chinese population, as well. Several other potential sources of social unrest lie just beneath the surface in the region, including the growth of Islamic fundamentalism in Malaysia and Indonesia and widespread unemployment among high school and university graduates in the Philippines. In addition, a number of Southeast Asian countries have experienced uncontrolled urbanization and a growing urban-rural income gap that has provided the potential for social conflict.³¹

Distress in Indonesia or in certain economically depressed parts of other countries could also threaten regional stability and cause intraregional tensions. Malaysia, for instance, is host to hundreds of thousands of illegal Indonesian workers. Among these are some who claim to be political refugees, such as those from a long-simmering separatist movement among ethnic Acehnese from the island of Sumatra, across the Straits of Malacca from the Malay peninsula. On March 26, 1998, several hundred mainly Acehnese Indonesians rioted when Malaysian authorities carried a mass deportation of illegal immigrants, reportedly leaving eight immigrants and a policeman dead as a result of the confrontation.³² On April 10, eight Acehnese immigrants entered the U.S. Embassy compound in Kuala Lumpur, Indonesia, seeking political asylum. With the ongoing slowdown of the Malaysian economy, and the government's plan to expel 200,000 illegal Indonesian immigrants by August 15,³³ more such clashes can be expected. Many of those expelled will manage to return again, much in the same way as illegal immigrants who are sent back across the U.S.-Mexican border, and both Malaysia and Singapore fear a tidal wave of job-seeking boat people from Indonesia if conditions there should continue to worsen.

Malaysia's Social Compact Potentially at Risk. Malaysia's stability could also be endangered because of the impact of an economic slowdown on the delicate social balance between the indigenous Malay majority and ethnic Chinese Malaysians who account for about 30% of the population. Severe ethnic riots in 1969 nearly tore the country apart. Since the early 1970s, the Malaysian government has promoted ethnic peace by carrying out an affirmative action program for the traditionally less educated, more rural, ethnic Malay majority. The Chinese largely have accepted Mahathir's "New Economic Program" and their own political marginalization because rapid economic growth has taken much of the sting out of programs that favor the Malays. A sharp economic slowdown could intensify the competition for jobs and government contracts, leading to rising ethnic tension. In the end, these

³¹See analysis along these lines in a survey article, *The Next Battle*, *Far Eastern Economic Review (FEER)*, Nov. 20, 1997: 18-28.

³²Malaysia Riots Kill 8 Immigrants and an Officer. *New York Times*, March 27, 1998: A4.

³³*Washington Post*, April 11, 1998: A10; *ibid.*, April 12, 1998: A20.

developments could upset the country's fragile social compact and undermine the umbrella party status of the ruling United Malays National Organization (UMNO.)

For the time being, Malaysia's social and political stability seems likely to remain intact. Although the government revised its 1998 growth forecasts downward to 2%-3 % in late March, one-third or less of recent levels,³⁴ analysts rate the country's economic fundamentals as sound. These include a fiscal surplus, low (but rising) inflation and low external debt, and a high savings rate. Moreover, while Prime Minister Mahathir bin Mohamad has railed at foreign speculators for causing the precipitous decline in Malaysia's currency, his Deputy Prime Minister and Minister of Finance, Anwar Ibrahim, presumably with the Prime Minister's support, has quietly engineered pragmatic economic policy adjustments, including an 18% cut in government spending for FY1998, that have reassured the local business community and international lenders.³⁵ Some analysts worry, however, that the government is focusing too much on shoring up politically favored businesses and giving the appearance of normalcy, while failing to adequately liberalize the financial sector and strengthen the banking system.³⁶

Potential Accelerated Succession Crisis in Indonesia. In Indonesia, the world's fourth most populous country, the crisis has raised new questions about the competence and stability of the government headed during the past 32 years by President Suharto. The reelection of President Suharto on March 11 has not dispelled the possibility of a change of leadership before the end of his seventh five-year term, given the scale and scope of Indonesia's problems, Suharto's age and reported health problems, and rising discontent with his rule. The collapse of the rupiah has led to unusually direct criticism of the government by opposition leaders and technocrats, and food shortages have sparked riots in three towns in the eastern part of Java, the country's most densely populated and most politically important island, as well as similar outbursts in several other islands, and non-violent but unusually vocal demonstrations by students at major universities throughout the country.

Until the economic crash, the military-backed Suharto regime generally had received good marks from economists and development experts for maintaining strong growth and spreading its benefits to a wide spectrum of the population. In recent years, however, its image has frayed considerably due to high level corruption, including financial scandals involving the president's family, the repression of a populist opposition party led by the daughter of Indonesia's first post-independence leader, and its heavy-handed suppression of the long-festering rebellion in East Timor, a former Portuguese colony forcefully occupied by Indonesia in 1975. Many experienced Southeast Asian scholars feel that corruption has gotten worse in recent

³⁴Sheila McNulty, Malaysia Cuts Economic Growth Forecasts. *Financial Times*, March 25, 1998: 8.

³⁵Chen May Yee, Malaysia Unveils More of Austerity Plan. *Wall Street Journal*, Dec. 9, 1997: A19.

³⁶ *Financial Times*, March 25, 1998, op. cit.

years, and have described the state of affairs as resembling the government of President Ferdinand Marcos, in the Philippines, in its last years.³⁷

While many analysts have questioned President Suharto's willingness to carry out reforms that threaten the structure of his patronage-based government, the political maneuvering that preceded his reelection demonstrated that at present those who may be dissatisfied with his leadership have no viable alternative. This equation could change, however, were the military to decide that he had become a net liability to national cohesiveness or the institutional interests of the Army itself. The likelihood of such a change would be greatest if the urban middle classes — who heretofore have sided with the forces of law and order — were to identify with more radical students and unemployed urban workers and directly protest against rising prices and falling incomes. This scenario could become more credible if moderate Islamic parties and leaders were able to give more structure to the opposition to Suharto, thereby reducing middle class fears of political chaos or rampant populism.

Even without a major political upheaval, Indonesia's small Chinese minority — perhaps 3 % of the population — could become the scapegoat target of a violent backlash, since most of the countries failing banks and conglomerates are Chinese-owned. In early January 1998, one prominent international financial analyst, David Hale, of Zurich Kemper Investments, in Chicago, warned of the possibility of an "ethnic pogrom" against the Chinese minority in Indonesia if the financial crisis leads to a political breakdown.³⁸ Reportedly, Chinese money is already flooding into Singapore's real estate market out of concern that the country may experience a replay of the 1965 period.³⁹ This flight of Chinese capital has created an angry reaction among the ethnic Indonesian majority, who have questioned the patriotism of the Chinese minority. Thus far, however, there appears to be no concerted movement against the ethnic Chinese on the part either of the regime, the military, or the political opposition.

Finally, many observers doubt that rural villages can absorb the millions of urban workers now without jobs, and argue that structural changes in the Indonesian economy suggest that the growing ranks of the unemployed will become a permanent and volatile part of the scene in Jakarta and other large cities and towns. Some analysts recently returned from Indonesia forecast growing social and political tensions both in rural areas, which have lost a steady flow of remittances from recent urban migrants, and in the urban areas themselves, where the jobless are fighting for survival.⁴⁰

³⁷A number of prominent U.S. and foreign scholars expressed this view at two panel discussions at the March 26-29, 1998, annual meeting of the Association for Asian Studies (AAS), in Washington, DC..

³⁸Paul Blustein and Sandra Sugawara, *Rescue Plan for Indonesia in Jeopardy*. Washington Post, Jan. 7, 1998: A15.

³⁹Paul Blustein, U.S., IMF Assurances Not Quelling Doubts on Indonesia. *Washington Post*, Jan. 14, 1998: A14.

⁴⁰This was the assessment of a number of scholars who participated in two discussion (continued...)

Politically Volatile Setback to Thailand's Aspirations. Successive rounds of currency devaluations have rocked Thailand, the country in which the crisis originated, and brought it to a political crossroads. A constitutional monarchy and an on-off-again-on-again parliamentary democracy, Thailand regained a democratic government in mid-1992, after angry middle class citizens took to the streets and forced the reversal of a 1991 military coup. The current crisis has suddenly impoverished many among the emergent middle and professional classes in Thailand, and sent urban workers back to their homes in the countryside, with few prospects for employment.

On the positive side, the financial collapse led to the resignation of the widely disparaged government of Prime Minister Chavalit Yongchaiyudh, which the *Economist* described as having "been seen as unusually corrupt and incompetent, even by the standards set by some of its predecessors."⁴¹ The crisis also tipped the political balance in favor of a new constitution, the sixteenth since the establishment of a constitutional monarchy in 1932, whose provisions aim at reducing political corruption, increasing accountability and transparency, and establishing minimum educational credentials for elective office. Notably, the Army kept to the background but lent its weight to adoption of the new constitution, as did the King, who still wields great influence. The new Prime Minister, Chuan Leekpai, leader of the formerly opposition Democratic Party and a previous prime minister (1992-1995), has been praised for bringing back into the administration the technocrats who had guided Thailand's economic takeoff during the late 1980s.

Many observers expect that the financial collapse which has devastated Thailand's economy will exacerbate existing fissures in the society. Potential sources of trouble include a severe urban-rural income gap, a restive urban labor force, a suddenly impoverished middle class, and a potential political backlash by ethnic Thais against the minority of assimilated ethnic Chinese, who largely control the economy.

More positively, some analysts judge that the effect of crisis will fall less heavily on the still largely subsistence rural economy, and that agricultural exports, boosted by the currency devaluation, will partly offset the decline of other sectors.⁴²

Overall, Thailand has received praise for making a good start on shoring up its financial system, but doubts remain about its ability to export its way back to economic vitality. Chuan received a boost from a state visit to Washington in early March, during which he received a warm welcome from President Clinton and other U.S. officials, and had an opportunity to explain his policies to the business community. More concretely, the Clinton Administration helped ease Thailand's fiscal problems by agreeing to the cancellation its \$250 million contractual obligation to purchase of eight F/A-18 fighter aircraft, which will now be bought by the U.S.

⁴⁰(...continued)

panels at the AAS annual meeting in late March, 1998.

⁴¹Thailand: Reaching for the Moon. *The Economist*, Sept. 20, 1997: 45-46.

⁴²Michael Vatikiotis and Khon Kaen, The Good Earth. *FEER*, Oct. 23, 1997: 20-21.

Marine Corps, and offering up to \$1 billion in Export-Import Bank trade credits and \$400 million in OPIC investment insurance.⁴³

The IMF tacitly endorsed Thailand's efforts in delivering the third of four quarterly installments of its \$17.2 billion rescue package in late February. As in the case of Indonesia, the Fund reportedly agreed in the latest letter of intent to relax its previous fiscal austerity requirement in recognition of the potentially destabilizing effects of the economic slowdown. In return to a broader commitment to privatization the Fund agreed to allow Thailand to run a 2% budget deficit, instead of the 1% surplus contained in the original agreement.⁴⁴

Ongoing Uncertainty in the Philippines. The stability of the Philippines may also be in doubt because of the intersection of the financial crisis with an already uncertain political situation. President Fidel Ramos, who generally has earned good marks for putting the Philippines on a growth path after long being regarded as the "sick man of Asia," cannot succeed himself under the Philippines constitution. While Ramos' reforms have boosted growth, they have also further widened an already large income gap between the rich and the middle classes, on the one hand, and the large mass of Filipinos living in deep poverty, on the other. Comparatively speaking, the Philippines has suffered less than its neighbors, partly because it had less far to fall, but the impact on those below the poverty line has been severe.

Because the odds-on favorite for the presidency in May 11 elections, Vice-President Joseph Estrada, espouses a populist agenda that sounds hostile to globalization, some analysts have questioned "whether democratic politics and globalization can coexist in a developing country like the Philippines."⁴⁵ Others have taken encouragement from the emergence of two challengers in the field of 76 candidates, a wealthy businessman and former governor of Cebu, Emilio Osmena, and the Mayor of Manila, Alfredo Lim, but also concern about a possible polarization of politics along regional and linguistic lines.⁴⁶

Potential for Advancing Democratization. The impact of the crisis on political stability may not be wholly negative. Some analysts project that the crisis will have a healthy effect on the prospects for democracy and better governance. They cite the effective mobilization of angry middle classes in Thailand in support of a new constitution, the partial reining in of President Suharto's children in Indonesia, and the election of long-time democracy advocate Kim Dae Jung in South Korea as signs of a healthy reaction against the "Asian values" arguments for authoritarianism. According to this line of argument, recent failures of economic management by

⁴³Paul Blustein, Thai Leader Given Warm Welcome, \$1.7 billion in Aid. *Washington Post*, March 14, 1998: A19.

⁴⁴Paul M. Sherer, Thais Signal Commitment to IMF: Slowing Economy is Recognized. *Wall Street Journal*, Feb. 25, 1998: A19.

⁴⁵Nayan Chanda, Blown Away: 1997; the Year in Review. *Far Eastern Economic Review*, Dec. 25, 1997 & Jan. 1, 1998: 24.

⁴⁶Rigoberto Tiglao, Late Surge. *Far Eastern Economic Review*, March 5, 1998: 23.

governments that exhibit varying degrees of authoritarianism will be a boon for democratic values and greater accountability.⁴⁷

Two realities raise questions about the validity of this view. First, some previous limited steps towards more democracy in several Asian countries have, in the opinion of many analysts, led to setbacks for good economic management, as political leaders, seeking to boost their popularity, have promoted unwise economic policies. Most notably, it is argued that Thailand's economic management suffered from an excess of populism and corruption after the parliamentary elections of 1992 — i.e., beginning with the first administration of current Prime Minister Chuan Leekpai, but especially his two successors, Banharn Silapa-archa, once described as “the quintessential rural machine-patronage politician,”⁴⁸ and the discredited Chavalit Yongchaiyudh. Partly in response to the conventional wisdom that national politics has been corrupted by the influx of rustic machine politicians since the 1992 democratic opening, the new Thai constitution includes minimum educational qualifications for legislators.

Democracy has been riding high since the election of President Kim Young Sam in South Korea, the once persecuted opponent of dictatorial military rule, but the country's initial democratic opening did not produce an effective government. President Kim Young Sam, the country's first popularly elected President and a would-be reformer, failed badly. He was widely criticized for political ineptitude and economic mismanagement, and for following a vacillating policy towards the North. Moreover, because of the impending December 1997 presidential election, the South Korean national assembly had balked at passing important financial reform measures and thereby deepened the crisis.

The second reality is that the short term consequences of the crisis could include considerable social and political conflict, especially in the more authoritarian regimes such as Indonesia that lack the institutions for a smooth political transition. Commenting on the replacement of the discredited Chavalit government with the coalition headed by Chuan Leekpai, a senior Thai political leader noted that the ability of Thailand to achieve a smooth power transfer in response to an economic crisis was the result of political openness, but that the same result “probably could not be expected in other countries of the region.”⁴⁹ Even in this instance, some analysts believe that the Chuan government may be the last chance for elected politicians.

Implications for Regional Trade Liberalization

The Asian financial crisis raises serious questions about the prospects for opening up regional markets to U.S. exports, a major and long-standing U.S. foreign

⁴⁷For an argument along these lines, see Keith B. Richburg, *Across Asia, Stirrings of Democracy*. *Washington Post*, Dec. 16, 1997: A1, A18. See Also Thomas L. Friedman, *Thailand's New Song*. *New York Times* Op Ed, Dec. 15, 1997: A29.

⁴⁸Daniel E. King, *Thailand in 1995: Open Society, Dynamic Economy, Troubled Politics*. *Asian Survey*, Vo. 36, No. 2 (February 1996): 136.

⁴⁹Michael Vatikiotis, *High Hopes*. *FEER*, Nov. 20, 1997: 24, 28.

policy. On the positive side, at the November 1997 APEC meeting in Vancouver, the leaders agreed to put nine industrial sectors covering global trade totaling \$1.5 trillion on a fast track to tariff reductions in pursuit of the established goal of regional free trade by 2010 for the industrialized countries and 2020 for the developing countries.⁵⁰ While the Asian financial crisis inevitably dominated the agenda and discussions, many observers took comfort in the fact that the affected countries did not seek to backtrack from their previous commitments.

The conditionality imposed by the IMF for its emergency credits includes requirements that recipient governments end the kinds of collusive practices that have brought about the current crisis, and which have the effect of giving special advantages to favored domestic producers and monopolies, and open up their economies to foreign trade and investment. These are over and above more basic requirements to put their banking and financial systems in better order, achieve budget surpluses, and — somewhat contradictorily — reduce their trade deficits. For instance, the IMF's program for South Korea requires that Seoul agree to a WTO compatible timetable to remove export subsidies and restrictive import licensing, remove arbitrary regulatory barriers to imports, and raise the ceiling on foreign ownership of Korean stock shares.⁵¹ The IMF program requires Indonesia to reduce tariff and non-tariff barriers, and eliminate certain import and marketing monopolies, among other trade-related structural changes.⁵²

In the longer term, these developments may pay large dividends in the reduction of trade and investment barriers. In the shorter term, however, the affected Asian countries face hard choices. On the one hand, they need to satisfy the market opening objectives of the IMF, foreign lenders, and investors, who view liberalization as a spur to greater economic efficiency. To do otherwise, would jeopardize the very basis for their previous rapid economic growth. On the other hand, they feel a strong desire to pursue policies that they calculate will minimize business failures and preserve employment in sensitive industries and economic sectors, including counter-recessionary government spending and measures — both formal and informal — to discourage imports.

Implications for Regional Security

Even the worst case possibilities for domestic instability in Asian countries do not necessarily pose direct threats to U.S. security interests, but the indirect threats could be significant should affected countries undergo destabilizing internal political turmoil. In his January 27, 1998, State of the Union address, President Clinton asserted a strong linkage between stability in Asia and U.S. security interests. According to a National Defense University publication, more than half of the world's

⁵⁰*USIS Washington File*, Transcript: 12/10 Amb. Wolf Worldnet on Vancouver APEC Results. Dec. 11, 1997.

⁵¹IMF Approves SDR 15.5 Billion Stand-By Credit for Korea. IMF Press Release No. 97/55, Dec. 4, 1997.

⁵²IMF Approves Stand-By Credit for Indonesia. IMF Press Release No. 97/50, Nov. 5, 1997.

shipping passes through the straits of Malacca, Sunda, or Lombok, and past the Spratly Islands, including well over half of the world's supertankers.⁵³

A political breakdown or armed power struggle in Indonesia could engulf Singapore and other regional states in a wave of refugees, embolden regional separatists, or reawaken irredentist claims on Malaysia's states on Borneo, Sabah and Sarawak. A internal Indonesian conflict theoretically could interrupt the free passage of commercial vessels and U.S. Navy ships through the important Sunda and Lombok straits, and jeopardize the safety of thousands of expatriate Americans and billions of U.S. investment. An interruption of oil production in Indonesia could possibly disturb oil markets. Ironically, though, the current depressed price of oil in global markets is itself a threat to the economies of the Southeast Asian oil exporters.

For now, most regional conflict scenarios arising out of the financial crisis still appear far-fetched. In mid-February, in the Malaysian capital of Kuala Lumpur, Prime Minister Mahathir Mohamad and Singapore's Prime Minister Goh Chok Tong pledged to strengthen ties and resolve outstanding disputes during a reportedly warm meeting -- the third such session in a month's time.⁵⁴ In general, the ASEAN countries have largely shelved their territorial disputes with each other, and these likely would be reawakened only in a worst case situation in which assertive nationalism replaced thirty years of ASEAN cooperation. Some analysts worry more that China might seek to exploit the distraction of the Southeast Asian countries and the postponement of their military modernization programs to seize territory in the contested Spratly Islands. Thus far, China seems to have used the crisis to make a show of support and regional leadership, not aggrandizement.

If the crisis were to lead to internal ethnic conflicts in one or more Southeast Asian states, however, these could have wider consequences. For instance, an outbreak of ethnic conflict in Malaysia, might cause Singapore to intervene militarily to protect the Chinese minority, which is heavily represented in Johore State, just across the strait. Apart from other significant implications for U.S. security interests, a conflict between Malaysia and Singapore could create an untenable situation for the U.S. naval and air force personnel at the facilities that they currently use on a semipermanent basis, including the former British naval base at Sembawang, on the Strait of Johore.

Perhaps more likely is the possibility that American security interests on the Korean Peninsula, where the United States has deployed 37,000 troops, could be jeopardized by South Korea's financial problems. Early in the crisis, some U.S. officials and private analysts expressed concern that North Korea might seek to take military advantage of South Korea's problems. This possibility seems to have faded, if for no other reasons than North Korea's continuing food shortages and economic prostration, the Pyongyang regime's presumed awareness of the near certainty that serious aggression would lead to a devastating American military response. Tensions

⁵³John H. Noer, Southeast Asian Chokepoints: Keeping Sea Lines of Communication Open. *Strategic Forum*, No. 98, December 1996, Institute of National Strategic Studies. Table 1, p. 3. These data are for 1993.

⁵⁴Oon Yeoh, Malaysia to Keep Water Tap Open. *Nikkei Weekly*, Feb. 23, 1998: 23.

have also lessened since the installation of the Kim Dae Jung administration in Seoul, which has made considerable progress in creating a dialogue with Pyongyang.

A less direct, but more likely, threat to American security interests is the possibility that South Korea may be unwilling or unable to play its expected role under a U.S.-North Korea nuclear accord of October 1994, thus jeopardizing U.S. nonproliferation objectives. Under the U.S.-DPRK Agreed Framework, the Clinton Administration agreed to organize the supply of two 1,000 megawatt light water nuclear reactors (LWRs) in return for North Korea's commitment to freeze its existing nuclear program and eventually open up all of its facilities to international inspection. South Korea has informally committed itself to assume about 60 % of the \$5-6 billion estimated construction cost, and a South Korean company is the prime contractor. The overall project is being carried out by the multilateral Korean Peninsula Energy Development Organization (KEDO), but the U.S. is the ultimate guarantor of the project, subject to congressional approval.

Despite various provocations towards the South by Pyongyang, the North Korean regime has met the minimum conditions laid down for moving ahead with the first phase of the project, and KEDO is ready to begin construction. No serious work can begin, however, until South Korea provides about \$150-200 million for initial construction activities.⁵⁵ Even before the economic crisis ensued, it was unclear how the South Korean government would mobilize the requisite political capital to persuade the National Assembly to approve funding for a project that remains highly controversial. Now, although President Kim Dae Jung has expressed his support for the project, his political opposition controls the national assembly. Because of South Korea's financial situation, it is unclear where the funds will come from, even if the political will is present. If the project stalls, however, North Korea might react by refusing to abide by its nuclear freeze, or committing new provocations against the South or American interests.

The financial problems of U.S. friends and allies in Asia also seem likely to adversely affect security cooperation and result in some cancellations of arms purchases from U.S. defense contractors, thus impeding regional military modernization programs. Reportedly, South Korean defense officials have indicated their desire to negotiate some relief from the nearly \$400 million annual dollar cost of Seoul's host nation support of U.S. forces.⁵⁶ Several countries reportedly already have canceled or postponed major purchases of U.S. weapons systems.⁵⁷ As noted above, Thailand has officially been relieved of its obligation to purchase eight F/A-18

⁵⁵North Korea must also enter into a nuclear cooperation agreement with the United States, which will require it to clear up uncertainties about its suspected diversion of nuclear material, before any sensitive components or materials are delivered. For further background, see CRS Report No. 97-356 F, *The U.S.-North Korea Nuclear Accord of October 1994: Background, Status, and Requirements of U.S. Nonproliferation Law* [by Richard P. Cronin and Zachary S. Davis.]

⁵⁶South Korea: U.S. Official Cohen to Bring 'Mixed Bag' of Gifts, Demands. Seoul, *The Korea Times* (Internet version) in English, 0719 GM, Jan. 19, 1998.

⁵⁷Charles Aldinger, U.S. Defense Secretary Sets 11-Day Asian Visit. *Reuters*, Jan. 6, 1998.

aircraft. Some see the arms cutbacks as benefitting China's presumed ambitions for regional hegemony,⁵⁸ while others may view the cancellations as a welcome reduction in what they see as a budding Southeast Asian arms race.

Last but not least, U.S. alliance relationships could also be affected adversely if the United States fails to show leadership, or if its leadership appears to Asian allies to be narrowly geared to protect the financial interests of U.S. banks and investors. In this respect, Asian allies and other affected regional countries will most certainly be concerned if Congress does not support funding for the IMF or restricts the ability of the Clinton Administration to provide bilateral loans from the Exchange Stabilization Fund. Such concerns could create doubts regarding the credibility of U.S. security commitments. Providing reassurances on issue seemed to be a major purpose of Secretary of Defense Cohen's swing through the region in January.

Implications for U.S. Influence vis-a-vis Japan

For a time after the initial collapse of the Southeast Asian currencies, it appeared that Japan would move aggressively to fill a void that had been created by a generally passive response to the crisis by the Clinton Administration. Unlike the case of Mexico's debt crisis, the United States Government initially declined to take the lead in organizing a rescue of Thailand, and only committed funds to assist South Korea and Indonesia when the crisis spread and deepened.

In contrast with the relatively small commitment of U.S. funds, Japan deployed substantial resources in support of the beleaguered economies. Tokyo's commitments and contributions have included \$ 4 billion for Thailand, \$ 5 billion for Indonesia, a \$10 billion commitment to the IMF-led \$57 billion package for South Korea, contingent on the deployment first of loans from the IMF and other international financial institutions, and a \$1.3 billion "bridge" loan to Seoul pending the receipt of the IMF funds.⁵⁹

Japan also initiated a short-lived bid to play the role of a regional financial leader. In September 1997, at an IMF meeting in Hong Kong, Japan's Finance Minister proposed a \$100 billion Asian Monetary Fund to stabilize Asian currencies. The plan was widely thought to be the brainchild of a senior official of the Ministry of Finance, who is well-known for touting the virtues of Japan's bureaucratic-led economic model and criticizing the western, market-centered economic orthodoxy promoted by the IMF and the World Bank.

The Japanese never spelled out the exact contents of the plan, but the goal appeared to be to provide an alternative to the IMF's intrusive fiscal austerity and structural reform conditionality. Despite backing by Malaysia, however, the idea failed to gain support at a meeting of APEC deputy finance ministers in Manila in late November 1997, although the officials agreed to a U.S.-backed compromise involving

⁵⁸This view was expressed by one participant in a January 13, 1998, CRS workshop on Southeast Asian security issues.

⁵⁹*Japan Digest*, Dec. 4, 1997: 3; Jathon Sapsford, Japan Makes Big Bridge Loan to South Korea. *Wall Street Journal*, Dec. 19, 1997: A13.

the establishment of a supplementary “second-line” Asian fund, based on voluntary commitments from Asia-Pacific economies, for deployment should the IMF’s resources prove inadequate. Both the United States and the IMF itself had lobbied hard against the AMF proposal, on grounds that a lack of conditionality would remove the necessary incentives for reform and create a “moral hazard” problem -- i.e., the continued provision of risky loans under the assumption that defaults would be made good by taxpayer funds from unaffected countries.⁶⁰

Japan’s opportunity to expand its regional influence was further undercut by the decision of the Clinton Administration in the fall of 1997 to take a more direct role in addressing the crisis. After standing in the wings while Thailand’s first devaluation played out, the Clinton Administration in late October committed \$3 billion in “second-line” support for a \$37 billion rescue plan for Indonesia, and played a leading role at a meeting in Manila of Asia-Pacific finance ministers. In December, and once it was satisfied that South Korea would adopt the necessary financial and structural reforms, the Administration committed \$5 billion to support South Korea, and agreed to accelerate the delivery of funds. In late December the U.S. Treasury Department also played a key role in getting U.S., European, and Japanese banks to agree to roll over some \$24 billion in short-term loans to South Korea and, in March, the United States rectified its earlier stand-off attitude towards Thailand by extending trade credits and investment insurance.

In sum, after assuring itself that the affected countries were willing to adopt the IMF’s required reforms, and after verifying the need for more funds than those available to the IMF from its own resources, the United States emerged as still the most influential power and the only one with the ability to assert clear leadership. As one analyst noted, “For all the complaints about Washington’s bullying Asia, the U.S. is Asia’s largest export market and the key to maintaining regional peace.” Rather than taking the lead from the United States, Japan’s bid to promote an Asian Monetary Fund simply served as a catalyst to get the United States engaged. When the United States weighed in, it was the single most important influence on IMF policy.⁶¹

Japan has been handicapped in its effort to play a regional leadership role by its own financial system headaches and sluggish economy, and the fact that Tokyo would not or could not do what the Asians most desired — stimulate its own economy and open up its markets further to its neighbors’ exports. Prime Minister Hashimoto of Japan reportedly informed Malaysia’s Prime Minister Mahathir and other Asian leaders in mid-December that Tokyo lacked the ability to lead the region out of its problems unilaterally, and that without a central role for the IMF neither the IMF nor other countries would offer the necessary aid⁶² At a first-ever summit of 12 regional leaders in Malaysia, Hashimoto explained that Japan could not expand its

⁶⁰Edward A. Gargan, Asian Nations Affirm I.M.F. as Primary Provider of Aid. *New York Times*, Nov. 20, 1997: D2.

⁶¹Bob Davis and G. Pierre Goad, Asia Reaffirms U.S. Primacy on Bailouts. *Wall Street Journal*, Nov. 20, 1997: A16, A18.

⁶²*Japan Digest*, Dec. 15, 1997: 1.

imports of Asian goods because of its own economic problems.⁶³ Japanese aid, while impressive, fails by a large measure to compensate for the increase in the effective debt burden caused by the fall in the Asian currencies, and its efforts have been widely viewed as largely aimed at protecting the interests of Japanese banks.

The reassertion of U.S. economic and financial leadership can be a two edged sword. Asians widely view the United States as a key force in the economic globalization phenomenon because of its long-standing efforts to lower barriers to trade, investment, and capital flows. Japan, meanwhile, generally has played a strong role in generating export-led growth in Asian countries while working within, rather than challenging, existing trade barriers and requirements for local content in foreign manufacturing operations. Since many in Asia see the current situation as largely a consequence of too much liberalization, too fast, the U.S. role in leading the region out of the crisis is likely to be more critically evaluated than the response of Japan.

Factors Influencing the Duration and Severity of the Crisis

The ultimate implications for U.S. regional and foreign policy interests may depend on the duration and severity of the crisis and the perception of Asian countries of the U.S. role. Several factors may influence the duration and severity of the crisis. All but one of them are substantially outside American control, but several are susceptible to U.S. influence.

The Responsiveness of Affected Asian Governments to the Need for Structural Reform and Greater Financial System Transparency

It goes almost without saying that a longer term solution to the region's problems can only be found if the affected governments carry out reforms that will eliminate the practices that contributed to the crisis in the first place. This will require an enormous amount of political will and nerve, since some reforms such as better accountability and transparency in the financial system inevitably will further dry up credit and cause additional bankruptcies. More basic structural reforms, such as reducing the role of bureaucratic and political influence in the allocation of credit, and reducing formal and informal trade barriers, will inevitably damage powerful vested interests. To date, South Korea and Thailand have earned good marks from the IMF and other foreign benefactors, while Indonesia has continued to teeter on the edge of a total economic breakdown. Malaysia, on its own, has adopted some of the fiscal measures and reforms that might have been required had Kuala Lumpur found it necessary to seek IMF assistance.

⁶³James Kynge, Economic Clouds Darkened Summit Skies. *Financial Times*, Dec. 17, 1997: 6.

Japan's Success in Addressing its Economic Problems

Perhaps the single most important substantive determinant will be Japan's success in dealing with its bad loan problem and attendant credit crunch, and finding a way to regain an economic growth path. On an exchange rate basis, Japanese GNP has constituted about 75% of the East Asia region's total output in recent years. Thus a comparatively modest increase in Japan's growth rate could substantially raise its imports of Asian goods and thereby help its neighbors to revitalize their shattered economies.

As of the spring of 1998, some Japanese and foreign analysts saw Japan on the edge of a "malign" deflationary spiral. Reportedly, U.S. economic officials have become "deeply worried that Japan's deflationary problems are gaining dangerous momentum," with the possibility that the economy will be sent "spiraling rapidly downward."⁶⁴ Skepticism abounds, also, regarding the government's plan for a "big bang" financial sector deregulation and other administrative reform and deregulation initiatives.

The Hashimoto government has taken a number of significant, but thus far unsuccessful steps to revitalize the Japanese economy and address the country's massive banking system problems. These include a partial reversal of what many have criticized as an overly restrictive fiscal policy and the aforementioned commitment of \$250 billion to shore up the banking system. In early April 1998, shortly before the G-7 financial ministers meeting, the Prime Minister unveiled a \$124 billion economic stimulus package, the fifth, and largest yet, since October 1997.

As the new fiscal year began on April 1 Japan faced a gloomy economic future, with the highest male unemployment rate since records began to be kept and a dispirited corporate sector. Efforts by the ruling LDP and the finance ministry to boost the stock market through the announcement of the latest economic stimulus plan, and stock purchases using public trust funds, appears to have misfired. Many analysts criticized the fact that the plan was heavy on "pork barrel" public works spending, and only provided vague, and temporary, tax cuts totaling \$30 billion over a two year period.

In general, the Hashimoto government's measures have been judged inadequate by most Japanese and western analysts. The finance ministers of the Group of Seven (G-7) industrialized democracies, meeting in London in late February 1998, barely concealed with diplomatic language their impatience with Japan for failing to take more effective steps to resuscitate its ailing economy. On the eve of the February 21, 1998, meeting U.S. Treasury Secretary Rubin commented to reporters that "As we all focus on these questions of what to do in Asia, probably nothing is more important than Japan getting back on a path of strong domestic-led growth."⁶⁵ On April 9 Secretary Rubin indicated less than an enthusiastic response to the latest spending and

⁶⁴Sandra Sugawara, Fears of Deflation Rising in Japan. *Washington Post*, March 14, 1998: D1, D9.

⁶⁵Patrice Hill, Japan's New Plan to Fix Economy Disappoints G-7. *Washington Times*, Feb. 21, 1998: A5.

tax proposals, welcoming the move but noting “what is crucial is that Japan move quickly to put in place a strong program.”⁶⁶

The most severe reaction has come from the markets. While the government openly aimed at boosting the market to above the 18,000 level on the benchmark Nikkei 225 index, the fiscal year ended with the Nikkei index at 16,500. The index fell to 15,750 the following day, after the release of a dismal quarterly Bank of Japan report on business confidence. Had the government succeeded in temporarily boosting stock prices, companies and banks could have ended the fiscal year showing a profit on their holdings. Instead, the plan’s failure stood out in bold relief, and businesses and banks began the new fiscal year with further depleted assets. The chairman of Sony corporation reportedly declared in early April that the economy was “on the verge of collapse.”⁶⁷

Whether the Crisis Spreads to China

Thus far China has been insulated from the crisis, even though its 1994 devaluation was one of the contributing causes of the problems of the Southeast Asian countries. China contributed \$1 billion towards the IMF package for Thailand, and its leaders have declared that China would not carry out a further currency devaluation. Despite these favorable policy decisions, analysts worry that some 20% or more of China’s own bank loans are non-performing and that Beijing faces a gargantuan problem in seeking to stem the losses of its inefficient state owned industries (SOEs.)

To date, China has avoided trying to match the declines in the currencies of its Asian competitors, but growth has already slowed to 8% from its usual double-digit figures and unrest reportedly is rising along with unemployment.⁶⁸ The more the other Asian currencies plunge, however, the stronger will be the pressures on Beijing’s economic managers to devalue so as to protect China’s export markets and the stability of the regime. Reportedly, U.S. officials are particularly concerned that a sharp slide in the Japanese yen will cause China to devalue.⁶⁹ China could also be forced to devalue its currency if Hong Kong cannot continue to maintain its peg against the U.S. dollar.

⁶⁶Sandra Sugawara, Hashimoto Cuts Taxes \$30 billion. *Washington Post*, April 10, 1998: A1, A18.

⁶⁷Makoto Sato, Fiscal Year-End Spurs Market Intervention. *The Nikkei Weekly*, March 23, 1998: 1, 12; *Japan Digest*, April 2, 1998: 1.

⁶⁸Pamela Yatsko and Matt Forney, Demand Crunch: With Growth Sliding to a Danger Level, China Must Act Fast to Create Jobs and Stave Off Social Unrest. *FEER*, Jan. 15, 1998: 44-47.

⁶⁹Sandra Sugawara, Fears of Deflation Rising in Japan. *Washington Post*, March 14, 1998: D1, D9.

The Effectiveness of U.S. Leadership

The effectiveness of U.S. leadership could affect the extent of possible damage to the U.S. economy and the global trading system, especially in regard to rising political instability and a growing loss of confidence among the populations of Asian countries. Not only does the United States have the largest and most robust economy, and the largest and most open market, but the crisis has also demonstrated that only the United States has the institutional mechanisms for coordinated crisis management and the will to lead. It is almost inconceivable that the IMF or any collection of Asian countries could adopt policies that were not supported by the United States.

Notwithstanding its prominent role, some have characterized U.S. leadership — at least until recently — as being generally more tactical and technical, and more focused on the financial aspects of the crisis that are the principal concerns of U.S. banks and the IMF, than with the larger foreign policy implications. Due to the nature of the crisis, U.S. intervention has been led by the Treasury Department. Senior State Department officials and other members of the U.S. foreign policy apparatus have been largely silent, despite the considerable foreign policy implications of the crisis. Some change in this situation was indicated by President Clinton's numerous personal phone calls to Indonesian President Suharto, Secretary of Defense William Cohen's trip to the region in mid-January 1998, and the state visit of Prime Minister Chuan Leekpai. In general, however, the Administration had done relatively little until January 1998 to indicate a broader view of the potential political fallout, a fact that caused no little comment on the part of former officials and pundits.⁷⁰

Longer term U.S. interests may also be affected by *perceptions* of the U.S. role, not just its effectiveness. While Japan is in some respect the "headquarters" economy for Asia, the United States is still the center of financial capitalism and the single most influential member of the IMF. In that sense, whether the United States responds with strong leadership or a more narrowly defined defense of its economic interests, may have a significant impact on whether the affected countries treat their current difficulties as a "hiccup" on the road to mutually beneficial global economic integration, or as victims of fickle western capitalists and financial speculators.

One possibility is that Asian allies and friends will regard the United States as having let them down in their hour of need. Most well informed Asians understand the degree to which their own leaders and institutions contributed to the crisis, but it is only natural that they look elsewhere for complicity, especially when the IMF, the World Bank, and western financial analysts had so recently praised the same countries for their strong economic fundamentals and prudent macroeconomic management. In this respect, they tend to have unrealistic expectations that the United States, as the leading capitalist country and the strongest advocate of the financial sector liberalization will somehow share their pain. To the extent that U.S. policy is seen as self-centered, the Asian reaction may negatively affect a number of U.S. interests, including alliance and military access relationships.

⁷⁰See, for instance, Robert B. Zoellick, A Larger Plan for Asia. *Washington Post*, Jan. 6, 1998: A13.

Implications and Options for Congress

Exactly how the United States should respond to the Asian financial and economic crisis has become a highly divisive issue for Congress, given that U.S. leadership inevitably requires the commitment of a significant level of taxpayer funds in pursuit of policies whose very premises are subject to strongly differing points of view. Whether it wants to or not, the United States, as the largest economy and principal architect of the current international financial and trading regime, cannot avoid the *expectation* that it will assume the mantle of leadership, even if Japan and the European Union arguably have a larger economic stake in the outcome of the current crisis. The extent to which the United States should shoulder the main burden of leadership, the direction in which it should lead, and the exact policy prescriptions that it should support, are matters of intense congressional debate.

The debate is all the more heated because the issues involve a complex mixture of objective factors, competing economic theories, and ideological premises that are not reducible to provable outcomes. Consequently, policymakers and analysts tend to promote solutions that are strongly colored by their core philosophical and ideological beliefs. In addition, because the recent rapid growth of the Asian economies has been predicated substantially on reliable access to foreign capital, the affected governments themselves face a kind of Hobson's choice between economic policies designed to reassure the financial markets and policies that might produce better results in the domestic economy and/or create less stress on social stability. In a real sense, therefore, the arguments over the IMF's conditionality cannot be reconciled because the very premises of the Fund's critics and supporters are different, and each believes that its approach will more effectively address broadly shared concerns.

The Asian crisis and the IMF's response also has triggered a variety of questions about the Fund's role and its internal operations. A number of congressional initiatives seek both to prevent the emergence of similar crises in the future and to change the way that the IMF responds to them, if preventive measures should fail. Others seek fundamental changes in the IMF's operations, especially the goal of greater transparency regarding its activities and agreements with borrower nations.

Many Members are frustrated that past legislative directives requiring that the Administration use its "voice and vote" in support of greater transparency in the Funds operations, as well as trade liberalization, and the protection of labor rights, have not produced the desired results. This has led congressional critics of the IMF to seek to tie U.S. contributions to the requirement that the Administration pursue, and in some cases achieve, results on such matters as greater transparency of the IMF's operations and the Fund's support for a variety of sometimes conflicting loan policy objectives.

From the perspective of U.S. foreign policy interests, while many of the changes sought by Congress might, if actually carried out, bring long term benefits for the stability of the international financial system, the failure of the United States to support the quota increase and the NAB would undoubtedly generate a negative reaction in Asia, among the G-7 partners of the United States, and within the

international banking and investment community. The U.S. business community, and representatives of states and localities with a major stake in trade with Asia, have also expressed dismay at the possibility that Congress will refuse to provide funds for the IMF or will reach an impasse with the Administration over the language in the funding legislation.

FY1998 Supplemental Appropriations Request

The current congressional debate is focused on the Administration request for \$17.9 billion in supplemental FY 1998 appropriations for the IMF. This includes a previous request of \$3.4 billion for the U.S. share of the IMF's proposed New Arrangements to Borrow (NAB) and \$14.5 billion for the proposed quota increase.

Neither of these would support the current IMF loans to Asian countries but they would affect the ability of the IMF to respond to future emergencies. Neither can go into effect without the participation of the United States and other major economic powers.

The NAB request consists of a special levy on 25 major economies, while the quota increase would apply to all 182 IMF members. Both assessments are proportionate to the size of the member economies. The NAB funding, which was requested by the Administration well before the current Asian problems emerged, would provide back-up medium-term credit lines that the IMF could draw against as a supplement to its quota-based resources to assist countries facing a financial crisis. The credit line would be raised to approximately \$46.6 billion if fully funded by 25 prospective contributors.⁷¹ Most likely, the NAB would be activated in crises caused by sudden movements of short-term capital that threatened the stability of the international financial system, i.e, a crisis at least as bad as the one that hit Asia last year. That crisis did not satisfy the conditions of the IMF's existing credit line, the General Arrangements to Borrow (GAB), which requires the Fund to first demonstrate that its resources are inadequate.

The Senate had included the NAB contribution in its version of **H.R. 2159**, the Foreign Operations, Export Financing, and Related Appropriations Bill, 1998, most believed the funding would be included in the final version of the bill. At the last minute, however, the conference leadership dropped this provision, along with funding for UN arrears and the reorganization of the foreign policy agencies, as part of an effort to resolve an impasse over a House amendment outlawing U.S. contributions to overseas family planning agencies and NGOs that counseled, promoted, or carried out abortions — the so-called "Mexico City" language adopted by the Reagan Administration but overturned by the Clinton Administration. The Administration had threatened to veto any bill containing the abortion provision.⁷²

⁷¹For further details, see CRS Issue Brief 97038, The International Monetary Fund's "New Arrangements to Borrow." Updated regularly [by Patricia A. Wertman.]

⁷²For background on this impasse, see CRS Report 97-211 F, Appropriations for FY1998: Foreign Operations, Export Financing, and Related Programs. Updated Dec. 11, 1997 [by Larry Nowels.]

The Clinton Administration also agreed earlier to contribute about \$14.5 billion to a recently negotiated IMF quota increase, and was expected to request the funds in the FY1999 budget.⁷³ Whether as a tactical move, or out of genuine concern about the recent drawdown of the IMF's resources, or both, the Administration decided to combine the NAB and quota increase in the same FY1998 supplemental appropriations request.

Members of Congress thus far have given mixed signals as to how the funding request for the IMF ultimately will be dealt with. Those supporting the request emphasize the need to stabilize the situation and to prevent a continued downward spiral of currency values, arguing that the further the Asian currencies fall, the greater the effect on the U.S. trade deficit and on U.S. jobs. Even though the measure does not involve an increase in budget outlays — being treated technically as an exchange of dollars for IMF "special drawing rights" — congressional opponents and the public at large tend to view it as a "bailout" of the international banks and Asian companies with taxpayer funds, and, at a minimum, to seek strengthened conditions to protect or promote various U.S. interests. Some Members favor the elimination of the IMF altogether, arguing that the world of international trade and finance has changed radically since the Fund was created in the aftermath of World War II, and that its role is no longer relevant.

Even proponents of the funding request have expressed at least partial dissatisfaction with the conditionality imposed by the IMF for its assistance in the Asian crisis, and also from initiatives aimed at promoting fundamental changes in how the Fund operates, especially concerning its emergency financing mechanisms and procedures for surveillance and data dissemination. Proponents, however, argue that the goals of reforming the IMF and reshaping its conditionality should not be allowed to jeopardize the current request. Opponents, on the other hand, would make the new funding contingent on the achievement of these changes.

Legislation

As of the beginning of the spring recess, Members of the House and Senate had introduced well over a dozen bills and resolutions that would affect U.S. participation in the IMF and/or seek changes in the Fund's operation. Those receiving action include the following:⁷⁴

H.R. 3114, International Monetary Fund Reform and Reauthorization Act of 1998.

Referred to the House Committee on Banking and Financial Services on Jan. 27, 1998, and ordered to be reported (amended) by a margin of 40-9. As reported to the House (H.Rept. 105-454), March 18, 1998, **H.R. 3114** authorizes the full \$17.9

⁷³For more details on the quota increase, see CRS Report 98-56 E, The International Monetary Fund's (IMF) Proposed Quota Increase: Issues for Congress. January 16, 1998 [by Patricia A. Wertman.]

⁷⁴For more details, see CRS Report 98-123 F, Supplemental Appropriations and Rescissions for FY 1998. Updated April 14, 1998 [Larry Nowels, coordinator.]

billion request for the IMF subject to conditions regarding improvements in workers' rights in countries receiving IMF support and other matters that the Administration either found unobjectionable or has actively supported.

H.R. 3580 (House Version), Making Supplemental Appropriations and Rescissions for the Fiscal Year Ending September 30, 1998, and For Other Purposes. Unlike the Senate bill, the House Appropriations Committee has split the FY 1998 supplemental into two separate bills.

- **H.R. 3579**, passed by the House on March 31, 1998 (212-208), contains supplemental appropriations for emergency disaster assistance, overseas peacekeeping funds for the Department of Defense, and for a number of government departments and agencies, and for other purposes.
- **H.R. 3580**, reported March 27, 1998 (H.Rept. 105-470), would appropriate \$3.4 billion for the IMF's proposed New Arrangements to Borrow (NAB) and \$14.5 billion for the IMF quota increase, but with conditions which the Administration finds objectionable and in some cases "unworkable" due to the likelihood that other member countries would refuse to support the proposed changes.

Sec. 401 of H.R. 3580 would hold up the release of funds for the NAB until 15 days after the Secretary of the Treasury has notified the appropriate committees of Congress that the IMF has adopted a policy of conditioning standby agreements in excess of \$500 million on provisions requiring the recipient country to:

"(1) comply with the terms of international trade agreements, of which the borrowing country is a signatory;

"(2) eliminate the practice or policy of Government-directed lending by private or public financial institutions, and;"

"(3) guarantee nondiscriminatory treatment in debt resolution proceedings between domestic and foreign creditors and for debtors and other concerned persons."

The Administration argued in a March 30, 1998, policy statement, that it "believes that the practical effect of this section alone would delay indefinitely the implementation of the quota increase," since it would condition the release of funds on IMF-borrower agreements over which the United States had no control.⁷⁵ Getting the IMF to adopt many of these loan provisions would require lengthy negotiations and the agreement of the major members, and might never be adopted.

⁷⁵Executive Office of the President, Office of Management and Budget, Statement of Administration Policy: H.R. 3579 — Making Emergency Supplemental Appropriations, FY 1998; H.R. 3580 — Making Supplemental Appropriations and Rescissions, FY 1998, March 30, 1998. p. 3.

Likewise, the Administration has strongly objected to **Sec. 408**, which forbids the release of funds to the IMF unless the Secretary of the Treasury certifies that the Fund has met a number of conditions regarding the transparency of its operations. The Administration agrees with the objectives but complains that the section not only would be likely to delay indefinitely the implementation of the quota increase, but also that it is written so broadly that it could also delay the release of previously appropriated funds for existing programs, as well as the NAB.⁷⁶

Apart from the provision of funds and limitations on their release, H.R. 3580 contains numerous reporting requirements and provides for a high level International Financial Commission Advisory Commission composed of at least four former Treasury Secretaries and representatives of labor, business and non-governmental organizations, and a nine member Advisory Committee on IMF Policy. **Sec. 407** of the bill would require the Treasury Secretary to instruct the U.S. Executive Director of the IMF "to use aggressively the voice and vote of the Executive Director" in support of 14 different policy objectives and 19 detailed sub-objectives. These include such goals as exchange rate stability and the avoidance of competitive devaluations; market oriented reform, trade liberalization, economic growth, democratic governance, and social stability; privatizing industry in an equitable manner; economic deregulation, establishing or strengthening key elements of a social safety net, and opening agricultural markets.

H.R. 3579 (Senate Version), 1998 Emergency Supplemental Appropriations Act. Passed the House Amended, by 212-208, on March 31, 1998. Passed the Senate, amended, on March 31, in lieu of **S. 1768**. Senate conferees appointed, March 31.

The Senate passed a single supplemental appropriations bill combining the funding measures in the House-passed **H.R. 3579** and House-reported **H.R. 3580** in one bill, including \$17.9 billion for the IMF and legislative language imposing a number of constraints on the disbursement of funds and policy guidance and requirements regarding IMF conditionality and the transparency of its operations. The major provisions of the bill largely parallel those in H.R. 3580, but the Senate bill includes some key language changes requested by the Administration regarding provisions that the Administration had deemed unworkable. For instance, whereas Sec. 401 of the Senate bill provides that funds cannot be disbursed for the quota increase *until* the IMF adopts several significant policy changes regarding trade liberalization, government-directed credit, and debt resolution, the Senate bill only requires a certification that the major IMF shareholders (essentially the G-7 industrial democracies) *will seek* to implement these policies.

- Like the House-reported H.R. 3580, of the Senate passed version of H.R. 3579 (Sec. 5003) would create an International Financial Institution Advisory Commission to consider and report on the implications of consolidating the activities of the IMF and the World Bank. The Senate bill goes further, however, in also including the World Trade Organization (WTO) and in directing the President to call for a new Bretton Woods conference to consider

⁷⁶*Ibid.*

a new structure for achieving exchange rate stability, economic growth, and responding to international financial crises (Sec. 5004.)

- Both H.R. 3580 and the Senate-passed H.R. 3579 contain sections that seek to insure compliance with the IMF's program for **Indonesia**. The Senate bill, however, would also require the U.S. Executive Director to the IMF to oppose the extension of IMF resources to or for the benefit of the President of Indonesia and also to oppose further installments of credits to Indonesia on less stringent terms than those imposed on Thailand and South Korea.
- The Senate-passed H.R. 3579 appears to go further than the House-reported H.R. 3580 in regard to efforts to prevent IMF support to the semiconductor, steel, automobile, and textile and apparel industries. These provisions would clearly relate **South Korea, Thailand, and Indonesia**, though they are not specified by name. Whereas the Senate bill (Sec. 5006) directs the Treasury Secretary to certify that no IMF resources or guarantees have been provided in support of these industries, the House bill (Sec. 402(a)(2)) only requires reports on the success of measures undertaken by the U.S. Government and the IMF to insure that any country receiving U.S. Economic Stabilization Fund (ESF) loans does not provide subsidies or bail outs to individual corporations, especially in the semiconductor, steel, plywood, and paper industries.

Potentially, the biggest risk to funding from the IMF comes not from the restrictive provisions, some or all of which could be dropped by the House-Senate conferees, but by the likely attachment to H.R. 3580 of an unrelated anti-abortion amendment during floor consideration in the House. Despite some modifications of the amendment's language since it was split off from the conference report to the regular FY1998 foreign operations appropriations bill (**H.R. 2159**), the Administration has continued to warn that it will veto any measure containing the amendment.

S. 1769, reported by the Senate Appropriations Committee on March 17, 1998, includes the same IMF provisions as the Senate-passed version of H.R. 3580. The Senate adopted the language of S. 1769 as an amendment to S. 1768, which gained final passage as H.R. 3580. This could become the main conference vehicle if the House passes the supplemental appropriations in two separate bills.

H.R. 1757, The Foreign Relations Authorization Act. The conference report on H.R. 1757, which was filed on March 10, 1998, includes authorization of \$3.4 billion for the IMF's NAB. Because the bill also includes the anti-abortion provision that the Administration has threatened to veto, its main significance to the IMF funding request is that it, rather than the pending supplemental appropriations, could be the vehicle for addressing the abortion issue. Were the President to sign H.R. 1757 in its present form, there would be no need for the attachment of the anti-abortion amendment to the supplemental appropriations bill.

Other Executive Branch and Congressional Options

Apart from consideration of funding for the IMF, the Executive branch and Congress have a number of options for lessening the destabilizing effects of the Asian financial crisis and promoting a rapid economic recovery.

Executive and Congressional “Gaiatsu” Directed At Influencing Japan’s Economic Policies. For most of the postwar era, Japanese leaders have relied on *gaiatsu* — foreign pressure — to help them overcome the opposition of vested interests to measures designed to harmonize trade and economic relations with the outside world. During the first three years of the Clinton Administration, U.S. officials replaced *gaiatsu*, with its patron-client overtones, with a more confrontational posture, including demands for the negotiation of “results-oriented” trade agreements. The Clinton Administration largely abandoned its confrontational approach after the conclusion of a compromise autos and auto parts agreement in mid-1995, and the emergence of new concerns about the future of the U.S.-Japan security relationship. The latter derived primarily from the adverse reaction in Japan to the September 1995 abduction and rape of a Japanese schoolgirl in Okinawa by three U.S. servicemen, and efforts by China to intimidate Taiwan by means of provocative military exercises and missile tests.

Until early 1998, U.S. officials had been highly restrained, at least in public, in prodding Japan to stimulate its economy and reduce its reliance on exports to bolster the economy. The reasons for this reticence are unclear, but may be partly related to the goal of protecting and expanding U.S.-Japan security cooperation, and partly out of a desire not to create panic in U.S. markets.

Beginning in January 1998, the Administration’s low key approach to dealing with Japan’s apparent policy gridlock gave way to a more assertive posture. Senior officials from the Treasury, Defense, and State departments stopped in Tokyo after a round of visits to Southeast Asian capitals, reportedly with the mission of strengthening the resolve of the Hashimoto administration to take adopt more effective measures to clean up the Japanese banking system’s problems and stimulate the economy. In keeping with the *gaiatsu* tradition, the U.S. pressure for greater efforts to revive the Japanese economy reportedly was welcomed by some Japanese bureaucrats. While Prime Minister Hashimoto and other senior political and bureaucratic figures bristled at U.S. policy advise, an anonymous senior finance ministry bureaucrat tellingly indicated that the United States still played its historical post-World War II role as the unofficial opposition party. “Japan is,” the official reportedly said, “in a way, waiting for the U.S. to come [and apply] some pressure.” According to the official, “In order to get the understanding of the Japanese public, the Japanese government also has to have the U.S. in the scheme.”⁷⁷

Congress, for its part, has several limited ways to convey a greater sense of urgency regarding Japan’s failure to adopt policies that adequately address its economic and financial problems, including hearings focused on Japanese and regional

⁷⁷James L. Tyson, U.S. to Lecture Tokyo on Helping Asia. *Christian Science Monitor*, Jan. 14, 1998: 1, 7.

economic issues, and Sense of the Congress resolutions. One such House initiative, **H. Res. 392** (Bereuter/Berman), calls on Japan to take more effective steps to address its economic and financial problems, and reduce informal barriers to trade and investment, as a means of alleviating the Asian financial crisis, insuring against a global recession, and reinforcing regional stability. The resolution was introduced on March 24, 1998, and referred to the House Committees on International Relations, Banking and Financial Services, and Ways and Means on the same day. **Sec. 410 of H.R. 3580** also expresses in more brief and less specific language the Sense of the Congress on the role of Japan in restoring regional and global economic growth.

In choosing to put the spotlight on Japan, Members of Congress, like Administration officials, have to weigh the potential benefits of American pressure against the possibility that Japanese leaders will actively resist measures called for by the United States in order to show that they cannot be intimidated by outsiders. Given the severity of Japan's problems and Prime Minister Hashimoto's revealing declaration that Japan will not lead the world into a depression, any resentment of U.S. and other foreign pressure is likely to be tempered by a pragmatic desire to deflect criticism by successful policy intervention. Thus, to the extent that Administration officials and Members of Congress emphasize policy approaches that enjoy support among Japanese economists, business leaders, and the media, U.S. initiatives could have an impact. The prospect of success would be enhanced further if other countries within the G-7 industrialized democracies and Japan's Asian economic partners similarly call for new approaches to revitalizing the Japanese economy.

Support for New Asia-Pacific Economic Cooperation Mechanisms and/or Significant Changes in the IMF. The United States could undertake new initiatives to promote a pan-Pacific approach to the problems of the East Asian economies, perhaps within the framework of the present 18 member Asia-Pacific Economic Cooperation organization (APEC.) For instance:

- under the existing framework of 10 APEC working groups, the United States could support the creation of an additional working group on common financial sector standards and/or agree to be a "shepherd" taking responsibility for coordinating the effort that might help Asian countries bring their regulatory mechanisms up to international standards.
- the United States could also take the lead in following up on an agreement by the APEC finance ministers in Manila in November 1997, for the establishment of a supplementary "second-line" Asian fund, based on voluntary commitments from Asia-Pacific economies, for deployment should the IMF's resources prove inadequate.
- alternatively, if Congress is unwilling to support funding for the IMF under terms acceptable to the Administration or other major countries, the Administration also has the option of reversing course and encouraging Japan to reintroduce its proposal of last summer for the creation of an Asian Monetary Fund. This likely would be viewed as a decision by the United States to abandon its postwar regional leadership, however, and it is not clear that the Japanese themselves are currently prepared to assume the

responsibility that this would imply in the context of an implied reduction in the U.S. regional leadership and burdensharing.

A number of Members of Congress have called on the Administration to examine alternatives to the current IMF on grounds that conditions have changed radically since the days of the original Bretton Woods agreement, including the increasing predominance of private capital flows in creating currency crises and balance of payments problems. As noted above, Sec. 5003 of the Senate version of H.R. 3579 would create a high level International Financial Advisory Commission to consider issues concerning “the future role and responsibilities, if any, of the International Monetary Fund, and the International Bank for Reconstruction and Development [the World Bank] and the World Trade Organization.” Sec. 403 of the House-reported H.R. 3580 contains a similar provision. Sec. 5004 of the Senate bill also would require the President to call for a new Bretton Woods conference on the roles of the IMF, the World Bank, and the WTO.

Thus far, the Administration’s reaction to these proposed initiatives has been equivocal. With regard to U.S. foreign policy interests generally, especially in the Asia-Pacific region, any American initiative likely would meet with the most favorable response from other major countries if it were backed by unencumbered financial support for the IMF quota increase and NAB. Conversely, the United States likely would receive less support if Congress and the Administration failed to come to terms on the pending supplemental appropriations request.

Bilateral Economic Assistance. Congress and the Administration could also promote U.S. foreign policy interests, including trade and humanitarian interests, through bilateral assistance to the affected Asian countries. Indonesia and Thailand especially are experiencing growing distress both in rural areas and in cities as a result of soaring prices for rice, edible oils, and other basic foodstuffs, caused both by currency devaluations and the effects of a prolonged drought. Imports of capital goods, raw materials, and technology that are critical to export manufacturing have been sharply depressed in all three IMF program countries due to the lack of letters of credit and hard currency reserves.

The timely provision to food aid to Indonesia and Thailand, as well as expanded import credits from the U.S. Export-Import Bank, could reinforce social stability in both by reducing hunger and distress arising out of economic contraction. This could help to shore up Thailand’s democratic government and help to prevent widespread political instability in Indonesia. While many analysts view the Suharto regime as in the same general position as that of Philippines President Ferdinand Marcos, in the mid-1980s, there is at present no opposition movement comparable to that led by Corazon Aquino and no established democratic tradition. If President Suharto were to be swept from office by a massive social eruption, he would likely be replaced by a figure from the Army or an Army-backed civilian. Under these circumstances, most Indonesian specialists judge that the Indonesian people as well as Indonesia’s neighbors and interested countries such as the United States and Japan, have more to lose than to gain from the kind of economic desperation that would provoke widespread violence.

On March 24, 1998, the State Department announced the extension of some \$70 million in new assistance to Indonesia for humanitarian relief. The package includes \$25 million in PL-480 Title II food aid to be distributed by drought-stricken Eastern Indonesia; \$ 6 million in essential medical supplies; and \$25 million in concessional loans under PL-480 Title I for public sector purchases of wheat, soybeans, and rice. The U.S. Agency for International Development (USAID) is also considering a request for loan guarantees totaling \$14 million, to be used to support small, labor-intensive infrastructure projects in urban areas with large-scale unemployment. USAID's existing \$45 million development assistance program is already targeted on economic and financial sector reforms, and efforts to strengthen the social safety net — all policy goals that have been emphasized in pending supplemental appropriations legislation for the IMF.