SPECIAL REPORT

United States Institute of Peace

Beyond the Asian Financial Crisis:

Challenges and Opportunities for U.S. Leadership

A Special Report of the United States Institute of Peace

About the Workshop

Management of Asia's currency crisis will have implications far beyond the immediate task of short-term economic stabilization and will reshape the context in which Asian nations relate to each other and to the United States. Recognizing that economic crises have historically preceded political instability and issues of war or peace, the United States Institute of Peace initiated a preliminary assessment of the effects of the Asian financial crisis on political and security relationships in the region. To examine the long-term implications of the crisis, the Institute convened a group of nearly thirty senior policy makers, businessmen, government officials, and academic and think-tank analysts for a workshop held on February 23, 1998. The agenda for the meeting appears at the end of this report.

This report, authored by Institute Program Officer Scott Snyder and President Richard H. Solomon, draws on the workshop discussions and media reporting of the Asian financial crisis. Their objective was to identify major themes and potential lessons from the crisis and to provide an initial assessment of the U.S. response. The workshop and report mark the initial efforts of the Institute to focus on this subject. Marcus Noland, David Timberman, and Robert Fauver reviewed and commented on initial drafts of the report, for which the authors are grateful.

As current developments unfold, the Institute's Research and Studies program may focus on additional developments related to the Institute's charter. For more information regarding the workshop, please contact Scott Snyder at (202) 429-3808, or visit our Web site at www.usip.org.

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Key Points

- Asia's financial crisis has already begun to force potentially important changes in the institutional relationships between government, private sector, and citizenries in these countries. Also at stake in this crisis is the structure of the global financial system and the ability of international financial institutions to prevent future economic crises and to regulate an increasingly integrated global economy. **The principal opportunity and challenge for the United States is to assume a leadership role in resolving the crisis and in promoting global standards for 21st century economic and political management.**
- Asia's political leaders must manage the adjustment from the era of the "economic miracle" to a climate of lower growth, possibly accompanied by political turmoil and heightened regional tensions. By adopting International Monetary Fund (IMF) reforms, Asia's leaders risk high unemployment, lower living standards, domestic unrest, and their own political legitimacy. On the other hand, if they fail to adopt needed reforms, their countries' economic woes will continue—to their ultimate political peril. Fortunately, Asia's leaders have thus far remained committed to participation in the global economic system. Yet the implications of the crisis go far beyond trade and finance. **Asia's financial crisis may mark a shift in relative long-term influence in favor of China at the expense of Japan. An effective regional strategy that would avoid this outcome but respond to the crisis would mobilize Japan toward instituting market liberalization measures and growth-oriented policies.**
- The current crisis will affect security relationships in the region, particularly if protracted political instability in Indonesia leads to refugee or other humanitarian crises. Although Asia's recent reconsideration of defense procurements has

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dampened the possibility of near-term military conflict or a regional arms race, economic difficulties may pressure financial arrangements between the United States and Japan and between the United States and Korea to provide financial support for American troops stationed there and may limit other nations' participation in regional security cooperation with the United States. **Therefore, the United States should bolster weakened regional cooperation through more political support for the Association for Southeast Asian Nations (ASEAN) and the ASEAN Regional Forum (ARF).**

- Political instability resulting from the economic crisis might create a dual "moral hazard" for U.S. leadership. First, attempts at economic stabilization might be perceived as a "bailout" for foreign investors or political leaders who took reckless financial risks. Second, the perception also exists that the United States may take unfair advantage of the crisis by using the IMF to demand economic reforms that benefit U.S. businesses in Asia. In the words of Hong Kong industrialist Gordon Wu, "This whole issue is very simple. If the United States extends a helping hand today, the Asians will remember. If it doesn't, the Asians will remember that, too." **To demonstrate U.S. leadership in coping with the crisis, limited offers of short-term assistance—such as the Export-Import Bank credits offered to Thailand on the occasion of Prime Minister Chuan Leekpai's visit to Washington in March—will earn valuable political capital and neutralize frustrations with IMF reform programs and perceived U.S. failure to lead.**

- It is better for U.S. leadership to try to contain the crisis and risk partial failure than to do nothing and risk further spread of the contagion—potentially jeopardizing U.S. economic performance and regional influence. **The Asian financial crisis thus far has demonstrated that the United States remains the essential economic, political, and security stabilizer in Asia.**

- Congressional support for economic and political transparency in IMF operations during the crisis and the effort to avoid stabilization programs that heighten the concern about "moral hazard" have been constructive components of the U.S. response to the crisis. **Congress should consider the potential costs of the spread of the crisis as it debates support for IMF replenishment and other legislation. Some relatively limited capital investments in the short term may help the nation achieve its long-term objectives of sustaining American influence and pursuing economic growth and security in the Asia-Pacific region. A prerequisite for U.S. leadership in reforming the international economic architecture so to avert future economic crises on this scale, however, is cooperation between Congress and the Administration.**

Introduction

> *The International Monetary Fund (IMF) and World Bank were created together at Bretton Woods [in 1944] under American leadership, with the understanding that there are economic causes of war . . . Sometimes when we think of economics, we think we're only dealing with economics. The background to all the Bretton Woods agreements, however, was war and peace, and when people don't think in those terms, I think they're making a major mistake.*
>
> *—Congressman Jim Leach*
> *February 23, 1998*

Following two decades of rapid growth, social change, and industrialization, the countries of the East Asian region are experiencing their first regionwide economic crisis. The responses of leaders in Asia and the United States will have an impact far beyond the immediate task of restabilizing near-term confidence in increasingly integrated economies. Current events will in time reshape political and security trends and relationships within the Asia-Pacific region. These changes will bring new challenges for policymakers and political leaders seeking to restore stability and growth to the region that until last summer had been characterized as the engine of global growth. A "paradigm shift" in Asia's economic and political dynamics thus seems well under way.

The Asian financial crisis—which tests our ability to effectively manage an increasingly globalized, interdependent economy according to uniform international standards—represents one of three major global challenges that are now at the top of the international agenda now that the Cold War is over. The other two are the continuing Gulf confrontation with Iraq and Iran over proliferation of weapons of mass destruction and current efforts in Bosnia and the Middle East to make peace agreements stick.

The immediate economic causes of Asia's financial crisis—especially unsustainable short-term foreign debt incurred by the private sector and exposed by the sudden devaluation of overvalued local currencies—have been identified. The first stage of a policy response to contain the crisis has been implemented to varying degrees in the countries most immediately affected: Thailand, Indonesia, and South Korea. However, the crisis is not over; in fact, its most challenging aspects may lie ahead—the political and social effects of economic recession and reform in the countries whose economic vulnerabilities have been exposed by the crisis.

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Recent developments underscore that economic, political, and security trends remain inextricably interrelated, forcing difficult political choices that were avoidable during times of prosperity and economic expansion. The onset of recession and reforms needed to stimulate new growth will affect social stability and public support for political leaders. This is a lesson of the global recession of the 1930s, which created conditions leading to World War II.

Asia's financial crisis raises several fundamental questions. For example, what is the relationship between transparent, regulated, market-based economic systems integrated into the global economy and the institutionalization of broadly based participatory democratic practices? What is the impact of global interdependence on national sovereignty? Will the prescribed "cure" of International Monetary Fund (IMF) intervention actually make the patient worse or stimulate a nationalist backlash? How will economic crisis affect major power relations in East Asia? And does the United States have the long-term capacity and willingness to extend its role in

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the region to that of *economic as well as* political and security stabilizer?

Over the past two decades, Asia's economies have flourished in a stable and secure environment, and America's economic ties to the region have shown remarkable growth. East Asia today is a market for 30 percent of American exports, and the estimated half-point slowdown in U.S. gross domestic product (GDP) growth attributed to the Asian crisis represents $40 billion in lost expansion. Asian capital provides the underpinnings for the U.S. Treasury bills that have financed our budget deficits. The United States has sustained essential military and security relationships with Japan and South Korea, and has developed cordial economic and security relationships with almost all of the Association of Southeast Asian Nation (ASEAN) member countries.

The challenges for U.S. leadership in response to the region's current financial crisis are to contain the damage so that it does not cause a round of global economic deflation and domestic instability that could harm regional security and to sustain confidence in U.S. leadership to stimulate reform of the regulatory system for managing global capital flows. At the same time, it is in the U.S. interest to provide support to individual countries that are trying to stabilize their own economic systems. This will require complex, assertive policy management to avoid serious political instability, nationalist backlash, or the "moral hazard" of bailing out either irresponsible investors or unreformed political leaders. But proactive management of such complex policies will require the development of congressional support for programs that will sustain U.S. international leadership while containing the political fallout from growing U.S. trade deficits with Asia, an unpalatable but necessary part of Asian recovery programs. And the United States must take the lead promoting reforms of the international financial institutions to prevent the recurrence of this type of financial crisis.

Background of the Crisis and Current Situation

The Asian financial crisis marks the start of a major post-Cold War adjustment to changes in the global economic system, an adjustment that is potentially as significant as the Bretton Woods agreements that have shaped global currency regulation for the past half-century. The massive increase in global capital flows and the development of technology and information services that facilitate twenty-four-hour-a-day movement of those flows have accelerated global interdependence—at the same time eroding national economic sovereignty. Despite the increased volatility of currency and capital movements, there is not yet a uniform regulatory system capable of managing the increased risks associated with those flows. The need for such a system is perhaps the major lesson to be learned from the IMF bailouts of the 1990s, including Mexico and now the Asian countries.

The immediate causes of Asia's financial crisis were overinvestment in productive capacity and widespread overvaluation of currencies in the region.

The immediate causes and key events in Asia's financial crisis are as follows: Japanese overseas investment in the late 1980s in Korea, Taiwan, and Southeast Asia replicated "economic bubble" conditions that had developed in Japan itself, resulting in overinvestment in productive capacity and widespread overvaluation of currencies in the region. The devaluation of the Japanese yen relative to the U.S. dollar in early 1997 caused the prices of Southeast Asian goods to increase because most currencies were partially pegged to the dollar. As a result, Southeast Asian goods lost their competitive price advantage and export growth slowed, revealing preexisting weaknesses in the region's banking and regulatory structures. Moreover, Southeast Asian goods lost their competitive price advantage while the growth of China's export capacity was further increasing competitive pressures. Decreasing competitiveness of Southeast Asian goods caused foreign direct investment to slow, making it more difficult to finance dollar-denominated short-term loans and current account deficits, which in the case of Thailand had grown to about 8 percent of GDP. Japan's own sluggish growth, which has persisted through the 1990s, has prevented it from contributing to U.S. market shares that are essential to an Asian recovery.

Accordingly, central banks in Thailand and Korea in the second half of 1997 did not have the resources to defend overvalued currencies, exposing their underlying weakness. When currencies such as the baht and the won were allowed to float against the dollar in the last half of 1997, currency speculators tested their true strength for the first time. Subsequent currency devaluations lessened investor confidence and encouraged additional speculation by traders after targeting Thailand, Malaysia, and Indonesia, then saw the Hong Kong dollar and the Korean won as potentially overvalued. The Hong Kong peg to the U.S. dollar—backed by a strong central banking system—held in October. However, the Korean won devaluation followed the pattern of the Thai baht and the Indonesian rupiah devaluations. The won's devaluation exposed large amounts of corporate foreign debt incurred by businesses that had invested "cheap" foreign money in domestic projects, a practice that guaranteed high rates of return but created inefficient overcapacity in real estate and industrial markets.

The root of the crisis is not simply a matter of money; rather, it is a management crisis stemming from "crony capitalism," poor economic surveillance and politically distorted decision-making, and weak financial and regulatory institutions.

At the critical moment in each country's crisis, the IMF entered into negotiations to provide emergency financial assistance to Thailand in July of 1997, to Indonesia in October, and to Korea in November, providing infusions of cash to economic systems that had been dangerously decapitalized by central bank attempts to defend currencies against market pressures for devaluation. A major challenge for these economies has been regenerating export growth needed for their recapitalization. In the case of both Korea and Indonesia, a second round of IMF/U.S. Treasury interventions in December 1997–January 1998 and negotiations with private banks to roll over and reschedule short-term debt were necessary to stanch the alarming flow of dollars out of the financial system. As the price for its intervention, the IMF required programs of rigorous fiscal stringency, regulatory systems improvements, and greater transparency of financial information in both the public and private sectors, and the opening of the financial sectors in each country to foreign investors.

The unique aspect of the Asian financial crisis is that unlike past crises (such as Latin America in the 1980s) most of the debt is corporate, as opposed to state-held or sovereign debt, and the costs of reforming the structure of government-business relationships to ensure transparency are larger than in other crises. The root of the crisis is not simply a matter of money; rather, it is a management crisis stemming from "crony capitalism," poor economic surveillance and politically distorted decision-making, and weak financial and regulatory institutions. At stake has been the loss of credibility of the "Asian model" of government-business relations, in which collusive business practices prevented full market transparency. Thus, simply "throwing money" at each of the troubled Asian economies—in the form of IMF infusions of capital—fails to address the primary challenge of the crisis: inefficient and corrupt economic management. It is not just the financial system that has to be restructured, recapitalized, and properly regulated. These countries must adopt reforms to restore confidence that all parties are competing on a playing field "leveled" by criteria of economic efficiency. To restore confidence, banks and corporations must adopt effective and transparent mechanisms and structures of economic management.

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At this stage, financial stabilization of the at-risk economies is only beginning to take hold. Fred Bergsten of the Institute of International Economics suggests that the Asian countries most directly affected now face at least one to two years of "lost" economic growth (compared with a lost decade in Latin America during the 1980s), and economic restructuring will mean a return to growth rates closer to half those of the precrisis period. (Other analysts, however, are more pessimistic about the amount of time it may take for these economies to re-establish a pattern of solid economic growth.) These are the benchmarks for restoring market confidence: faithful implementation of the respective IMF reform programs; the absence of destabilizing competitive devaluations from China and Taiwan; Japan's implementation of economic reforms, including market opening to absorb exports from other parts of Asia; successful debt-restructuring negotiations; and continued global support for an open-market system that will allow Asian countries to export their way out of their current difficulties.

Social and Political Costs of Economic Destabilization

Personal bankruptcy rates are rising, jobs are being lost, and the incomes of many workers are being reduced to subsistence levels as prices increase in Thailand, Indonesia, Korea, and other parts of Asia less directly affected by the crisis.

The downward revision of Asia's economic growth forecasts for 1998 provides a quantitative picture of the anticipated effects of the crisis on the region's economies. The effects will be felt in different countries at different times, because the high points of the crisis were staggered over the last half of 1997. As the origin point of the crisis, Thailand has experienced the greatest economic stresses to date in the forms of layoffs and economic contraction, while the social effects of the crisis have yet to be fully felt in Korea. Local circumstances will affect the severity of the pain in each country, but individuals are suffering from the economic recession, layoffs, and the doubling in prices of foreign goods (including energy imports). Personal bankruptcy rates are rising, jobs are being lost, and the incomes of many workers are being reduced to subsistence levels as prices increase in Thailand, Indonesia, Korea, and other parts of Asia less directly affected by the crisis. The ability of each country to cope with the effects of the crisis will be shaped by the domestic political leadership—specifically, the ability of each government to convince its people to accept the IMF reforms despite the widespread privation that will accompany the economic downturn. An important element of a politically effective response will be to share the costs of reform and an equitable restructuring across all sectors of these societies.

In addition, the economic crisis is testing the relationship between a liberalized economic system and sound democratic governance in Asia. Democratic and relatively more participatory political systems such as those of Korea, Thailand, Taiwan, and the Philippines appear to have fared thus far better than more authoritarian and opaque systems such as Indonesia's. On the other hand, the relative economic isolation of China, with its authoritarian government, and Singapore's highly regulated society have provided unexpected short-term benefits in containing the crisis, while growing public frustration with Korean or Thai political leaders may eventually unravel the social consensus in those countries that support reform programs.

THAILAND: Thailand's economy will face recession in 1998 after slowing to 4 percent growth in 1997 from average annual growth rates of over 8 percent during the past two decades. The recapitalization of the Thai economy and systemic adjustments may require three to five years of recovery, according to some estimates. Up to one million Thais, as much as 8 percent of the work force, may be unemployed as a result of the crisis—an enormous shock in a system with no significant social safety net. The large Thai agricultural sector may reabsorb hundreds of thousands of the unemployed who migrate from Bangkok to the countryside, possibly reducing the likelihood of violence or political instability in the near term. Thailand's coalition government, led by Prime Minister Chuan Leekpai (who replaced Chavalit Yongchaiyudh as a result of the crisis), currently has sufficient public support to manage the initial phase of the crisis and received generous, if belated, political backing from the United States during his March 1998 visit to Washington. However, if erosion of public support threatens to unravel his ruling coalition or blocks economic reforms prematurely, the military and the monarchy are the key institutions that will assure political stability and protect the institutionalization of Thailand's democratic system, which has recently adopted a new constitution. Contagion effects, including the impact of a potential collapse in Indonesia, might again put at risk Thailand's ability to stabilize its financial system and restore the confidence of the markets.

INDONESIA: The most serious social and political consequences of economic destabilization are in Indonesia, where the financial meltdown has deteriorated into a political crisis of confidence in President Suharto's leadership. The corrupt and nepotistic leadership appears to be out of touch with the needs and frustrations of Indonesia's own people, yet the president continues to be held in esteem by the military—and the public is fearful of widespread chaos reminiscent of the 1960s. One result is that measures thus far taken by Suharto to try to resolve economic problems on his own—such as the use of a currency board to stabilize the value of the rupiah—have weakened confidence in his leadership base. The continuing standoff between President Suharto and the IMF has raised the stakes of the crisis and has put the credibility of both sides on the line.

The 75 percent drop in the value of the rupiah have pushed up prices of key staples, and sporadic food riots have underscored the danger of mass political unrest. Suharto's response, unlike that of Thailand and Korea, has been to appoint cronies as his closest advisors. Suharto is deeply suspicious of foreign appeals for Indonesia to take strong medicine that may in fact poison his ability to maintain social order and protect the perquisites of power that benefit his family's business holdings.

If the economic crisis and the IMF reforms serve to destabilize Suharto's leadership, will a more reform-minded leader replace him and restore confidence in Indonesia's economic and political future? How does the economic crisis threaten the fragile basis for Indonesia's remarkable ethnic and political coherence of the past three decades, particularly in the absence of a designated successor clearly committed to a program of national unity and ethnic harmony? A lack of transparency and the risks that family members and cronies will be rewarded magnify the "moral hazards" for the United States in dealing with authoritarian leaders. Yet there appear to be few, if any, external policy levers for stimulating reform in Indonesia without also risking instability and social chaos—which carries the special risk that the ethnic Chinese community, which has been instrumental in facilitating much of Indonesia's past economic growth, will be scapegoated.

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Any protracted destabilization in Indonesia would have serious repercussions for regional stability in Southeast Asia. President Suharto has played a constructive role in regional integration since the late 1960s through his support for ASEAN. In addition, the possibility of Indonesian separatism or ethnic, racial, or class conflict might create refugee flows and destabilize a strategic trade route for energy supplies to Northeast Asia. Suharto may muddle through the current crisis, but a violent upheaval or prolonged leadership vacuum would present the international community with challenges even more severe than those associated with Indonesia's current financial difficulties.

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SOUTH KOREA: The social pain of economic destabilization will also be felt in Korea, where President Kim Dae Jung, elected to office in December of 1997, must induce sacrifices from labor and management to sustain the social cohesion necessary to overcome the most serious effects of the economic crisis. At the same time, economic reforms are forcing changes in the fundamental structure of Korean society. Labor is being asked to tolerate much more flexible employment practices, including layoffs, while Korea's large conglomerates (*chaebols*) must accept strict international standards of transparency, and stop playing a shell game with subsidiaries to hide the truth regarding their real financial health. "Shared pain" will come in the form of nearly zero economic growth in 1998 and a more than doubling of the current unemployment rate to 6 percent. The structure of the job market will change, and preferential deals between business representatives and government officials should be curtailed as part of measures to ensure transparency in business practices. These fundamental adjustments in Korea's economic structure are just beginning and will be highly contested by interest groups, both *chaebols* and unions, who stand to lose from necessary reforms.

Korea faces a revolutionary challenge of overturning within a few months its entrenched social and business practices in favor of a system in which considerations of economic transparency are given greater weight than personal relationships. President Kim Dae Jung's most significant leadership challenge will be to maintain domestic political support from all sectors even as the financial crisis causes the contraction of Korea's real economy; otherwise, Korea could face a political crisis that would undermine its capacity to recover.

MALAYSIA: Other countries in Southeast Asia have also been forced to take belt-tightening measures as a result of Asian currency devaluations. The Malaysian government has avoided seeking an IMF bailout, despite sharing with its neighbors some of the same structural weaknesses in government-business relations and having weak regulatory systems that brought such difficulties to Thailand and Indonesia. In order to avoid appealing to the IMF for a bailout, Malaysia has needed to make many of the same structural changes the IMF has called for in other countries. The crisis has also revealed tensions under the surface within Malaysia's own political leadership. Devaluations of the Singapore dollar and the Philippines peso have also forced those countries to tighten their belts, slowing economic growth to a crawl, increasing the burden of the poor, and forcing modest retrenchments in plans for future investments.

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Political Dilemmas of IMF Intervention

The IMF—designated as a financial line of defense because of its capacity to provide liquidity in times of global crisis—was criticized for its initial response to the Asian crisis, but there appears to be no existing credible alternative to the IMF's "firefighting" role in containing the effects of a liquidity crisis. The IMF's intervention raises fundamental questions regarding the implications for national sovereignty of global economic interdependence, the risks of a nationalist backlash against international intervention, and the relationship between requirements for economic transparency and the institutionalization of democratic political practices.

International Monetary Fund (IMF) Managing Director Michel Camdessus, left, looks on as Indonesian President Suharto signs a new IMF deal at Cendana Residence in Jakarta, Thursday, Jan. 15, 1998. (AP Photo/Muchtar Zakaria)

Global Interdependence, National Sovereignty, and the Possibility of a Nationalist Backlash

Global capital flows have grown almost 300 percent in the past ten years, and much if not all of this growth has been allocated by global markets rather than sovereign governments. Development aid or governmental assistance now represents only a small proportion of the financing available for the vast majority of development projects. Asia was the destination for half of all global foreign investment in 1996, and until recently the region has been a primary beneficiary of the increased role of foreign direct and equity investments, thus accelerating Asian growth rates. However, the benefits of economic growth have turned into a humbling dependency on international financial institutions for assistance as the flow of investment funds reversed itself in the crisis. This reversal deflated not only Asian economies but also Asian pride in the economic accomplishments of the past three decades. "Easy" foreign money was revealed as a major reason for the crisis. The disparity between the management requirements of global markets and indigenous economic practices—cronyism in investment capital allocation and government/business collusion rather than market-discipline in shaping investment decisions—produced overinvestment. The humiliating image of national dependence and loss of economic sovereignty was captured most starkly in the photo of Indonesian President Suharto signing of the second letter of intent with the IMF, with a seemingly smug IMF Director Michel Camdessus looking over his shoulder like a teacher.

The financial crisis has exposed the limits of governments to manage economic growth, providing a stark object lesson that governments have little room for failure in formulating policy. Governments will be measured by the degree of confidence shown by the markets—an emerging new constituency in a globally interdepen-

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dent world. The crisis also has underscored the potential dangers of dependency on "hot" investment money—in the form of short-term loans—that can easily be pulled out of a country in times of crisis. Asia's difficulties might lead some countries to consider measures to protect their sovereignty at the expense of integration into the global market. Some Asian leaders have noted that the nonconvertibility of China's currency has shielded Beijing from the worst effects of the Asian devaluation, although the crisis has also forewarned Chinese policymakers of the weaknesses and dangers in their own banking and industrial systems, as will be explored below.

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Southeast Asian governments have considered proposed regulations to curb an investor's ability to pull hot money out of a country, and to denominate trade in local currencies to prevent overdependence on a strong U.S. dollar; and Indonesia has contemplated the installation of a currency board. But many of these proposals for reform have been shot down by negative reactions from the markets or the IMF. Some economists express concern that the crisis may encourage a backlash that would cause the region's governments to step away from their commitments to globalization in favor of measures to enhance sovereignty and buffer against the volatility of markets. These economists argue that to step back from trade liberalization measures will limit future economic growth. This dilemma reflects similar circumstances in the 1930s, when currency devaluations and tariff increases led to world wide economic depression and ultimately political turmoil and war.

The crisis has exposed Southeast Asia's dependence on an impersonal and unpredictable global financial system in which the markets' unyielding criticism of economic performance has immediate consequences. In addition, the further humiliation of having to cede sovereignty over mechanisms of fiscal and monetary policy has predictably yielded frustration. Indeed, the IMF itself has admitted mishandling aspects of its own initial response in the Indonesian case. In a secret internal report, the IMF evaluated its initial restrictions on food prices and government spending to have been harsher than necessary, with the unintended result of increased social instability rather than restored economic solvency.

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There have been signs of nationalist backlash against the IMF—and, by extension, against the United States, which is widely seen as the real "doctor" prescribing the IMF-imposed prescriptions for the Asian crisis. The challenge of responding to Asia's financial woes constitutes a double bind for the United States. On the one hand, many Thais strongly believed at the height of their crisis that only the United States had the capacity to respond effectively with assistance, and they were disappointed by the failure of a concrete U.S. response. On the other hand, some Koreans and Thais believed the United States worked in a self-serving manner through the IMF to provide "help" with tough conditions that appeared to benefit U.S. financial interests. By the same token, some Western commentators stimulated resentment by using the crisis as a pretext for heralding the failure of "Asian values" and the Japanese model of collusive government-industry management even before the situation was brought under control.

During Prime Minister Chuan Leekpai's March visit to Washington, the Clinton administration made initial moves to repair some of the damage resulting from these negative perceptions. The Thai prime minister received up to $1 billion dollars in Export-Import Bank credits and was allowed to defer a major defense contract for purchase of F/A-18s that had become unaffordable as a result of the baht's 40 percent depreciation.

Economic Transparency and Political Liberalization

In both Korea and Thailand, a leadership transition coincided with the initial stages of IMF negotiations for external financial assistance to overcome the crisis. The public exacted a stern price from incumbent leaders in both Seoul and Bangkok for their economic mismanagement. Newly elected leaderships have supported the implementation of difficult reform measures as mandated by the IMF. In Indonesia, however, the Suharto family has responded in ways that seem designed to protect family wealth and position more than in safeguarding national interests.

The crisis and response thus far support the argument that an institutionalized and participatory democratic process reinforces economic growth, and vice versa. Authoritarian leaderships such as the Suharto regime find themselves caught in a bind if economic performance falters or if political succession is not guaranteed: Dependence on the global economy for capital as well as markets and technology to sustain growth requires leaders to give up a certain amount of control over the economy to meet external demands for economic transparency. When economic problems occur, international investors—a powerful new constituency—may ask questions regarding the ability of the leader to guarantee stability or to safeguard economic investments. An economic crisis forces leaders to walk a tightrope between gaining foreign capital needed to sustain rapid economic growth and taking on the risks that accompany the required transparency measures, such as the social instability that may accompany the downsizing or bankruptcy of inefficient or non-performing enterprises.

On the other hand, to the extent that the authoritarian leadership is independent of the global economic system, it is not exposed to pressures for economic transparency and eventual political liberalization. For instance, the Chinese leadership has thus far avoided the direct effects of the Asian crisis because the yuan is not convertible in global markets. However, the effects of decreased foreign currency flows to China in the form of foreign direct investment, and China's own need to repair an insolvent banking system and downsize state owned enterprises, are likely to slow China's economic growth significantly—if not provoke political instability. To the extent that the Chinese economy becomes more integrated into the global financial system, the Chinese public's demands for greater political participation, transparency, and a stronger legal regime to ensure a level playing field in economic and political affairs are likely to increase. As in Indonesia, a period of economic crisis in China would create contradictory effects of heightened social instability and more rapid economic reform.

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Implications of the Asian Financial Crisis for Regional Security Issues

Asia's economic troubles will have a significant—if mixed—impact on regional security. The crisis will reduce somewhat the possibility of near-term military conflict as these nations focus on their own internal difficulties and as they reduce their military budgets. At the same time, the possibility exists that internal instability or refugee spillovers might bring about the military's involvement to contain social unrest and maintain civil order. Paradoxically, the Asian crisis has illustrated the need for stronger regional institutions for cooperation, while underscoring the incapacity of existing institutions to mount an adequate response to the crisis.

The devaluation of local currencies has forced governments in the region to examine budget-tightening measures; it has also effectively doubled the price of many of their arms procurements on the international market, thereby turning defense procurement programs into albatrosses for government officials struggling to make ends meet.

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The devaluation of local currencies has forced governments in the region to examine budget-tightening measures and has also effectively doubled the price of many of their arms procurements on the international market, thereby turning defense procurement programs into albatrosses for government officials struggling to make ends meet. Thailand found itself unable to finance a planned F/A-18 purchase, and required U.S. flexibility to get out of the deal. Likewise, South Korea's defense budget procurements have been cut drastically, and the Philippines, Indonesia, and Malaysia have deferred planned purchases.

If defense procurements continue to be deferred over several years, and if China's defense acquisition plans remain unaffected by the crisis, some analysts suggest that Southeast Asians will have heightened sensitivities about China's military growth. Also, deferred defense procurements may weaken the ability of the region's militaries to participate effectively with U.S. forces in joint military exercises, particularly if the region's militaries are forced to use outdated equipment lacking in interoperability.

In the case of the long-standing Korean conflict, South Korea's financial crisis (in combination with North Korea's chronic economic difficulties) may have the ironic effect of creating a psychologically balanced atmosphere between the two Koreas, perhaps setting the stage for renewed progress in inter-Korean dialogue. At the same time, the crisis has eliminated the remote possibility that South Korea could finance the costs of any near-term reunification process on its own and has shifted attention in Seoul to the immediate task of resolving its own crisis and away from North-South issues. The current period may also prove to be an opportunity for the United States to consolidate basing arrangements that would support a transition in U.S. troop deployments from forward bases to rear area support located south of Seoul. Less clear are the implications of the crisis for the crippled North Korean economy, which is likely to feel the effects of South Korea's reduced cash flows and the resulting decrease in opportunities for barter trade via northeastern China. Also, whatever limited prospects might have existed for investment in North Korea have been deferred as competition for investment dollars has increased as a result of the currency devaluation. Southeast Asian "fire sale" investment opportunities have made North Korea an uncompetitive venue for foreign investment; accordingly, its economic recovery will be even more difficult. Although the prospects for military conflict on the Korean peninsula seem reduced, a few analysts warn that increased economic pressure on North Korea—and a perceived window of opportunity as South Korea undergoes its own economic adjustment—might tempt a suicidal last gasp of North Korean adventurism.

In Southeast Asia, the critical security threat remains the prospect of prolonged destabilization in Indonesia and the implications for cooperation and leadership in the region. The prospect of refugee flows and the potential political and economic costs that such instability would impose on neighboring societies is worrisome and most of Indonesia's neighbors remain unprepared for such a development. In addition, Indonesia's political weakness may undermine the effectiveness and major accomplishments of the ASEAN, and by extension, ASEAN-driven multilateral processes such as the Asia-Pacific Economic Cooperation (APEC) Forum and the ASEAN Regional Forum (ARF). For instance, the Asian economic crisis has diverted attention from Cambodia's political crisis and has undermined regional efforts to respond effectively. Likewise, Indonesian-led efforts to encourage dialogue on the South China Sea territorial disputes may founder as a result of domestic preoccupations.

The need for such institutional cooperation mechanisms to respond to the challenges of regional interdependence have never been more dramatically illustrated than in the current financial crisis. Yet the solutions to most of ASEAN's problems appear to be beyond the grasp of regional leaders, requiring economic and political support from the major powers. Another effect of the financial crisis has been to highlight both the strength of interdependence and weakness of linkages between Northeast Asia and Southeast Asia. The problems of both subregions have affected each other, yet in responding to the crisis national leaders have been consumed by their subregion's own immediate problems. The financial turmoil may provide a significant test of the long-term viability of multilateral security arrangements such as the ARF.

Indonesia's political weakness may undermine the effectiveness and major accomplishments of ASEAN.

Impact of the Crisis on Major Power Relations

The Asian financial crisis has also tested the leadership roles and responsibilities of the major powers in the region. A definitive judgment on the biggest winners and losers in the crisis may be premature. But it is not too early to assess the relative political and economic strengths and weaknesses of Japanese and Chinese reactions, or to examine the influence of and consequences for the major powers as they manage the crisis.

The Japanese response to the crisis thus far has received heavy criticism from those who believe that Japan has done little both to resolve its own financial vulnerabilities—especially its insolvent banking system and sluggish growth—or to assist Asian neighbors on the road to economic recovery. First, Japan has been harshly criticized for failing to implement fiscal policies to stimulate its own economic recovery. Tokyo's focus on budget balancing has taken a priority over tax reduction and public works spending necessary to reflate the Japanese economy. The result has been that the Japanese economy growth has foundered at 1 to 2 percent growth for almost eight years. In addition, Japan's growing trade surplus has been a source of friction in its relationships with both the United States and the rest of Asia.

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Second, many economists argue that strong Japanese growth is needed to stimulate demand for Asian exports, which will be a necessary part of the region's economic recovery. These critics say that market-opening measures and stimulating domestic consumption through lower taxes might allow Japan to play a more constructive role. Despite promises of "big bang" deregulation and imminent tax cuts, Japan's bureaucracy has consistently undercut major reforms in Japan's economic structure, revealing deep-rooted bureaucratic perceptions that the cause of the Asian financial crisis is that the global infrastructure has failed, rather than the constricting effects of Japan's own over-regulated economy.

Third, the Japanese model of intimate business-government relations—the model of economic cronyism throughout the region—has been widely discredited during the course of the current crisis. Yet Japanese efforts to work out solutions to the crisis—such as Japan's November 1997 proposal for an Asian currency fund that did not require the same reforms that would accompany an IMF program—suggest that Japanese officials have missed the point and, as a result, may be tempted to work at cross-purposes with the United States on the critical issues of structural reform.

Although political weakness and bureaucratic obstacles have hindered an effective Japanese response to the crisis, Japan may be regarded in the region as more sympathetic to the plight of its struggling neighbors than has been the United States.

China's response to Asia's financial crisis thus far has been surprisingly active, engaged, and constructive—if self-interested.... A major reason for Chinese cooperation may be an acute sense of self-interest and an awareness of the vulnerability of China's own domestic economy.

The region welcomed a Japanese initiative to support a monetary fund for Asia during regional meetings among finance ministry officials in Manila last November, although the proposal was tabled by U.S. Treasury officials who were concerned that such a fund would only encourage irresponsible lending and policy making while failing to impose the reforms necessary to resolve the management problems at the core of the financial crisis. U.S. Treasury officials report, however, that Japan's Ministry of Finance has been a constructive and effective partner in some important areas, and behind the scenes has effectively encouraged regional consultation and cooperation in response to the crisis, despite Japan's own financial problems and domestic political inertia.

China's response to Asia's financial crisis thus far has been surprisingly active, engaged, and constructive—if self-interested. China's pledge to contribute $1 billion to the Thai bailout and its repeated affirmations that it would not devalue the yuan during 1998 have been welcomed as constructive steps that have prevented the contagion from spreading. In addition, Chinese resolve to support the Hong Kong dollar peg has helped to contain devaluation pressure on regional currencies. And senior Chinese officials have been surprisingly eager to engage in a constructive and substantive dialogue with U.S. Treasury counterparts on issues stemming from the financial crisis.

A major reason for Chinese cooperation may be an acute sense of self-interest and an awareness of the vulnerability of China's own domestic economy. While the nonconvertibility of the Chinese yuan has shielded China from the direct effects of the financial crisis, the structure of the Chinese economy (including the financial drain on banks of contributions to state-owned enterprises) and its most serious problems are similar to those of Thailand, Indonesia and Korea. Also, China's strategy for growth requires stable and growing foreign export markets. After all, many aspects of China's economic strategy derive from Korean and Japanese models of export-led industrialization, and the crisis has exposed some critical flaws in those models. Chinese economic officials understand the potential severity of some of these problems and appear to be taking proactive measures, limiting the potential for instability associated with an economic slowdown in China.

The most acute domestic economic priority among Chinese officials is to resolve the problem of insolvent state-owned enterprises—a massive drain on the central government budget—without risking the social instability that would result from widespread unemployment. Already there have been sporadic reports of local factory workers taking to the streets to protest failures by state-owned enterprises to pay wages—usually resulting in some form of compensation by the government to pacify workers rather than to risk widespread social unrest. Support for state-owned enterprises often takes the form of "policy loans" made by Chinese banks at the direction of the Chinese central or regional governments. The fallout from the Asian financial crisis led the central government to convene a January 1998 emergency meeting of economic officials to issue a directive forbidding loan approvals by local or regional banking authorities. (Whether a prohibition on local loan approvals can be enforced in the face of an economic contraction remains to be seen.)

An apparent drop in foreign direct investment flows into China has been the most immediate effect of the Asian slowdown on the Chinese economy. And as the environment for attracting foreign investment is made more competitive by Southeast Asian currency devaluations, and as the flood of foreign investment to the region slows, the pressure to devalue the yuan will increase. Although Chinese officials claim that China will resist temptations to devalue its currency to enhance economic competitiveness, this contraction in foreign investment is likely to slow down China's economic growth, heightening prospects of growing unemployment and social instability. This prospect is indeed worrisome to Chinese officials, some of whom have promised a significant multi-year US $1 trillion "pump-priming" operation to fund domestic infrastructure projects in order to forestall such a slowdown in 1998. However, budget information from the March 1998 National People's Congress did not clearly indicate the source of funding for such an effort. Chinese researchers have carefully studied the impact of increased unemployment on inland rural, coastal, and urban areas of China to determine the growth ranges at which heightened unemployment would become unsustainable or lead to widespread social protests such as those that led to the Tiananmen Square incident in 1989. It is likely that infrastructure projects would be directed to the areas deemed most at risk of political or social instability.

Another side-effect of the crisis has been the reinitiation of an active "southern strategy" by Taiwan to encourage political and business contacts between Taipei and its Southeast Asian neighbors, much to the consternation of officials in Beijing. Armed with cash and a solid record of successful management experience (underscored by its ability to come through the Asian crisis relatively unscathed), Taipei is trying to convert financial difficulties in Southeast Asia into renewed economic and political relationships. Taipei-based businessmen have actively explored business opportunities at the encouragement of the government, but appear reluctant to make investment decisions solely on a political basis. Likewise, Taipei was quick to offer a $5 billion contribution to the Asian monetary fund proposed in Manila last November and has renewed economic and political contacts with South Korea. Some critics have also claimed that Taiwan's 10 percent devaluation of its currency in October 1997 was intended to undermine fiscal stability in Hong Kong to threaten China's ability to manage a smooth post-handover political transition. Others, however, have seen this devaluation in relatively benign terms as an adjustment driven more by domestic business pressures than by a spoilsport strategy toward Beijing.

Some analysts have noted the wisdom of China's surprisingly generous contribution to the Thai bailout package, which apparently was made following consultations with and at the recommendation of Hong Kong-based advisors. That decision, and China's promise not to engage in a destabilizing currency devaluation, have built valuable political capital for Beijing and enhanced China's relations with its Southeast Asian neighbors. In addition, the initiation of an ongoing dialogue between financial officials in Washington and Beijing has been a constructive side-effect of the crisis. But the United States has not appreciated rumors of quiet Chinese warnings delivered to some Southeast Asian neighbors to guard against American "hegemonic ambitions" to take advantage of the crisis.

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The IMF and New Ideas for Managing Global Capital Flows

The role of the International Monetary Fund has been a lightning rod for criticism of the international response to the Asian financial crisis. Central to the debate over the effectiveness of the IMF has been the question of "moral hazard" (that is, whether a bailout mechanism encourages international lenders to make irresponsible financial risks). The IMF's "firefighter" role has remained a focal point for discussion, obscuring somewhat an emerging debate over ways to fix problems in the global

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financial system, including how to ensure global financial transparency (i.e., how to remove unseen risks that may accompany hidden debts and collusive government-business relationships) and how to moderate the volatile negative effects of cross-border flows of capital.

The IMF itself has expanded its original role as guarantor of the global financial system following World War II to become an institution that monitors fiscal policies of member countries and provides technical assistance to economies in need of financial reform so that they can participate in managing the global economy. These roles were honed in the Latin American debt crisis of the 1980s and in response to the adjustment needs of former socialist countries in Eastern Europe during the early 1990s.

As it approached the Asian financial crisis, the IMF replicated its past practices in Eastern Europe and Latin America of negotiating stiff terms of economic reform and liberalization measures as conditions for disbursing loans. Initial IMF prescriptions came under fire for having had the unintended effect of exacerbating declines in the value of the currencies under attack by signaling that the economy might continue to be weak. By doing so, the IMF created hardship for workers who faced higher prices and the increased possibility of unemployment. The loan conditions and bank closings imposed by the IMF dried up the local money supply, precipitating a sudden rash of cash crunches and bankruptcies among local companies with high debt exposure, some of which might have survived otherwise and contributed to economic growth. In effect, the initiation of bailout negotiations has been criticized for signaling to the international investment community that a country's fiscal situation was weak. As a result, in the weeks following an announcement of an IMF bailout package, the country in question unwittingly became an even more inviting target for currency speculators. Indeed, many of these criticisms were justified because the IMF initially imposed high-interest-rate policies and sharp restrictions on government spending that shrank the supply of capital available to keep the real economy running, in turn making these countries' currencies even more inviting targets for currency speculation.

To a certain extent, the IMF has recognized these problems and corrected some of its initial prescriptions as the crisis has progressed, loosening restrictions on government spending to stimulate economic growth and gradually adjusting interest rates downward on a country-by-country basis as it became clear that exchange rates had stabilized. At the same time, the IMF rescue effort has generated a broad debate over appropriate financial reform focused on measures to avoid "moral hazard," increase the transparency of financial markets, and manage the volatility associated with increased foreign capital flows. Editorial discussion of each of these issues has generally been divided among those who seek to strengthen publicly funded regulatory mechanisms or institutions to "discipline" the markets, and those who advocate adjustments in the financial system that might allow the markets to more effectively discipline themselves.

The debate over the future of the IMF and efforts to prevent future currency crises continues to develop. But the lines of argument have been articulated. For instance, a "Tobin tax" on all international securities transactions has been proposed as a way to privately fund a fiscal "firefighting" institution—presumably an enlarged IMF-type organization—and as a way of eliminating reliance on taxpayer funds as the source of financing for bailout loans. Henry Kaufman has suggested that a "super-IMF" with increased access to information of central banks might play the role of a global regulating and ratings agency. Others have suggested that private ratings agencies—which failed to predict the most recent crisis—would be up to the task if only investors required greater transparency and a more effective regulatory system in each country. George Soros has proposed establishing a publicly financed organization that would offer global insurance guarantees to protect risk on certain investments, while investors would make non-sanctioned investments at their own risk. In testimony before the U.S. Congress, international economist Marcus Noland endorsed the concept of such an insurance guaranteeing institution, but noted that such an institution would be viable only as a private organization. Former Secretaries of State and Treasury George Schultz, William Simon, and international banker Walter Wriston have responded with strong criticism of the Soros proposal and of the IMF for interfering with the capacity of international capital markets to impose the harsh discipline of failure, a proper penalty for investments that run excessive risks.

The Asian crisis and subsequent public discussion have also stimulated consultations among regional central bankers to identify weaknesses in and to improve the architecture of the global financial system. For example, the Group-of-Seven (G-7) members have discussed proposals to decrease the volatile effects of "hot" currency flows, and regional finance ministry consultations are designed to heighten surveillance and provide early warning of weaknesses that could lead to financial crises.

The weight of international markets in shaping economic and political choices overwhelms the influence of traditional state institutions such as central banks and foreign aid providers. There are clear limits to the ability of government agencies—including the U.S. Treasury—to effectively manage or control economic events or financial outcomes.

Choices and Options for U.S. Leadership

Asia's financial crisis presents critical challenges and opportunities for the United States as it seeks to support Asia's economic and political stability. At the same time, it must be recognized that the weight of international markets in shaping economic and political choices now overwhelms the influence of traditional state institutions such as central banks and foreign aid providers. There are clear limits to the ability of government agencies—including the U.S. Treasury—to effectively manage or control economic events or financial outcomes. Thus far, U.S. handling of the Asian financial crisis has not been perfect, but American leadership has clearly helped to stabilize the crisis in the absence of leadership from any other country in the Asia-Pacific, and because of the limits of the IMF.

The Asian financial crisis has posed the following questions for U.S. officials:

- Can the United States promote economic and political reform in individual countries without provoking a nationalist backlash?
- Can the United States lead the way in developing and reforming global financial institutions such as the IMF to respond appropriately to the negative effects of accelerated global capital flows?
- Within the limits of our own fiscal capabilities, can the United States help ease the impact of the crisis on impoverished populations in Asia as a way of demonstrating U.S. leadership?
- Can the United States maintain a strong regional security presence in Asia if its military partners (including Japan, South Korea, the Philippines, and others) are financially weakened?
- Will the U.S. Congress support an administration program, including IMF replenishment, designed to stabilize the region's economy and demonstrate U.S. leadership and concern?

- Can the U.S. economy sustain the increasing trade deficits that will be a part (Asian recovery strategy of export-led rejuvenation without suffering either a mestic political backlash or damaging prospects for sustaining its own econo prosperity?

The situation has created a psychological mismatch in U.S. economic relations with Asia: In certain countries of Asia per capita purchasing power has been halved by the crisis; hence, American thrift or budget-balancing efforts may now seem stingy and mean-spirited.

The risk of a nationalist backlash against the United States must be taken s ously. While many parts of Asia have keenly felt the effects of economic recessio has had relatively little negative impact on the U.S. economy. (American consum have even benefited from cheaper imported manufactures and lower interest ra on home mortgages.) The situation has created a psychological mismatch in U economic relations with Asia. We should not forget the domestic effects of our o great depression of the 1930s or the security consequences of the world-wide d pression of that era. In certain countries of Asia, per capita purchasing power h been halved by the crisis; hence, American thrift or budget-balancing efforts m now seem stingy and mean-spirited. To Asians who face a dramatic drop in the personal incomes, the U.S. response seems to be an abdication of leadership, b this view neglects the increased importance of the United States as both a maj buyer of Asian products and as a source of political stability in the region.

The U.S. Treasury, to isolate problems and stem the financial contagion withi the region and in other at-risk economies such as Brazil, Turkey, or Russia, has trie to encourage international markets to views the at-risk Asian economies individu- ally instead of lumping all of them into the same category. At the same time, Trea- sury officials have begun to seek a global solution to the destabilizing effects of "hot" short-term currency flows, including more transparent and effective regulatory and preventive mechanisms to forestall crises. The initiation of regular meetings among Asian finance ministry officials in an attempt to provide greater surveillance and early warning mechanisms is one measure already under way. And the U.S. Trea- sury will continue to explore global initiatives coordinated through the G-7, such as reform of the IMF or development of new global response mechanisms necessary to contain and prevent future financial crises like Asia's.

A relatively modest effort to counter negative perceptions of the U.S. policy re- sponse might include an emergency fund for use in assisting the innocent victims of the crisis: recently unemployed laborers and impoverished families in countries implementing IMF programs, including Indonesia, Thailand, and South Korea. For instance, the US $1 billion in Export-Import Bank credits offered to Thailand dur- ing the Prime Minister Chuan Leekpai's March visit to Washington was a prudent reward for Thailand's faithful implementation of the reform program, which has increased market confidence in Thailand's economic recovery. The United States might also encourage Japan to increase overseas development assistance as one com- ponent of a program designed to blunt the negative effects of social instability in the region. Regional defense consultations to prepare for the effects of potential refugee flows from Indonesia might also be necessary in the event of protracted instability resulting from a failure to restore confidence in that country's political leadership.

The financial crisis highlights the need for a sustained U.S. security presence in East Asia, both to protect against the renewal of old tensions and to respond to the potential outbreak of new sources of political instability.

The financial crisis highlights the need for a sustained U.S. security presence in East Asia, both to protect against the renewal of old tensions and to respond to the potential outbreak of new sources of political instability. However, the financial cri- sis has placed new limitations on Japan's and Korea's host-nation support for the U.S. security presence in those countries and on opportunities for joint exercises necessary to sustain strong military cooperation with key allies and friends. U.S. support for regional cooperation mechanisms such as ASEAN, APEC, and ARF is likely to be even more important as regional cooperation is weakened by stresses stemming from the financial crisis.

The U.S. congressional debate over supplemental funding for the IMF has focused on policy measures to protect American taxpayers from either the "moral hazards" or other developments that would put America's current economic vitality at risk. During the debate, positive support has been generated for greater transparency both in the operation of the IMF and in Asian government-business relationships. For instance, Congressman Doug Bereuter has noted that some IMF conditions on domestic infrastructure spending may be counterproductive to the purpose of stimulating economic recovery, "but in a country [Korea] where people had expected to be employed forever by a company, with the prospect for major demonstrations in the streets, I certainly would be looking at that alternative."

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Supporters of additional funding for the IMF noted that money disbursed to countries requiring assistance is in the form of loans—which, as in the Mexico crisis, would be paid back with interest. Making a contribution to the IMF is analogous to raising the limit on overdraft protection of a checking account; it ensures that the "service charges" connected with global financial default are avoided. Critics of IMF replenishment have applied constructive pressure on the U.S. Treasury and other finance ministry officials to review the "moral hazards" and to consider reforms to eliminate the unfair risk-and-reward structures and other weaknesses in the architecture of the global financial system.

In his congressional testimony, Federal Reserve Board Chairman Alan Greenspan has referred to the "gathering clouds" of the Asian economic crisis that will move toward the United States during 1998. He anticipates the likely negative effects on earnings of companies that depend on Asia as an export market may cut economic growth in the United States by approximately one-half-of-one percent during 1998. Marcus Noland of the Institute of International Economics has projected that the U.S. trade deficit may increase by as much as $50 billion in nominal terms ($100 billion in real terms) primarily because of increased imports of lower-priced goods from Korea and Japan. This enlarged deficit is likely to generate new trade frictions between the United States and Asia, and there will be little room for engineering a political fix as a result of likely increasing political frictions in the United States on trade issues. A rising trade deficit may increase pressure on the Federal Reserve to raise interest rates to curb financial pressure on the United States, possibly squeezing prospects for continued economic growth.

The United States, with its currently robust economy and capacity to absorb the Asian exports necessary to prevent a regional recession, can be only one of the tugboats needed to pull Asia out of its economic crisis, however. Help is needed from Japan, and American officials will continue to pressure Japan to take the market opening measures necessary to become a second engine for pulling the other East Asian economies away from the abyss of severe recession. At the same time, the economic and political burdens and expectations placed on the United States as the world's economic and political leader will increase. If the political burdens of trade deficits or the pressure to restrict American or global support for market liberalization measures become too great, the risk is that global currency devaluation might lead to stalled global economic growth and economic depression, as Congressman Jim Leach has stated, the "economic causes of war."

Conference Agenda

Beyond Asia's Current Financial Crisis:
Challenges and Opportunities for U.S. Leadership

[was held] Monday, February 23, 1998
10:00 a.m.-3:00 p.m.
United States Institute of Peace
1550 M Street, NW
First Floor Conference Room

- **Introduction**
  Richard H. Solomon, U.S. Institute of Peace
- **The Asian Financial Crisis: Overview and Current Situation**
  Fred Bergsten, Institute of International Economics
  Timothy Geithner, Department of the Treasury
- **ASEAN's Response to the Asian Currency Crisis Thailand/Indonesia/Malaysia**
  Mort Abramowitz, Council on Foreign Relations
  Paul Wolfowitz, Johns Hopkins SAIS
  Karl Jackson, Johns Hopkins SAIS
- **Korea's Crisis and Response**
  Don Oberdorfer, Johns Hopkins SAIS
  Marcus Noland, Institute of International Economics
- **Japan's Financial Challenge**
  Michael Armacost, Brookings Institution
- **China: beneficiary or next victim?**
  Ezra Vogel, Harvard University
- **Congressional Perspectives**
  Jim Leach (R-IA), U.S. House of Representatives
- **A Response from Wall Street**
  John Whitehead, AEA Investors
- **U.S. response; political/policy response capability**
  Doug Bereuter (R-NE), U.S. House of Representatives
  Stanley Roth, Department of State
- **Impact on Major Power relations**
  Jim Woolsey, Shea and Gardner
  Arnold Kanter, The Scowcroft Group

Other participants:

J. Paul Bremer, III, Kissinger Associates
Peter T. Brookes, House International Relations Committee
Chester A. Crocker, Board of Directors, U.S. Institute of Peace
Patrick M. Cronin, U.S. Institute of Peace
Robert Dugger, Tudor Investment Company
Steve Ecton, Department of State
Robert Fauver, National Intelligence Council
Tom Gallagher, Lehman Brothers
Robert Hormats, Goldman Sachs
Oakley Johnson, American International Group
Robert A. Kapp, U.S.–China Business Council
Mark E. Leland
Phyllis Oakley, Department of State
Steve Piezcenik, Consultant
Stephen Douglas Wrage, U.S. Naval Academy