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East Asia's Rolling Economic Crises: Worries for the Year of the Tiger by James A. Kelly

By all normal lights, the assessment of recent political and security developments in Northeast Asia should be glowing. The Four-Party Talks relating to the Korean peninsula resolved a long impasse over agenda issues and began in Geneva. Sino-United States relations are the best in years after President Jiang Zemin's State Visit to Washington, and President Clinton will finally travel to China sometime in 1998. Negotiations on China's membership in the World Trade Organization are showing solid progress. Japan and Russia have set in motion a promising new process that may produce the long delayed World War II peace treaty. At the same time, both countries' relationships with China have also tangibly improved. Hong Kong's reversion to China was smooth. And the Republic of Korea's truly democratic presidential election brought an opposition leader to power for the first time.

But an unexpected and unwelcome reality, the rolling economic crisis of 1997 has sapped confidence widely. Coming out of what should have been manageable problems in the fast growing Southeast Asian economies, the disease has taken different forms that seem to attack each economy at its weak spots. China, Hong Kong, Taiwan, Canada, and the United States have been little affected thus far, but problems are entirely possible in each, as well as more serious manifestations in Japan, which has been the region's primary engine of growth.

Behind the politico-economic problems is globalization. No country's people want to have their development and prosperity vulnerable to distant events and choices by other peoples. But autarky --trying to go it alone -- brings very slow development or even none at all, and the price in foregone technology and growth is inevitably found to be too high. North Korea, whose model has gone to extremes to emphasize self-sufficiency, has had serious problems of food and energy supply that require external support. For most of East Asia, the rapid growth afforded by export industries, foreign technology and capital has fit well with energetic people and ingrained habits of saving and of valuing learning. The result has been the so-called "Asian miracle," but now the problems of being part of the global economy are beginning to bind.

The problem of globalization vs. self-sufficiency is one of blending and balancing controls and incentives. The recipient must welcome outside loans and investment, and the natural tendency is to seek more and more. But 1997 shows that sometimes the funds from outside are used unwisely, for uneeded or unusable facilities. Then repayment falters, and outside investors recoil in panic.

Economic interchange among nations is now far more intangible than concrete. Transactions have changed, especially in velocity, but also in their nature. Before 1970 trade in goods and services was responsible for 90% of international financial flows. Now, only 10% of cross-border monetary movements relate to trade. The preponderance of movement is investment and speculatory capital, necessarily bringing near instant feedback, especially when problems develop. Rapid flashback is particularly troublesome when coupled with the too-extensive practice of borrowing readily available short-term money for long term purposes. The result is growth and greater wealth than was even dreamed about, but with a dangerous accompanying volatility.

Foreign capital has many choices, and is very easily frightened so that the problems of one country raise questions about others, and the "rolling" crisis has spread to Northeast Asia. There has been a sudden, even shocked reappraisal of Asian investment risk. South Korea is the latest victim. Although Koreans still work hard, and have built few unneeded homes, offices, roads, railroads, or monuments, workers' toil earns much more than it did, so business costs are up, and industrial capacity has been built that goes well beyond what can be supported by sales. Korea's already strained lending/financial sector has had to tighten credit, and that sector's own short term financing from foreign sources dried up as several large industrial groups collapsed or tottered. Weak supervision allowed questionable loans to follow one after another. The result was an hemorrhage of South Korea's foreign exchange reserves, and after painful negotiations, the $57 Billion International Monetary Fund package. And that package comes with terms that are painful, unprecedented, unfamiliar, and unpopular.

Even Japan, with a giant economy and huge financial and foreign exchange reserves of both government and its citizen savers, has developed new problems. While its export industries remain the envy of all, Japan's financial sector -- ever so slowly working itself out of loan portfolios devastated by the decline in property values after the "bubble" of 1985 - 1991 -- has been struck with a new wave of loans that cannot be repaid from Southeast Asia and now, perhaps, from Korea. Worse, the weak yen policy that was keeping exports high and interest rates low to eventually heal the financial sector, has brought its own unintended effects. It will send the politically, if not economically, sensitive U.S. trade deficit to unheard of and politically dangerous heights, and it has contributed mightily to worsening South Korea's (and Southeast Asia's) problem by making Korean (and some Thai, Malaysian, and Indonesian) exports much less competitive in world markets than they might have been.

These unwelcome economic pressures will affect everyone. After a scare in October, American markets seem to believe that they will be little touched. But that judgment may prove mistaken. Too many companies' stocks have soared on earnings prospects that are likely to fall short, and the impact might shake the ebullient confidence that is being exhibited as this is written. The prospect of more and cheaper imports is counter-inflationary, but may contribute to some of the pain that still arouses fear in the work force, especially managers in the big company sector. This widespread worry amid a boom has persisted in the United States.

Agricultural exports are already sliding, which will affect Canada as well. And the trade deficit will soar as noted. It may approach an unprecedented $300 billion in 1998 with Japan and China setting records. There will be political effects of the sort manifested when President Clinton's own party led the refusal to grant trade negotiating authority in early November. The United States may be enjoying confidence and prosperity, but many have doubts.

So far, China's remarkable economic progress has also apparently been little affected. Yet it is clear that the vast amounts of foreign capital coming into China will diminish. Overseas Chinese in Southeast Asia have their own problems, and American and European capital is skittish. At the same time, although China's *renminbi* cannot be attacked by speculators because of its limited convertibility, the competition from devalued Southeast Asian products will intensify China's already large problem with bulging inventories of unsold goods. The effects, at minimum, will be further slowing of China's economic growth, how much being the critical question.

Political and Security Effects of Economic Disruption

The region's economic problems will have political impact. Five areas readily indicate possible repercussions:

- Political Legitimacy, Stability, and Succession. For many countries of East Asia, political legitimacy itself has been based on an implicit social contract by which citizens support their governments in exchange for a steadily enlarging prosperity. To the extent that people can "no longer count on getting rich," as the *New York Times* puts it, the results are not easy to predict. But if the burgeoning city populations in China suffer sharply increased rates of unemployment, it could try the ability of the government and the Communist Party to maintain stability as well as challenge the leadership succession that so far has moved very smoothly. China intends not to devalue its currency, but signs of instability may force the leadership to do so in an attempt to boost exports. If it does, there will be effects on confidence that would spread to Hong Kong as well.

Unemployment in Korea (levels are being predicted as large as 6%, twice the present level) will also be severe. The IMF package itself, despite obtaining approval signatures from all three leading presidential candidates, has drawn intense criticism although it is clear that President-elect Kim understands the seriousness of the liquidity crisis. To foreign eyes, lending with conditions seems to draw more indigenous antagonism than not loaning at all. The lengthy interregnum in Seoul from the December 18 elections until the February 25 inauguration may also contribute to uncertainty, although both incoming and outgoing President Kims have worked to avoid this.

Finally, North Korean officials are politically shrewd, but they are most unfamiliar with modern economies and economic disruption. It is important that North Korean leaders not misread the serious effects in South Korea as instability that provides an opportunity for military pressure. Both Koreas have economic problems, but their economies are in no way comparable. Yet the talk about "absorbing" the North will certainly have ebbed among Southerners, which could help prompt the restart of the North-South dialogue. The juxtaposition of South Korea's having to accept harsh conditions for loans matches poorly with North Korea's angry refusals of any conditions at all in its demands for food aid.

Indonesia's economic pain could also have serious political implications in 1998. President Soeharto will be reelected this year for another seven year term, despite his age of 75. But his critical choice of a vice president has yet to be made, and may prove controversial. Meanwhile economic uncertainty continues, the *rupiah* declines, unemployment soars, and lenders watch to see whether insisted reforms will affect the banks and businesses controlled by the President's family members and close associates as well as Indonesian business in general.

- Military Budgets and Aspirations. Economic disruption will affect military establishments up and down East Asia. At minimum, budgets for foreign weapons purchases are likely to be reduced, but domestic funding will also be impacted. China's modernization of its military, always measured, will likely go through some further slowing. In South Korea, military spending is already at about 3% of the GNP, down by half from ten years ago. But the fast growing economy had led to overall increases, which are not likely to continue. Southeast Asian arms purchases are being cutback and some payments are slipping. There could be many effects, not all bad, especially if mutual and balanced reductions were possible in Korea under the Four-Party talks or, better, in North-South context.

- Assistance/ODA. As economic problems spread, it will further limit both capacity and willingness of wealthier countries to provide Overseas Development Assistance (ODA). Japan's levels are already falling, and political pressure has developed to provide more of the aid that is given on a "tied" basis to domestic businesses. This is not likely to reduce Japan's ODA package (yen loans, mostly) to China, but it will have effect on Japan's Southeast Asian partners, especially Cambodia, and might contribute to a slower accommodation with North Korea.

- KEDO. (Korean Peninsula Energy Development Organization) The costs for the provision of two light water moderated reactors to North Korea in exchange for freezing its nuclear programs have always been expected to be large. As site preparation proceeds smoothly inside North Korea under the agreement, out-of-pocket costs, especially to the Korean Electric Power Company, are presenting themselves at a time of maximum economic disruption. The weak won is certainly putting great pressure on the financial health of South Korea's electric power generator, for its fuel must be paid for in dollars. Japan too will have problems finding the necessary funds, and the U. S. government has repeatedly advised a skeptical congress that reactor costs would be the

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responsibility of the Korean and Japanese partners.

- Burden sharing and American Forward Presence. America maintains its forward deployed forces to further its full range of interests in East Asia, as well in fulfillment of treaty commitments with Japan and South Korea. Both cover some of the costs -- very substantially in the case of Japan -- of basing American forces. This assumption of costs, called burden-sharing, is unlikely to proceed untouched by present economic problems. Any reductions will, in turn, bring criticism from the U.S. Congress and further pressure on the declining American defense budget.

James A. Kelly is the President of the Pacific Forum CSIS. All of us at Pacific Forum wish each of you a happy and prosperous 1998. PacNet goes by fax and e-mail to over 500 recipients in many countries.