ECONOMIC COOPERATION in the ASIA-PACIFIC REGION

edited by John P. Hardt
and Young C. Kim

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Economic Cooperation in the Asia-Pacific Region

Acknowledgments

This volume is an outgrowth of a series of meetings held in Washington, D.C., in the spring and summer of 1989 under the auspices of The American Council on Asian and Pacific Affairs, Inc. (ACAPA). It contains the expanded versions of the papers presented at the final conference and therefore incorporates comments made by specialists from various academic research institutes and governmental agencies who attended the meetings. I would like to take this opportunity to express my appreciation to all the participants for their insightful analyses and stimulating discussions.

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Young C. Kim

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Introduction

John P. Hardt

Under the best of circumstances, the Asia-Pacific region may well become the engine of global economic growth as we move into the twenty-first century. The Asian market-oriented economies, following the Japanese example, have modernized their domestic economies, raised living standards, and competed vigorously in the global market economy. Indeed, South Korea, Taiwan, and Hong Kong have emerged as global leaders in economic performance in recent years. The most populous country of Asia, the People's Republic of China, embraced the general principles of Western economic success in the post-Mao period by keying its plans toward modernization. The countries of Southeast Asia have also been pulled toward growth and improved economic health, primarily by Japan and the Newly Industrializing Countries (NICs).

The region has had no major military conflicts since Vietnam, and the prospects for resolution of differences by peaceful means and reduction in military burdens in most of the major Asia-Pacific countries are good to excellent. Even the Soviet Union may move away from its militarily driven Asia policy toward reconciliation and economic cooperation. Indeed, the global East-West confrontation is moderating and settlements of arms issues and conflicts between regional powers, Great Powers, and East-West are more likely than at any other time since the World War II settlements.

However, this favorable economic picture is clouded by troublesome problems that, if not resolved, could reverse the favorable prospects. On the global scene, Japanese economic competition may have replaced the Soviet military threat in the psychology of the European Community and North America. Moreover, some Asian countries, while benefiting from Japanese economic assistance and cooperation, still have a fear of economic domination that reflects their earlier concerns about military domination in the pre–World War II period. Although the European Community 92 and the North American Free Trade Zone are not solely regional economic alliances to counter the perceived economic threat of Japan, there is at least an element of protective competitiveness in the policies of these regional groupings. Major U.S. deficits and Japanese surpluses in trade accounts and investable funds are evidence of a realignment of economic power. And yet the policy adjustments in international institutions and in the global market structure have yet to be made. Japan has not yet taken or been accorded the institutional recognition and responsibility commensurate with its economic power and command of investable funds.

The integration of the Communist economies into the global market has proceeded more in rhetoric than in fact. The East European economies and the Soviet Union are tied to Western industrial economies more through economic policies of aid than through improved competition. The People's Republic of China has receded from political and economic modernization and may be moving back to the policy of self-sufficiency and control that was so dominant in its former ideology.

Prospects for resolving the political-military sources of instability in Southeast Asia—namely, in Cambodia; in northern Asia, with the continued confrontational division of the Korean peninsula; in the disputed Northern Territories; and in the Soviet Union, which still has substantial military buildups—are all troublesome. Each appears to be on the agenda of regional powers and Great Powers and is potentially resolvable in the years ahead. However, regression on any or all of these areas would have serious impacts on political security and economic growth and cooperation in Asia.

Thus a theme that runs through the individual assessments in this book is that under the best of scenarios the region may pull itself and the global economy toward higher levels of performance through structural change and competitive trade. Indeed, the region may live up to its name as a "pacific" area of the world. However, in order to bring about this favorable scenario, decision makers in Tokyo, Washington, Brussels, Moscow, Beijing, and elsewhere will have to take steps to ameliorate the serious economic and political problems threatening growth and stability. If they do not, the engine of growth and stability may work in reverse. Instead of becoming a leader in economic progress and a major contributor to a liberal global market, the Asia-Pacific region may face economic and political confrontation and instability. The contributors to this book do not make prescriptions to those who gather in Asia-Pacific policy councils, the economic summits of major Western economic powers, East-West summits, or the myriad of bilateral meetings, but those decision makers and other readers will gain insights on the issues that are likely to influence the search for solutions.

1

Soviet Global Integration Prospects

John P. Hardt

GLOBAL TRENDS AND THE ASIA-PACIFIC BASIN

Regionalism and the Liberal Global Regime

The increasing popularity of the concepts of globalism and the liberal commercial regime and the emphasis on development investment over defense allocations provides a favorable climate for increased efficiency and competitiveness, commerce and growth. This increasing acceptance *in principle* of developing a global economy based on universally accepted principles of openness and competition rekindles the spirit of those who projected a liberal world economic order to grow from the ashes of World War II. This new international economic order was to be an open, universal system that allowed for the development of a growing yet stable global economy that would assure improved living standards and reduce the prospects of conflict. Prosperity and peace were set out as the twin visions for the postwar world—visions that have largely been sustained through the 1980s.

The United States and Japan are likely to continue to dominate the commerce and investment of the Asia-Pacific region. Each has apprehensions about the future. A fear of the United States is that without changes in the factors leading to the trade deficit, Japan might own and control too large a share of U.S. assets by the end of the century. A Japanese concern is that external pressure to force open the Japanese markets in agriculture and other sectors too quickly might create strong negative political reactions in their country.

While reduction in the U.S. domestic deficit would help reduce U.S. current assets and merchandise trade deficits, as would a flexible exchange rate policy, and more resources to raise domestic investment and productivity could help raise the competitive position of the United States in Asian markets, without these favorable developments pressures working against a liberal regime may mount. A shift in domestic policies in Japan and the Asian Newly Industrializing Countries (NICs) toward domestic priorities, such as housing and a further reduction in institutional barriers to domestic markets, would further liberalize trade.

U.S. attention to the debt reduction problem in developing countries would also be essential to preserving liberal markets. Foreign aid and cooperation in addressing the debt issue is one of the top priorities in current Japanese economic policies. In 1988, Japan's official development aid passed the $10 billion level, exceeding the $8.8 billion of the United States. This made Japan the world's largest source of official development aid. A comprehensive conception and implementation of the Brady Plan, with Japan and the World Bank playing key roles, is another indication that U.S. economic hegemony is waning and roles are changing.

Japan and the Newly Industrializing Countries of Asia might be especially helpful in encouraging the integration of the People's Republic of China and Soviet Siberian regions into the rules-based multilateral economic system. All Western countries, especially the United States and Japan, may facilitate this integration in a global context, with regional affiliations reinforcing rather than countervailing global openness.

Soviet Domestic Reform Economies and Integration into the World Economy

While the West can take significant steps toward facilitating the integration of the Soviet Union into the global economy, the primary precondition for successful integration is domestic economic reform in the Soviet Union. Especially pertinent are the issues involving monetization in order to create a domestic market system and reduction of defense spending to facilitate modernization and political acceptance into the Western system. Without successful market-oriented reforms to cope with pressing problems of monetary overhang and extreme weakness in necessary economic infrastructures, and without effective steps toward relief of hard currency shortages and progress toward convertibility, effective integration is not likely. Market-driven economies at home are a precondition for effective integration of socialist economies into the global market system.[1]

Price reform, scheduled to begin in the early 1990s, is a process whereby prices that were formerly set by administrative procedures are allowed to "float freely" as determined by the market forces of supply and demand. The implications of price reform are substantial: Consumer and wholesale price reform would essentially create a market-oriented, decentralized economy. Specifically, implementation of price reform would lay the foundation for guidance planning; economic decision making based on objective criteria (e.g., efficiency, rate of return, and comparative advantage); competitive performance standards; mechanisms of accountability; a freely convertible exchange rate; and a rational tariff structure. Still, price reform presents policymakers with an inherent dilemma: While it is an absolute precondition for monetization and decentralization of the economy, it carries with it high short-term costs. Undertaking price reform in an economy like the Soviet Union with excess demand and heavily subsidized consumer sectors, the leadership faces unbridled inflation and negative social consequences.[2] Questions of equity—particularly for those workers on regular salaries whose living standard will fall rapidly as consumer prices increase—have left doubts as to the best way to proceed with consumer price reform, further delaying price reform until after 1991.

Dealing with the excess purchasing power in the system—that is, the monetary overhang—is clearly the first-order problem facing Soviet policymakers. Minister of Finance Boris Gostev[3] proposed the following strategy for dealing with the acknowledged 100 billion–ruble overhang:

1. Discipline the economic mechanism by tying wages to productivity and requiring enterprises to end deficits. Wages rose last year by 12 percent, productivity by 5 percent; one out of ten enterprises had a deficit. The "hard budget constraint" restricts loans to failing enterprises in order to end the "evil of freeloading."
2. Increase revenues by placing additional taxes on incomes and profits, especially the "unearned incomes" of some cooperatives. Also, sharply reduce capital investments and cut defense spending by 14 percent.
3. Absorb purchasing power through a 12 billion–ruble increase in domestic production of consumer goods, including some imports, and reduce supplies to nonmarket consumers (a euphemism for cutting special privileges to members of the party and government bureaucracy).
4. Increase savings and personal investments through the sale of housing and property claims on farms, enterprises, and cooperatives.

Nikolai Shmelev, who estimates a much larger overhang, would reverse alcoholic prohibition and instead introduce a heavy tax abstinence policy and import on credit of up to $15 billion worth of consumer goods in one year and $3.5 billion on a continuing basis.

The defense "burden" issue[4] came to the public agenda in 1988 with critical discussion of defense spending; conversion of military-industrial plants; the necessity of the current military draft; and a public debate on allocation issues. The primacy-of-defense claim has been politically challenged and the burden of defense generally acknowledged. Instead, investment for civilian restructuring over military programs would place perestroika in conflict with the more traditional view of the requirements of military security. In 1989, for the first time in Soviet planning history, the "guns versus butter" argument appears to be moving in favor of butter. So far, several proposals have been advanced to commission new plant and equipment for modernizing industry and agriculture; to delay new resource allocation for upgrading models of tanks, aircraft, and artillery; to reduce the draft of eighteen-year-olds for military service and instead release them to pursue advanced education or to become gainfully employed in the industrial or agricultural labor force. New military force planning may shift from offensive to defensive capabilities requiring smaller forces and fewer officers. Reduced foreign policy roles for military sales and aid may require less military production and claims on hardware inventories.

Nevertheless, the last Soviet leader to challenge the military budget, Nikita S. Khrushchev, was widely opposed by the military and was eventually removed from power. The Soviet reformers must therefore find the "proper" balance; they must prove the validity of reform to the average Soviet citizen by showing positive results without losing the military bureaucracy to reactionary forces.

Shifting to market forces in management and incomes policy is a daunting task in any centrally controlled economy.[5] Proceeding directly to consumer price reform, say in the early 1990s, would create high short-term economic and political costs. Perhaps the most critical initial requirement is to manage demand by bringing the money supply into line with the supply of goods and services. While all elements of fiscal policy may be employed to reduce monetary overhang, improvement in the quality of goods supplied, together with rising real income for the productive workers, may allow for the inevitable increase in prices without the consequences of severe austerity.

The labor surplus created by improving productivity in the service sector could be redirected into new cooperatives. This policy could provide significant short-term improvements in the quality of life. The growing attention given to cooperatives suggests their important role not only in improving the quality of life but also in creating jobs. Thus, hundreds of thousands of cooperatives formed in 1987–1988 have served the dual role of providing more products and services for the population and providing a new source of productive employment. Still, in response to the official perception that cooperatives have led to "unearned" price increases (despite improved services and products), a sharp control of activities and profits of cooperatives was set down in December 1988, and a new regulatory decree on cooperatives has dampened the development of cooperatives in 1990.

Intervention by the center represents a major setback in progress toward reform: As long as members of the old bureaucracy trained in the thinking and decision making associated with central planning continue to intervene, local decision makers may continue to base decisions more on the interests of government bureaucrats and less on market forces. In addition, private producers, without the benefits of being inside the "old system," may find it very difficult to compete on an uneven playing field. Eventually reform begins to be suffocated at its root—the enterprise. These dynamics effectively undermine newly implemented reform measures, bolstering instead the very structure meant to be transformed.

Step-by-step approaches may be critical to minimizing the highly negative social consequences of price reform and avoiding the inflation/intervention cycle. Transition toward market forces could take place through the use of short- and medium-term strategies. In the short term, any shift in prices alone might result in overt or concealed inflation; only an increase in supply may dampen the wage-price pressure and cushion the impact of reductions in income that would result from increasing sensitive prices such as meat and rent. In the interim, effective incentive systems may bring about an increased availability of "hard goods" such as quality food products, home appliances, and services. Output in agriculture may be less an obstacle to improving food supplies than the infrastructure that "preserves the harvest and crop" from field to table. Thus, direct attention to losses in quality and volume in harvesting and transport may lead to substantial improvements where it counts—on the consumer's table.[6]

A transitional phase during which a "simulated market" was created would allow price ranges to be created for goods, which would lead toward a rational price structure but would also meet the political and equity concerns of the leadership. Movement of producer and consumer goods toward market clearing levels would both provide useful price indicators for management and restrict the role of the second economy. For example, both housing and meat are currently heavily subsidized. During the transitional period, higher relative price ranges could be set for housing and goods production, which would eventually stabilize at a market clearing price. The point would be to move in the direction of a rational price structure in steps.

During the transitional period, before a fully rational price structure is established and objective criteria for policy-making set forth, problems of inefficiency, corruption, and inflation will most likely persist. These negative aspects of a staged approach may, however, be mitigated by a strong emphasis on increasing supply—through growth of both social and private production. This approach would help to keep down the worst aspects of inflation and may broaden the influence of the market and weaken the control of central bureaucratic managers. While Western economists agree that it is only through comprehensive price reform that other aspects of reform can be successful, political economists might be more inclined to emphasize the transitional approach, taking into account the short-term politico-economic benefits of maintaining a staged approach.

Other countries share with Soviet leaders the desire to avert the negative social consequences of inflationary pressure. In the initial stages of the transition, Soviet efforts to produce rising real income through an increase in the quantity of agricultural products may draw on Western experience in managing the farm-to-market food system and service industries. Development of cooperatives, coupled with investment in the farm-to-market infrastructure, which would facilitate marketing from cooperatives and family units as well as state and collective farms, would promote an increase in real income. The United States, the Scandinavian countries, and Western Europe have developed experience in agricultural cooperatives, as Lenin was aware when he wrote his famous article on cooperatives, referred to in the seventieth anniversary speech of General Secretary Mikhail S. Gorbachev. Western techniques regarding food storage, transportation, and processing of perishable products, if successfully adopted by the Soviet Union, and marketing techniques in Western economies, such as in the United States and the European Community, are especially relevant for Soviet economists and businesspeople.

Interdependence entails the establishment of an effective interrelationship between domestic and foreign markets whereby external economic relations are based on calculations of comparative advantage rather than ideology. Gorbachev's conception of interdependence and globalism appear to go far beyond the strictly economic; it embraces the political as it bears on arms control, the environment, the sharing of world resources, problems in overpopulation—in brief, a whole range of interaction in our experience today.[7]

Soviet New Thinking and the Reasonable Sufficiency Security Policy

The application of the New Thinking to regional issues has led to the withdrawal of Soviet troops from Afghanistan, a cease-fire in the Persian Gulf, and new withdrawal negotiations in South Africa and Southeast Asia. The formula suggested by Soviet diplomats for settling regional crises is the Afghanistan formula. The prime areas not influenced in the 1980s by this New Thinking are Northeast Asia—the Northern Territories and Divided Korea—and Central America. The former is a major impediment in moving toward a peace treaty and a summit with Japanese leadership, which the Soviets project for the early 1990s. Divided Korea is a dominant issue for South Korea and for stability in Asia. In the view of the United States, Central American intervention by the Soviet Union and Cuba restricts U.S.-USSR normalization in that region.

The unilateral and proposed symmetrical reductions in Conventional Forces Europe (CAFE) have led to considerable expectations of deep cuts in Europe. These have not been reflected in comparable Asian military negotiations and reductions.

On New Thinking, leading Soviet foreign policy advisers aver that progress toward the settlement of the Northern Territories, a precondition for a Tokyo Summit, is possible.[8] In reassessing the status of the Kurile Islands, one possibility that has been mentioned is to institute a transitional mode preceding their return under which Japan could lease some facilities on the four islands. Were Gorbachev to include a stop in Seoul as part of his trip to Japan, some Soviet formula for negotiation of relations between the two Koreas might be explored.

On force reductions, the NATO proposal of General Andrew Goodpaster of a mid-term goal of a 50 percent cut with balanced forces might be applied to China border forces, and unilateral cuts in the Trans Baikal district might be explored.[9] These symmetrical Soviet changes in regional and security policy would reduce the threat and open the prospects of commercial normalization.

Prospects and Options for Integrating the Soviet Union into the Asian and Global Market System

Western developed economies could reinforce the rules-driven liberal market system in the global economy by further integrating the economies of the Common Market in Europe past 1992; further integrating the leading Asian economies, such as Japan and the Newly Industrializing Countries of Asia (South Korea, Taiwan, Hong Kong, Singapore); and further integrating the North American economies into the global system, especially the United States and Canada.

In addition, measures should be pursued through the Uruguay Round of Multilateral Trade Negotiations under GATT and other means to facilitate integration of the developing countries into the global system through improved policies dealing with the debt of Less Developed Countries (LDCs).

Domestic reform, or sustainable perestroika, in the Soviet Union would provide an economic and institutional domestic basis for effective integration of the Soviet economy into the global market. In time, progress toward joining the Bretton Woods institutions of GATT, the IMF, and the World Bank could be facilitated.

THE SOVIET UNION IN ASIA: ALTERNATIVE FUTURES

Status Quo: Defense-Dominant, Slow Commercial Development

The Soviet domestic policy of perestroika has very little to offer Siberian development—especially investment in East Siberia and the Far East. The era of the big projects, such as the Baikal-Amur Magistral (BAM), is over;

driving the golden spike to complete the rail line in 1984 was the last Siberian hurrah for some time from Moscow. Investment under Gorbachev is not for new large-scale Siberian projects but for renovation of hundreds of old European plants to bring about a Second Industrial Revolution. The Soviet "rust belt" has won out for the time being over the development of the Siberian frontier. Likewise, consumer goods and modernization have an edge over military outlays. So the two legs of Brezhnev's policy east of Baikal—BAM (the Project of the Century) and buildup of the Trans Baikal military district—have been deferred and may be reversed. Still, although Gorbachev has taken his new military leaders from their posts in this area—Marshals Dimitri Yazov and Nikolai Moiseyev—he may continue on the policy course set in motion by his antecedents. While the "Far Eastern Comprehensive Economic Development Plan to the Year 2000" was announced in August 1987 with a promise for investment to exceed 230 billion rubles, I expect this to be a largely empty promise along with the undeveloped part of BAM. The railroad and regional development may be the Project of the Century, but from current indications the century referred to will not be the current one. So an economic status quo in East Siberia and the Far East is likely unless a new environment permits substantially expanded commercial relations with Japan, South Korea, the PRC, and the United States. Continuity or the status quo would mean that the defense-dominant, economic deferral policy would continue.

New Global Integration Policy: Commercial-Dominant, Defense-Threat Reduction[10]

Soviet commercial relations with its Asian neighbors—the People's Republic of China, Japan, South Korea, and others—have been modest to date. "Soviet-Chinese commerce has increased from a relatively low level during recent periods of normalization and may be expected to increase at an accelerated rate."[11] Although the relative change in recent years is impressive, the absolute level is modest. Soviet shares of the markets in the PRC, Japan, and South Korea are likely to be quite small under present conditions. A major change in these relations may occur if the political, military, and economic constraints controlled by the Soviet Union are relaxed or removed. Gorbachev has indicated an interest in developing a new environment in the Pacific. Initiatives open to the Soviet Union to reduce the territorial, military, and economic constraints on trade would be consistent with policies Gorbachev has adopted for other regions, including Europe, South Asia and Southeast Asia, and with the domestic reform policy of perestroika.[12]

Japanese and South Korean authorities have indicated that if political constraints on improved relations were removed and the Soviet Union provided an environment for profitable business, then commerce and investment would increase.

Soviet commercial relations with the People's Republic of China may be facilitated by further improvement in the "three conditions" (settlements in Afghanistan, Cambodia, and a reduced military threat on the Soviet-Chinese Border). Resource-oriented joint ventures with developed Asian industrial economies and improvement in infrastructure-associated Special Economic Zones, such as Nakhodka, would improve prospects for profitable Soviet-PRC commerce.

In Soviet policy, a precedent for removal of political and security constraints on trade in Europe has been set through discussions of a "European House" and acceptance of deep verification and inspection in arms control. The Soviet Union has especially removed political constraints and improved prospects of profit for the Federal Republic of Germany. This application of European-style New Thinking in foreign policy and a new foreign economic strategy has been promised for Asia. There are some signs that the Soviet leader will continue to pursue this conducive environment for commerce.

Prospects for an Improved Political-Military Climate

If political and security constraints to normal relations are significantly reduced, the positive steps toward normal commercial relations will thereafter be facilitated in Soviet relations with Japan, South Korea, and the PRC. The criteria for serious progress in each case could involve engagement in an agreed upon step-by-step process:

Northern Territories. A leading specialist on the Soviet Union, Hiroshi Kimura, has suggested what he calls the "Hong Kong formula," i.e., "the combination of return of two islands upon the conclusion of a peace treaty and return of the remaining two by a definite deadline, say 1999—would also be good enough for Japan."[13] This formula might become attractive to the Soviet Union if no other nonnegotiable claims are made or opened for future negotiation and if the Soviet government and citizens are given a graceful exit. Kimura further noted that:

> Japan could sign a long-term economic cooperation agreement with the USSR—following the example set by many West European countries—to facilitate more active trade and economic intercourse. The Japanese Export-Import Bank, a semi-governmental bank, could agree to loan huge amounts of long-term bank credit at low interest rates. With the official blessing of the Japanese government, private business in Japan could positively participate in joint ventures with the Soviets. Taken together, the chances are that Soviet-Japanese economic relations could be improved to the level of Sino-Japanese relations,