

# AsiaPacific

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## I S S U E S

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*The U.S. Congress established the East-West Center in 1960 to foster mutual understanding and cooperation among the governments and peoples of the Asia Pacific region, including the United States. Funding for the Center comes from the U.S. government with additional support provided by private agencies, individuals, corporations, and Asian and Pacific governments.*

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**SUMMARY** Indonesia has emerged as the most serious casualty of Asia's financial turmoil. Until recently hailed as a model of successful economic growth, Indonesia is facing a grave crisis which is, in the most fundamental sense, political. A loss of confidence in the Soeharto government and a wave of violence sparked by deteriorating economic conditions have raised the specter of a general collapse. As the world's fourth-largest nation by population, possessing vast natural resources, and located at a key crossroads between the Pacific and Indian Oceans, Indonesia is strategically critical to the future of the Asia-Pacific region. Since 1965 it has played a responsible and active international role, and was a leader in establishing the Association of Southeast Asian Nations (ASEAN), the Asia-Pacific Economic Cooperation forum (APEC), and the ASEAN Regional Forum (ARF) for security consultations. Despite differences over human rights and some other issues, Indonesia is also an important regional partner of the United States. Disintegration in Indonesia would have serious consequences for the region and for U.S. interests.

Indonesia's current troubles come against a backdrop of the remarkable successes of President Soeharto's "New Order" government. Indonesia's economic growth averaged 7 percent over the 25 years before 1997. Per capita income (in U.S. dollars) rose from ca. \$75 in 1966 to ca. \$1,200 in 1996. After decades of importing rice, Indonesia achieved rice self-sufficiency in 1984. Its population at the World Bank's poverty level decreased from 60 percent in 1967 to 11 percent (22 million people) in 1997. Between 1970 and 1997 infant mortality (per 1,000 births) fell from 118 to 52 and average life expectancy increased from 48 to 64 years.

Soeharto's government contributed at least three key ingredients that made this record possible: a stable political and economic framework, including a degree of tolerance for freedom of speech and the press which provided a safety valve within a fundamentally authoritarian system; sound basic economic policies, largely developed by a group of American-educated economists (the so-called "technocrats") led by Dr. Widjono Nitisastro; and a willingness to make politically difficult decisions when faced with serious economic problems.

**Neglected problems.** Beneath these successes, however, were numerous shortcomings in the New Order approach: the heavy-handed authoritarianism of a military-based regime; pervasive, endemic corruption combined with cronyism and nepotism; a large, high-cost, inefficient state enterprise sector; and an often stifling top-down bureaucracy.

Perhaps most important, Soeharto paid little attention to long-term political institution-building or the succession.

Outside observers, donor governments, and Indonesians all saw these problems. But they seemed secondary as long as economic success lasted, and where Soeharto resisted change most were reluctant to force the issues.

Over time the impact of the problems increased. High costs reduced Indonesia's competitiveness in a globalizing economy. As Soeharto's original colleagues left the scene, the system increasingly centered on one aging leader and decision making began to falter. Nevertheless, few if any foresaw an economic downturn in Indonesia of the rapidity or

depth of that triggered by the Thai financial crisis of mid-1997, much less that it could lead to the collapse of the Soeharto regime.

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### **Battle of the Rupiah**

In mid-May 1997 the Thai baht dropped in international currency markets. The baht's sharp fall generated a ripple effect on other Southeast Asian currencies. On July 8 the Indonesian rupiah came under pressure.

The rupiah was vulnerable for two principal reasons: private Indonesian corporations owed some \$74 billion in overseas debt, much of it short term and not hedged against exchange-rate changes; and the fundamental weakness of the Indonesian banking system including its susceptibility to political intervention.

**Cures don't work.** The government's initial reaction to speculation against the rupiah was swift and sound. Rather than defending its currency as had Thailand, Indonesia expanded (from 9 to 12 percent) the range within which the rupiah's value was allowed to vary. When the rupiah depreciated by 13 percent, from 2,400 per U.S. dollar in July to 2,700 by the middle of August, the government floated the rupiah freely and raised interest rates to attract rupiah deposits. On September 1 the government canceled or postponed some 150 development projects to conserve government funds. However, the rupiah's slide continued.

On October 8, when the exchange rate passed 3,800 to the U.S. dollar, Indonesia turned to the International Monetary Fund (IMF) for assistance. By the end of October a bailout promising some \$23 billion in international assistance had been negotiated with the IMF in return for promises of reforms including ending most monopolies and government subsidies. The government immediately closed 16 of the nation's weakest banks, and in November the IMF provided an initial \$3 billion.

The rupiah briefly recovered (to 3,800) following the IMF agreement, but quickly fell again. Reasons included the impact of closing the 16 banks, which triggered a run on other weak banks, and the fact that the IMF agreement did not address the problem of private overseas debt. The rupiah reached

*The Government's shortcomings were obvious, but seemed secondary as long as economic success lasted*

### Dimensions of the Crisis: Indonesia in Early 1998

**Business:** 260 of 282 Jakarta stock exchange corporations were technically bankrupt as of mid-January; most Indonesian enterprises could not obtain bank letters of credit to finance imports.

**Banks:** At most 10 of 240 banks were solvent under Indonesian banking regulations.

**Debt:** Indonesia's total foreign debt was \$136 billion in March, up from \$83 billion in 1994, representing 83 percent of Indonesia's GNP. Of this, \$82 billion was corporate debt, up from \$28 billion in 1994 due partly to exchange rate changes but also to significant new borrowing.

**Reserves:** In early March Indonesia's foreign exchange reserves were \$16.3 billion, down from \$20 billion in July 1997. Analysts believed only \$10 billion was not already committed under various pledges. February showed a net decline of \$2.7 billion.

**Unemployment:** As of March, the government estimated 8.7 million people unemployed, nearly 10 percent of a total workforce of 90 million and double the total of June 1997. The government estimated unemployment would reach 13.4 million (15 percent of the workforce) by March 1999; private estimates ranged as high as 20 million by the end of 1998.

**Prices and Poverty:** Food prices had increased by 50 to 100 percent or more since 1997. Combined with a freeze of minimum wages at 1997 levels, this severely affected the living standards. The World

Bank estimated that 20 percent of Indonesia's 200 million people would be living in absolute poverty as a result of the crisis, compared with 11 percent in 1997.

**Health:** Hospitals faced growing shortages of medicines. An outbreak of dengue fever reached 13,000 cases in April and supplies of blood needed for treatment were inadequate.

**Transportation:** The transportation system was breaking down. In late April half of Jakarta's bus and mini-bus fleet was idled by the high cost of spare parts and ridership was down by over 30 percent. The situation worsened with a 70 percent increase in fuel prices the first week of May.

**Food:** The World Food Program (WFP) and the Food and Agriculture Organization (FAO) in April projected another reduced harvest in 1998 and an import requirement of 3.5 million tons of rice over the coming year. They estimated 7.5 million people were at risk of serious malnutrition—although they believed mass starvation and death would be avoided.

**Forest Fires:** With the continuing drought, forest fires flared up again at the end of the first quarter of 1998. Rain helped the situation but the danger remained.

**Demonstrations:** Student protests began in February and led to increasingly violent confrontations.

4,000 to the dollar by the end of November and 5,000 in December.

Concurrently Indonesia faced other serious problems. The El Niño weather phenomenon brought severe drought to most of the archipelago, drastically reducing the rice harvest. Also due to the drought, fires set to burn agricultural land and clear forests spread out of control—producing a huge pall of smoke that seriously affected neighboring countries and greatly embarrassed Indonesia.

Then, when Soeharto returned from the annual APEC summit meeting in November, his doctors ordered him to take 10 days of complete rest. This both reduced his ability to deal with the country's problems and raised concerns about his health and the country's political future.

**Political dilemma, budget mistake.** As 1997 closed, unemployment was growing rapidly—in rural areas from failed crops and in cities from the shutdown of construction and other projects due to high interest rates. Rising food prices were forecast

because of the drought-reduced harvest and because in 1998 the annual Muslim fasting month and subsequent holiday, during which food consumption and prices paradoxically rise, would fall in January to February. IMF-required reductions in government subsidies for food would cause further rises.

From Soeharto's perspective, the IMF reforms were damaging his political/financial support base—including family business interests—without rescuing the rupiah or reviving the economy. Further, the thousand-member People's Consultative Assembly (which meets every five years to elect the president and approve major policies) would convene in early March. While Soeharto firmly controlled this assembly and was guaranteed reelection, the reaffirmation would be somewhat empty with the economy in shambles and people suffering increasing hardships.

Thus Soeharto was increasingly dissatisfied with the IMF program, and began backsliding on the more painful reforms, particularly the elimination of monopolies and subsidies. These actions strained

*The number of Indonesians living in absolute poverty is expected to nearly double*

*Soeharto came to be seen as part of the problem—even the main problem*

relations with the IMF and its backers, including the United States.

Against this background, on January 6 Soeharto released his budget for 1998–99 (to begin April 1). Based on exchange rate and inflation assumptions discounting the looming economic crisis (see box on p. 5) it confidently projected continued growth.

This budget was a major miscalculation. On the day it was presented the rupiah crashed, losing nearly half its value (from 6,000 to 10,000 to the dollar), and the Jakarta Stock Exchange tumbled, in a massive vote of no confidence by the markets in the government and the president.

Since that time the international community and significant elements within Indonesia have viewed Soeharto as part of the problem—even the main problem—rather than as part of the solution.

**Soeharto fights back.** The president again reacted quickly, immediately relaunching negotiations with the IMF. On January 15 a revised agreement was signed promising up to \$43 billion in return for reforms stronger than those in the original package. The new agreement also established a committee to examine private corporate debt. Unfortunately, the agreement failed to convince the markets that the government had the economic situation in hand. On January 15 the rupiah fell again, from 7,200 to 9,300 to the dollar.

The president's frustration increasingly began to show. In the third week of January he publicly hinted that his candidate for vice president in the next term would be his personal confidante, Research and Technology Minister B.J. Habibie. A flamboyant advocate of high-tech, fast-growth development and expensive projects, Habibie was intensely disliked by the technocrats and much of the business community as well as many in the military. The possibility that he would become vice president sent the rupiah into another tailspin. It nearly hit 17,000, a more than 85 percent devaluation from the previous July.

On January 23, the finance minister released a revised budget reflecting the new IMF agreement. However, the exchange rate, growth rate, and inflation assumptions in the new budget were still unrealistic compared to market estimates (see box on p. 5).

The falling rupiah, high domestic interest rates, and heavy foreign debt threatened an increasing number of Indonesian companies. On January 27 Indonesia declared a de facto freeze on corporate payments of foreign debt, yet another negative economic signal.

**Violence.** Rising prices and increasing hardships sparked a wave of violent incidents between January and mid-February, mostly in Java and many directed at local Chinese-Indonesian merchants. On February 12 Soeharto called for a crackdown. On February 16 he appointed General Wiranto, one of the military's most highly-regarded officers, as the new armed forces commander. (At the same time Soeharto appointed his son-in-law, General Prabowo, to head the strategic command and special forces—mobile and highly trained units critical to controlling serious disorders.)

Soeharto also began showing renewed unhappiness with the IMF's economic prescriptions. Throughout February, he publicly toyed with a proposal for a fixed-exchange-rate system. While this system had worked elsewhere, most economists believed it would only invite further speculation in Indonesia. The IMF, Indonesia's major donors, and the head of the Bank of Indonesia strongly opposed the idea.

Soeharto's response was to fire his bank head and to politely ignore the pleas of foreign visitors, including former-U.S. Vice President Mondale and Japanese Prime Minister Hashimoto, that he stick with the IMF formula. However, the fixed-rate proposal was not implemented, and by the end of February it seemed to have been shelved.

**New term and team.** At the People's Consultative Assembly meeting (March 1–11), Soeharto spoke of the economic crisis as an external challenge compounding natural misfortunes such as the drought and fires and requiring national unity and sacrifice. He flatly stated that the IMF approach was not working, and called for an undefined "IMF-Plus" program. As preordained, the assembly reelected Soeharto and confirmed Habibie as vice president.

On March 16, weeks earlier than had been customary, the president announced his new cabinet. For the first time in 32 years it contained no

Widjoyo technocrats (apparently tainted by association with the IMF plan). The new minister of finance was a U.S.-trained economist from within the ministry—but was known to be personally close to the president and not connected with the technocrats.

Another cabinet first was the appointment of a Chinese-Indonesian as minister for industry and trade. Shortly after the cabinet announcement, Soeharto named another Chinese-Indonesian to replace Widjoyo as manager of the team implementing the IMF program. While the first was a long-time business associate and the second the son of Soeharto's oldest business partner, these appointments also gave new status to the Chinese-Indonesian business community, whose capital and investments were critical to economic recovery.

A third feature of the new cabinet was the appointment of Soeharto's daughter Siti Hardiyanti Rukmana (known as "Tutut") as minister for social affairs. A prominent business figure, Tutut had also been an officer of the government party Golkar and had been rumored as a possible vice president.

Finally, General Wiranto was named minister of defense, giving him both of the top operational security jobs.

There were other highly talented figures in the new cabinet, including former planning chief Ginandjar Kartasasmita as economic coordinating minister, and indigenous business executive Tanri Abeng (given the daunting task of reforming the state enterprises). However, the group as a whole received mixed reviews. Clearly the key criterion in Soeharto's appointments was personal loyalty. U.S. Assistant Secretary of State Stanley Roth noted the new cabinet represented "circling the wagons" by Soeharto rather than expanding his circle of support.

Built-in factions in the new cabinet—including Chinese-Indonesians, the Soeharto family, Habibie, other indigenous economic nationalists, and the military—also ensured clashes over policy.

**Third round with the IMF.** On March 6 the IMF had postponed the second \$3 billion payment pending talks with the new Soeharto team. Talks began almost immediately, and both sides indicated serious interest in reaching agreement. Indonesian signals included a further raise in interest rates on March 23 and on April 4 a freeze of seven weak

banks and takeover of seven others. A new agreement was signed on April 9.

The third agreement contained 117 specific requirements, even deeper reforms than previous versions, and milestones for implementation and reporting. A general framework was also agreed for dealing with private corporate debt.

In return for stricter reforms, the IMF eased requirements for reducing subsidies on food and fuel, to delay price rises and dampen social unrest. However the requirement for eventual elimination of subsidies remained.

Budget estimates underlying the third IMF agreement were again more realistic than the previous version but still more optimistic than market conditions (see box below). The markets did not react strongly to the agreement, suggesting investors were awaiting implementation.

On April 22 the government met the first IMF milestone. This included reducing export bans and taxes, new rules for bankruptcy and plans for establishing a bankruptcy court, and new requirements for minimum capital levels for banks and the handling of bank losses. The rupiah fell slightly, indicating that the markets were still withholding judgment. The IMF, however, was satisfied with Indonesian actions and, on May 4, released \$1 billion.

*The new cabinet is a 'circling of the wagons'—not a move toward national unity*

#### Indonesia's 1998–1999 Budget: Assumptions vs. Market Realities

##### Government Draft of January 6

	Budget Est.	Market
Exchange Rate (Rp/\$)	4000	6000
Growth (%)	4	0
Inflation (%)	9 (yr)	7 (mo)

##### Government Revised Draft of January 23

	Budget Est.	Market
Exchange Rate (Rp/\$)	5000	14,500
Growth (%)	0	- 4*
Inflation (%)	20 (yr)	13 (mo)**

\*(Economist est.)

\*\* (Feb)

##### Government/IMF Agreement of April 9

	Budget Est.	Market
Exchange Rate (Rp/\$)	6000*	8,050
Growth (%)	- 4	- 10
Inflation (%)	17 (FY)	45 (CY)

\*(target, not average)

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### Unraveling Order

By the end of April the Indonesian situation had all the makings of a national meltdown—economic, social, and political (see box on p. 3). Possibly the most dangerous development was escalating student protests, which had spread beyond the traditional centers of student activism in Jakarta and other university cities in Java to include Sumatra (especially Medan), Kalimantan, Sulawesi, Bali, and the neighboring island of Lombok. Students increasingly were demanding that Soeharto step down. While early demonstrations were largely confined to university campuses (there tacitly tolerated by authorities), in late April and early May students began to take to city streets, directly confronting the police and military.

Professionals and the unemployed began joining student demonstrators. Confrontations escalated from rock-throwing to the use of Molotov cocktails. Security forces responded with tear gas and rubber bullets. Reports of injuries mounted.

In April, students reported the disappearance of a number of protesters. Some subsequently reappeared and alleged serious mistreatment, presumably at the hands of security authorities. This renewed international criticism of Indonesia's human-rights record. In early May a series of worker strikes demanding higher wages to compensate for skyrocketing prices produced more violence.

On May 12, with the president out of the country, the violence crossed a new threshold, when five students were killed in a battle with security forces in Jakarta. This triggered mass rioting and looting in Jakarta and brought the political crisis to a head.

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### Why Indonesia?

Several factors help explain why, despite its good early response, Indonesia has been more seriously affected by the Asian financial crisis than most other countries.

*Indonesia's economic and government institutions are weaker and less mature than those of most other countries of Southeast or East Asia.*

Indonesian economic ministries sometimes lack even basic information on the economic sectors for which they are nominally responsible.

*Indonesia had an entrenched regime largely dependent on one aging leader.* In contrast, Thailand and Korea were able to change leaders and policies in an orderly fashion. These changes were part of their successful response to the crisis.

*Indonesia has a particularly problematic relationship between private business and the government.* Chinese-Indonesian businessmen control more than half (estimates range from 50 to 80 percent) of the country's economy, but the Chinese minority is regarded with suspicion by other Indonesians and is highly dependent on government officials (military and civilian) for services and protection. The government has long encouraged the development of indigenous enterprise, but blatant favoritism toward relatives of high officials, particularly the Soeharto family, has made it difficult for other indigenous businesses to compete. The lack of an integrated national business community is an increasing handicap for Indonesia in the globalizing economy.

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### Prognosis: Grim

The current economic package can see Indonesia through the worst of the immediate crisis but cannot avoid severe hardship.

The third IMF program was holding as of mid-May. Arrangements were being made to handle the corporate debt problem using a Mexican/South Korean model involving multitiered agreements between corporations, the government, international donors, and private creditors to repay and reduce debts. Other government efforts include an aggressive program to restructure state enterprises. Still, it will be difficult for Indonesia to meet the IMF schedule and fully complete the program.

New trade credits sponsored by Indonesia's trading partners—including Singapore, Japan, and the United States—will enable viable Indonesian corporations to obtain credit. Indonesia's trading partners believe it would not be wise to allow Indonesia to go "down the drain" and descend into chaos. But these arrangements take time, and meanwhile conditions will worsen.

Finally, a substantial humanitarian assistance effort by many donors is being coordinated by the World Bank. The Indonesian military and the state

*The country's dependence on one aging leader limited its ability to respond effectively*

*Rivalries between the top military leaders could pose the most serious threat to stability in Indonesia*

logistical bureau (BULOG) are capable of delivering supplies to almost every location in the archipelago. Thus mass starvation should be avoided.

However, even if these efforts succeed, Indonesia faces a minimum of one year, and probably more, of negative or no growth. Market confidence will be difficult to restore. Government officials targeted Chinese-Indonesians as scapegoats in earlier stages of this crisis. The appointment of two Chinese-Indonesians, both close associates of the president, to important posts was not sufficient to restore the confidence of the larger Chinese-Indonesian business community, and the mid-May riots led to further flight. International markets remain skeptical that the IMF reforms will be fully implemented, and foreign investors will be cautious until real change occurs.

Once growth resumes, it seems unlikely to reach the 7 percent annual rate of the previous 25 years. American economist Paul Krugman believes Asia could reach 5-plus percent average growth, but not the region's previous 8 percent. Many Indonesian businessmen believe 4 percent growth is the minimum needed to absorb new labor-force entrants and provide adequate profit for businesses to expand. At 5 percent, Indonesia would be close to the edge.

**Protest and power.** Criticism of the regime meanwhile continued to increase. A poll by former weekly magazine *Tempo* (closed by the government in 1994 but still operating on the Internet) found 80 to 95 percent agreement that the new cabinet is incapable of solving the country's problems and that a change in top leadership is necessary. Even after Indonesia passed the first IMF milestone, an editorial in the leading Indonesian-language daily *Kompas* argued that economic reform was not sufficient and that political reform was needed to overcome the crisis. In late April Amien Rais, leader of the 28-million-member Islamic organization Muhammadiyah, threw his support behind the protest movement and called for "completely new national leadership." Other voices steadily joined the rising chorus.

While continued outbreaks of violence appear inevitable, a successful popular revolution still seems

unlikely. Indonesians over 50 retain a horror of the bloodshed of the 1965–66 period when the death of hundreds of thousands of their countrymen accompanied the setting aside of Sukarno. In addition, most Indonesians now have more to lose in a violent upheaval than did their predecessors 30 years earlier. Further, although it is growing, the political opposition is not a cohesive group. On its own it cannot physically overthrow the Soeharto regime. The armed forces maintain an effective monopoly of firepower and, given time, continued discipline, and internal unity, the military should be able to regain control even in the face of widespread violence.

With his reelection and with a hand-picked vice president and cabinet, Soeharto confirmed that he remained firmly in charge of the government. Nevertheless he was no longer fully in control of events. With the violence reaching the stage of massive casualties, it is conceivable that the military leaders will conclude they have no choice but to prevail on Soeharto to stand down, much as he forced the resignation of founding President Sukarno in 1966. But this is a course they would only take reluctantly. The top military leaders all have personal ties to the president, and they remain divided by internal rivalries. Short of truly extreme circumstances it is difficult to see any group within the military coalescing to displace Soeharto.

However, Soeharto appears to have been fatally weakened by the general loss of popular support. As the most powerful force in the country, the military is in the best position to control the succession process. Vice President Habibie lacks a strong political base of his own. A unified military leadership could easily either dominate a government under Habibie or ease him out and choose his successor.

Ironically, it is rivalries between the top military leaders, which Soeharto has ensured through his recent appointments, that now pose the most serious threat to stability in Indonesia. There have been some indications both of conflicting views among the leaders over how to deal with the current unrest, and of contacts by different military factions with elements of the student movement. These factors may partly explain the scope and duration of the protests. Students in Indonesia have relatively little

*Indonesia should receive external support in the crisis because of its importance to the future of Southeast Asia and the larger region*

real power on their own, but they can become a major catalyst when there are divisions at the top of the government. And, as demonstrated by the mid-May events in Jakarta, in the volatile conditions created by the economic crisis, this combination can have truly explosive consequences.

**The road to reform.** Regardless of who leads the Indonesian government, the crisis has clearly demonstrated the necessity of serious reform and further development of Indonesia's economic and political institutions. This will be a very difficult challenge. It can probably only be accomplished by a broad coalition including technocrats, other experts, members of the business community, and political leaders—in other words, a government of national unity. It will be harder still to achieve if the current crisis leads to continued widespread violence and destruction. In this event, the crackdown necessary to restore order will be stronger, the economic and international costs to Indonesia will be greater, the level of continuing tension and distrust within the society will be higher, and the leadership will have to devote correspondingly more attention to order and less to recovery and institutional reform.

### **Saving Graces**

Despite the generally sobering outlook, there are still positive elements in the equation. Indonesia has solid economic fundamentals—the “miracle” of the last 25 years was not a mirage. Further, 1998 is not 1966; no present conflict matches that pitting the army and the Muslims against the communists which triggered the horrific events of 1965–66. No Cold War exists to fuel that kind of internal confrontation.

As previously noted, a reasonable package of reforms is possible. And lessons have been learned from the present crisis, at least by most parties, that can help both the government and the economy to recover.

Finally, Indonesia should receive the external support it deserves in this crisis, because of its inherent importance and the significant role, for good or ill, that it will inevitably play in the future of Southeast Asia and the larger region.

### **Note**

The statistical information and quotations in this article are drawn from press reports, official statements, and congressional testimony.

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#### **About the Author**

*Richard W. Baker is a Senior Fellow in the East-West Center’s Program on Education and Training and a former career American diplomat who served in Indonesia from 1972 to 1976. He is the coauthor and editor of the forthcoming book, Indonesia: The Challenge of Change, published by the Institute of Southeast Asian Studies, Singapore.*

*Telephone: (808)944-7371*

*Facsimile: (808) 944-7389*

*E-mail: bakerr@ewc.hawaii.edu*