

Sex, lies and capital controls

– The policy struggle in Malaysia during the currency crisis.

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Table of Contents

1.0	Introduction	2
1.1.	The argument established.....	2
1.2.	On the term ‘economic nationalism’	3
2.0	The devil’s choice – foreign capital or national autonomy?	4
2.1.	Economic policy before the crisis	5
2.2.	The crisis and its consequences.....	7
3.0	The necessity for monetary autonomy.....	8
3.1.	Malay economic nationalism: The Bumiputra policy	8
3.2.	Malaysian economic nationalism: Wawasan 2020	13
3.3.	Why both these policies presuppose monetary autonomy	14
4.0	Money – more than a medium of exchange	14
5.0	The threat that was Anwar Ibrahim	16
5.1.	Anwar’s crisis response – the neoclassical way.....	17
6.0	Mahathir strikes back – abandoning free flow of capital	19
6.1.and they lived happily ever after.....	20
7.0	Appendix	21
7.1.	List of tables and figures	22
7.2.	Note on the (lack of) use of Malaysian academic sources	22
7.3.	Literature list	22

“Contrary to the usual belief that I am a dictator, I actually work as a team.”

- Mahathir Mohammad (Fuller 1998b)

1.0 Introduction

As just a quick examination of the literature list for this paper will show, a huge amount of work has been produced by scholars worldwide on the Asian financial crisis of 1997-98. As among others Kishore C. Dash (2003:273) and Rudiger Dornbusch (2001:2) point out, economic factors can explain why the crisis broke out, but the subsequent management on it must also take the domestic political situation into account. Much more accomplished scholars than myself have examined to great length the reasons for the crisis and the results of the choices taken.

What this paper focuses on is to fill in the picture of why the crisis was handled the way it was, going beyond the macroeconomic arguments. The economy and the currency can be important tools for control and important totems of nationalism. I intend to show that regardless of macroeconomic concerns, Prime Minister Mahathir Mohammad had based his power on these tools and had all but painted himself into a corner, having no option but to choose the policy he did if he wanted to avoid the risk of serious damage to his regime.

1.1. The argument established

Three steps form a process of elimination by which closing off the Malaysian economy becomes the only viable solution for Prime Minister Mahathir:

Firstly, the possible policy choices were constrained by the Mundell-Fleming conditions, also dubbed the “unholy trinity.” They state that it is impossible to maintain both a fixed exchange rate, monetary autonomy and a free flow of capital simultaneously. Malaysia had still been fairly close to achieving this, but the face of a massive macroeconomic shock made it impossible to keep doing so. A choice about which goals to pursue had to be made. This is discussed more thoroughly in chapter 2.0.

Secondly, Mahathir’s power was strongly dependent on the economic network centered around the UMNO party that constituted the major part of his power base. Abandoning monetary autonomy, with the possibilities of high interest rates sure to hit sub-prime loan markets hard, posed a serious threat to the UMNO business conglomerate. Relinquishing monetary policy control thus seemed difficult. This is explored in chapter 3.0

Thirdly, Mahathir had through his Wawasan 2020 plan emerged on a path to bring Malaysia to become an industrialized nation through a new state-centered nationalism. The currency was a vital national symbol and currency stability was thus also prioritized. This is discussed more in chapter 4.0.

Making the two first options go from difficult to impossible was the the concurrence of a macroeconomic shock and a political crisis in the form of Anwar's challenge to Mahathir's rule. With attacks against his power in the elections of 1993 and 1996, Mahathir's apparatus for autocratic rule was being threatened. Anwar's advocacy of austerity measures threatened to shake the UMNO patronage system even more strongly. More on this can be found in Chapter 5.0.

Constrained by the Mundell-Fleming conditions, the last remaining option was to abandon free flow of capital, which had played a major role in the prosperity of the Malaysian economy to over the last decades. With a considerable distrust towards international markets, this option seemed less unthinkable to Mahathir than to most mainstream economists. Additionally, the policy facilitated both the discrediting of Anwar's supporters and the possibility to blame domestic economic problems on foreign actors. This explains why Mahathir was willing to go to great lengths to enforce these policies, regardless of the risks (or even predictions of impending doom) stressed by a unitary corps of international economists. This concluding part is elaborated in chapter 6.0.

1.2. On the term 'economic nationalism'

As I will show in the next chapter, two different economic nationalist policies were dominant Malaysia: The ethnic-centered Bumiputra policy, focusing on the Malay nation, and the state-centered patriotism policies inherent in the Wawasan 2020 program which had at the core the construction of a new Malaysian nation. To be able to do this, I will clarify what this term is taken to mean in this paper, which differs somewhat from the term as used in the course textbook.

Robert Gilpin admits in the opening chapter of his book *Global Political Economy* (2001:14) that he should distinguish more closely between the terms "economic nationalism" as a normative perspective with state-centric realism as an analytical one. This lack of distinction appears to be common in political economy literature. He is, however criticized for continuing to adhere to an understanding of economic nationalism as an analytical concept that centers on state interest rather than a definition of interest with a concept of a nation at

the core. His use of the term is thus as a descriptive of any state interventionist policy based on the perceived interest of a state. As the word “state” as it applies to Western European states would most often signify a nation state, this might be understandable. Also, true nationalistically motivated economic policies are also most easily distinguished from a more global liberalism when they result in state intervention, but this is not the important defining characteristic. A nationalist focus may well lead to liberal policies, as was to a large part the case with Malaysia before the crisis, not to speak of Great Britain and the United States throughout much of history (Helleiner 2002:308-11).

Eric Helleiner (2002:308-314) argues that we should look to the origin to find the core of what economic nationalism is really about. He cites the economist Friedrich List as the most prominent nationalist economist of the 19th century. Friedrich is most famous for his advocacy of intervention to protect infant industries, but Helleiner argues that the core of his contribution isn't his policy recommendations but what he puts at the core of his economic thought. In *The National System of Political Economy* (1909[1885]:XIV) List elaborates his focus on national interest in economics, first and foremost considering the good of the nation. This is in List's view more than aggregate economic interest of its members. A further elaboration on the definitions of national interest is not the issue of this paper, but I will use the term economic nationalism to refer to an economic policy based in a concept of national interest rather than a general term for state interventionism.

2.0 The devil's choice – foreign capital or national autonomy?

“Russ Cargil: I've narrowed your choices down to five unthinkable options. Each will cause untold misery...

President Arnold Schwarzenegger: I pick number three.

Russ Cargil: You don't even want to read 'em first?

President Arnold Schwarzenegger: I was elected to lead, not read. Number three!”

- Simpsons, the Movie

The Mundell-Fleming conditions, also dubbed “the Unholy Trinity”, or the capital mobility hypothesis, state that an economy cannot simultaneously maintain free capital mobility, fixed exchange rates and monetary autonomy (Cohen 2003:217, Gilpin 2001:248-50). This conflict is at the heart of the Malaysian controversy.

The formal argument relies on the Mundell-Fleming model, an expansion of the traditional IS-LM model of macroeconomics. It boils down to the fact that if the exchange rate is fixed and capital flows freely, an increase in money supply will simply make capital

move out of the country until the interest rates stabilize at the international level. The state must therefore keep adjusting money supply to match domestic money demand to international interest rates. If the exchange rate is allowed to float freely, it is possible to make money supply adjustments that will change the domestic exchange rate vis-à-vis the international market, as the exchange rate will modify to account for the exchange rate differentials in international capital transactions. Stopping the flow of capital across borders will effectively close the economy, making it unaffected by foreign transactions in domestic currency (which will then be completely pointless). In reality it is practically impossible for a modern nation to completely stop capital mobility, as it would mean no foreign trade was possible at all. Similarly, capital mobility can only be assumed to be near-perfect in economies with extremely efficient capital markets. Such markets are still bound to have some less liquid assets. In reality we therefore talk of a high or low degree of capital mobility and monetary autonomy (Blanchard 2000:382-98; Krugman & Obstfeld 2003:381-5, 470-4;).

Other criticisms have also been put forward against the model, both empirical and theoretical, but the model remains at the core of current political economic thought (Cohen 2003:217-8). For the purposes of this paper, its important role in economic orthodoxy is more important than the veracity of its content.

2.1. *Economic policy before the crisis*

The Wawasan 2020, the plan to become an industrialized nation by 2020 was the ruling principle of economic policy in the 90s. The plan included favoring export-oriented growth while shifting from labor-intensive to high-technological industries, cutting down on the need for foreign workers. Major government and government-controlled infrastructure megaprojects served both as a Keynesian means of increasing domestic consumption, but also to further improve conditions for the industry. This led to a high fiscal deficit, the highest in Asia at 9% of GNP in 1996 (Chin 1997:186, Mohamed Jawhar 1996:123-6). Openness of the economy facilitated growth through large inflows of capital through the early 1990s. Not primarily as FDI, but as bank loans and portfolio capital. (Dornbusch 2001:5)

1996 was Malaysia's ninth year in a row with more than 8% GDP growth. Malaysia still managed to maintain low inflation despite a high budget deficit. This was probably due to very good management of the economy, with tough measures implemented when necessary. With few scruples about intervening in the economy, the government under Anwar as finance minister set several measures in motion in 1995 to prevent overheating of the economy:

Increased minimum limits on credit card payments, increased airport taxes and road taxes for luxury cars, levies on foreigners' property purchases and raising employee's compulsory provident fund contributions. The supply of money was also kept tightly controlled.

International pressure was put on Malaysia to reduce its deficit, but the government refused to slow the pace of its major building projects to do so (Chin 1997:186, Mohamed Jawhar 1996:123-5).

In the foreign policy area, Malaysia argued strongly for flexibility and non-binding agreements about trade liberalization. By 1995 this had become a consensus among all countries but Singapore in Southeast Asia, and been accepted into the APEC regime (Mohamed Jawhar 1996:128). Being critical to the USA-dominated APEC, Mahathir also advocated an alternative, less market-oriented regime dubbed East Asian Economic Caucus (EAEC) to be put in its place. He also worked to insulate Malaysia from intrusions on its policies by the IMF and World Bank (Beeson 2000:349).

Umezaki So (2006) has empirically analyzed the management of the currency by Bank Negara Malaysia (BNM) before the crisis. He concludes that the management was characterized by very open capital markets at the same time as both exchange rate and inflation have been stabilized. According to the Mundell-Fleming conditions this shouldn't be possible. He explains this by the fact that capital markets are never as open as the model assumes, and that the BNMs interventions in the foreign exchange market were both imperfect and offset by interventions in the domestic market (so-called sterilizing).

Table 1: Select economic figures for Malaysia

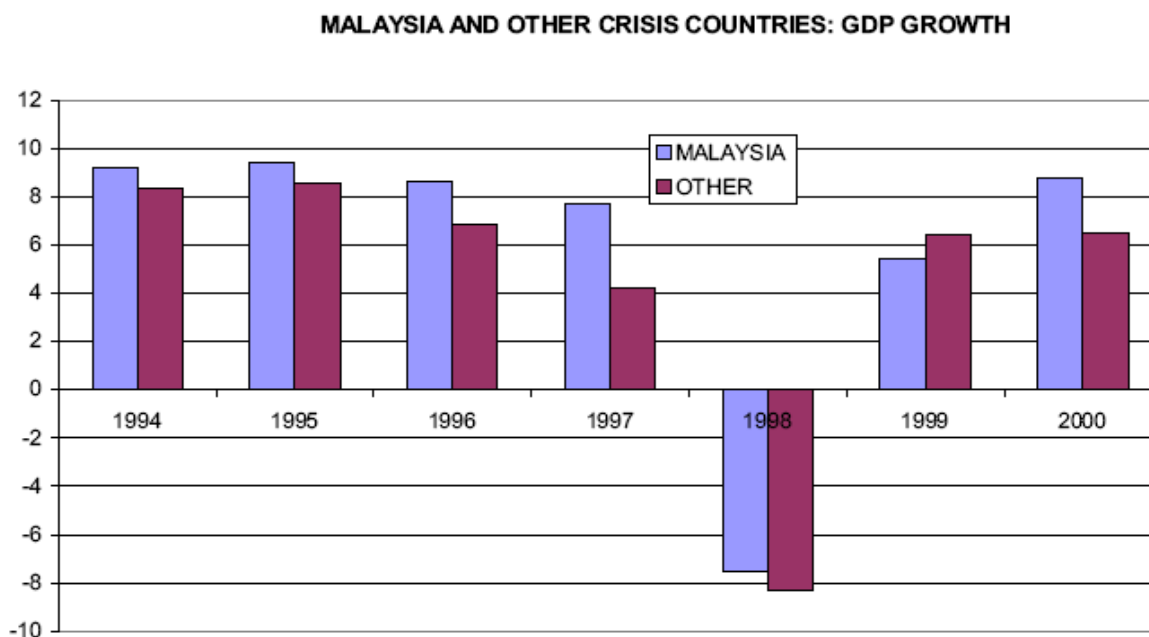
	1994	1995	1996	1997	1998
Real GDP growth (%)	9,3	9,4	8,6	7,7	-6,7
Inflation (CPI growth in %)	3,7	3,4	3,5	2,7	5,3
Unemployment (percent)	2,8	2,8	2,5	2,4	3,4
Trade balance (US\$ billion)	1,7	0,0	4,0	4,0	17,7
Gross official reserves (US\$ b)	26,6	25,1	27,7	21,7	26,2
Gross off. res. (months of import of goods and services)	4,4	3,2	3,4	2,6	4,3
Tot. External debt (% of GDP)	39,5	38,3	39,4	43,6	59,2
MYR/US\$ exchange rate	2,56	2,54	2,53	3,88	3,80

(International Monetary Fund 1999b)

2.2. *The crisis and its consequences*

As the currency crisis hit Thailand, Malaysia stood by and watched from the sideline. A strong belief in own economic fundamentals made Malaysian policy makers think it very little likely that the same would hit them (Mahathir 1999:52-6; Nesadurai 2000:85-88). As we see from the figure below, the crisis also started affecting Malaysia's economy later than the other crisis countries.

Figure 2: GDP Growth



(Dornbusch 2001:6)

In the end, even the Ringgit started a plunge. The monetary authorities tried to defend it, spending in excess of RM 9 billion (3.5\$ US) before abandoning the effort. The capital mobility that had facilitated inflows of foreign capital in the 1990s started producing accelerated outflows also from Malaysia as the countries assets were devalued with the currency (Dornbusch 2001:5; Nesadurai 2000:76; Sundaram 2006:490-1). Mahathir lashed out against the international finance world, laying all the blame on powers beyond Malaysia's control. His rhetorical wars with Al Gore and George Soros throughout 1997 and 1998 became famous (Sanger 1999, Friedman 1997, Beeson 2000:338, Nesadurai 2000:88). Various threats that measures would be taken to stop the forces at play through cutting them off from the Malaysian markets deepened market insecurities. As the phenomenal growth stopped dead in its tracks, Malaysia's balancing act of living on the edge of what the Mundell-Fleming model described possible seemed at an end. It was necessary to make some hard choices.

3.0 *The necessity for monetary autonomy*

“Dorothy: Come back! Come back! Don't leave without me! Come back!

Wizard of Oz: I can't come back! I don't know how it works! Good-bye folks!”

- The Wizard of Oz (1939 adaption)

As stated in chapter 1.1, abandoning monetary policy autonomy as per Anwar's austerity measures was not a very attractive prospect for Mahathir. I base this statement on two facts. Firstly Mahathir was burdened (or blessed?) with the legacy of the economic nationalist project known as the Bumiputra Policy¹, which had created a powerful business and political elite of Malay businessmen on whom much of Mahathir's power rested. High interest rates threatened several of their large companies with bankruptcy (Nesadurai 2000:98).

Secondly, at the core of his Japanese-style development project Wawasan 2020, was the ability to regulate markets in favor of a few select industries which were to bring Malaysia to become a developed nation. If autonomy over money, that is to say interest rates, were to be handed off to an international market which Mahathir mistrusted, his ability to intervene in order to protect these industries would be seriously diminished.

3.1. *Malay economic nationalism: The Bumiputra policy*

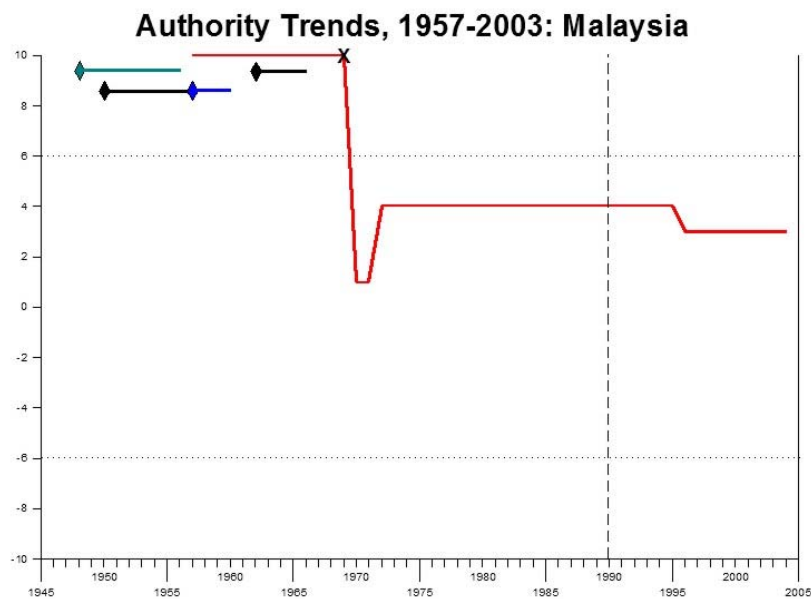
The foundation of Mahathir's economic nationalism was not in Malaysia as a state, but in the Malays as a nation. Through the book *The Malay Dilemma* (1970), he established himself as a nationalist, outlining the way for Malays to leave their backwardness and rise to greatness. Unlike the original development of nationalism as a requirement for industrialization, industrialization in Malaysia was chosen as a tool of ethnic nationalism, destined to bring wealth to the poor Malay peasantry (Case 2000:138-9). His ability to bring wealth to this majority of Malaysian citizens has been the foundation of much of his power, but as we will see, it also became a constraint under which he was forced to conduct his policy.

Malaysia is at best a “semi-democratic” nation. It is rated by Freedom House (2007) as “Partially Free” and declining, and has a rating of 3 on the Polity IV scale, not scoring well on any of the parameters. Polity (Marshall et al. 2004) acknowledges that Malaysia does have elections, even if the hegemonic power of the Barisan Nasional makes it very difficult for the opposition to win elections. As a challenge to conventional democratic theory, Malaysia has

¹ Bumiputra (or Bumiputera) translates to English roughly as “children of the land”, and is a term used to refer to the muslim Malay and Orang Asli (indigenous) population group. The distinction between the terms Malay and Bumiputra could be explored further, but that is outside the scope of this paper. For an in-depth look at the term see Siddique & Suryadinata 1981)

been a failure of the power of executive constraints. The level of personalization of leadership that is seen in the country should have signified underdeveloped political institutions. In Malaysia this doesn't seem to be the case, on the contrary they are quite sophisticated. The very institutions designed to constrain the executive, have been turned into tools for autocratic rule, with parliament, royalty, industry and the judicial working together to enforce the regime status quo (Slater 2003:82-3). Dan Slater (2003:81) paraphrases Max Weber in describing this as “an iron cage in an iron fist”.

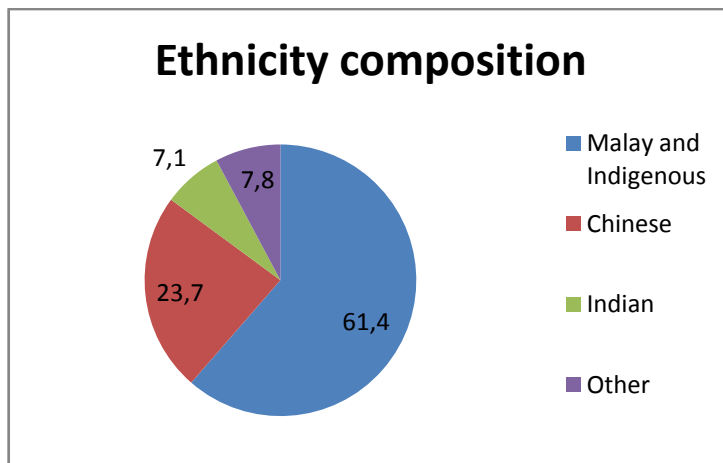
Figure 3: Polity IV Authority trends



(Marshall et al. 2004)

Malaysia has also remained what looks like a paradox of liberalist theory as a strengthening of authoritarian aspects of governments have gone hand in hand with industrialization, adaption to the market economy and the development of the middle class. The consequence of this being that the prime minister during Mahathir's reign has had an extremely high degree of control over Malaysian society. The answer to how this has been possible lies in the Bumiputra policy. (Abbott 1999:248; Jones 1998).

Figure 4: Ethnicity



(Central Intelligence Agency 2008)

A quick look at the demographics shows us that Malaysian society is divided into three major groups: The Malay (for this purpose including the indigenous Orang Asli population), Chinese and Indian. Most aspects of social life are separated along these lines, including language and culture, religion, organizational life and politics. In the 1960s, tensions between these groups increased as awareness of economic inequalities grew (Mahathir 1999:33; Time Magazine 1969).

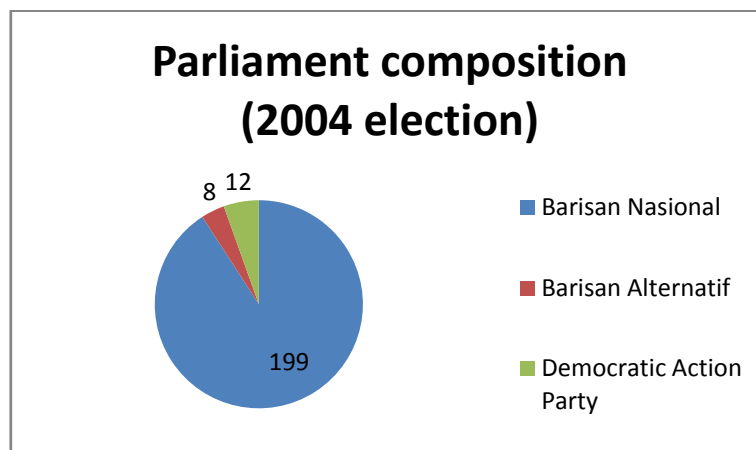
The Bumiputra program was a set of affirmative action policies intended to raise the majority Malay population out of the perceived backwardness compared to the country's Chinese. Although originally introduced by Tun Abdul Razak in 1971, it was built on Mahathir's writings, at the time a leading Malay ultranationalist and deputy prime minister from 1976 (Freedom House 2007:2, Siddique & Suryadinata 1981:676, Case 2000:137, Shamsul 1997:245).

A very important practical consequence of the Bumiputra affirmative action policies is the formation of a Malay business elite that has with government assistance surpassed the Chinese elite in most areas of Malaysian society. This elite, very much intermingled with the UMNO party, has frequently and for a long time been criticized for extensive nepotism and cronyism.

The coalition Barisan Nasional, or The National Front, has been in power since the state's independence in 1957. The backbone of this conservative nationalist coalition is the United Malays National Organization (UMNO), with ethnic Chinese and Indian support parties. This coalition has continuously had a very large majority in the parliament, never less than the 2/3 necessary to change the constitution. This leads to a state where the most important arena for political contention in Malaysian politics is within the UMNO, not the parliament itself

(Nesadurai 2000:104, Marshall et al. 2004, Abbott 1999:247, Case 1997:394). William Case (1997:393) even argues that the party is significantly more democratic than the state itself, to some degree alleviating the need for democratic reform of the government.

Figure 5: Parliament composition



(Central Intelligence Agency 2008)

UMNO and the Bumputra policy are intertwined very closely. The goal of the policy was to promote a class of Malay entrepreneurs. This did explicitly refer to making more Malay millionaires, (Mahathir 1999:39; Yik 2002:344). To let Malays into business ownership, the government started setting up companies to “hold shares on behalf of the Malays” until they got the capital to be able to buy them. As a completely dominant party within government, this put UMNO into a position of being able to control a huge amount of business capital intended for redistribution to its voters. UMNO became the principal channel for ambition within Malay society, and individuals perceived as taking responsibility were rewarded with lucrative deals and land grants. Eventually UMNO itself also began to exploit these policies more directly for itself, growing into a major business conglomerate in its own right. The expectation of personal wealth thus became associated with UMNO participation. To support their own ethnic groups, the other Barisan Nasional parties Malaysian Chinese Association (MCA) and Malaysian Indian Congress (MIC) set up similar funds (Case 1997:394-7; Yik 2002:339,344; Jones 1998:154).

All in all, one can say that positions in UMNO were held by men of ambition, expecting personal wealth to ensue from their involvement. As long as this is secured, these members of the Malay upper- and middle class have had very little incentive to speak out against government practices, while the ensuing unity of the ethnic majority has kept the non-Bumiputras on the sideline. Mahathir was therefore dependent on dispensing patronage to

remain in control. This was legitimized by the Bumiputra policy, and made possible by high economic growth (Nesadurai 2000:98; Case 1997:397; Yik 2002:339-40; Jones 1998:154-7).

3.2. *Malaysian economic nationalism: Wawasan 2020*

Mahathir's economic nationalism can not just be simplified into the admittedly far-reaching and rather complex Bumiputra policy. The Wawasan 2020 (Vision 2020) project was both a new breed of nationalism and a Japanese-style neomercantilist project, seeking to build a new pan-Malaysian nation pulling together to bring Malaysia to developed country by the year 2020. Although to some degree overlapping, these are two different forms of nationalism – the one being traditional ethno-centric nationalism on behalf of the Malay ethnic group, the other an effort to strengthen the Malaysian state through the creation of a pan-Malaysian nation.

The new Malaysian state-centric nationalism is most memorably phrased in the in 1998 ever present slogan “Malaysia boleh!” translating to “Malaysia can!”² The origin of this new nationalism can be traced back to the Malaysian recession in the early 1980s. According to Case (Case 2000:139-140) the Bumiputra policy and its focus on gaining Malays competitive advantages to the Chinese elite both through the enhancement of the former and the limitation of the latter. This in turn facilitated widespread disregard of ethnic Chinese business expertise, and may have hurt the overall development of the Malaysian economy. The emerging new line was therefore a drive to muster a concerted effort by all Malaysians to pull together to make Malaysia a great nation (Mahathir 1999:40-3).

The economic aspect of this new nationalism is clearly inspired by the so-called Japanese model of development that can be termed as neomercantilism. More than a focus on comparative advantages in labor, it focuses on development into selected high-tech industries. This is characterized by heavy state involvement in assistance, regulation and protection of these selected sectors (Gilpin 2001:156-8). What the Bumiputra policy had created was a Malay class of businessmen that could compete with the Chinese. What Malaysia still lacked was Japan's industrious and highly educated workforce driven by a sense of responsibility for society (Gilpin 2001:159).

Through this brand of nationalism, Malaysia also channels frustration over economic ailments from the Chinese within own borders to the western economic powers. From a

² In an otherwise good article on the subject, William Case (2000:132), seeking to portray a more dystopian picture of Malaysia in the late 1990s mistranslates this phrase into “Malaysia will overcome”. In addition to being a literal translation error, it conveys a less positive feel than a correct translation would. I refer to the *Kamus Dwibahasa Oxford Fajar Malay-English dictionary* (Hawkins 1997:25):

“**boleh** *k.d.* can; is or are able or allowed to; may (*p.t. might*), used to express a wish, possibility or permission.”

dependency on its former colonial master Great Britain, it now became more and more important to look to its eastern neighbors. By the crisis in 1997-98, Mahathir had all but shifted his focus from ethnic nationalism to the new Malaysian nationalism (Case 2000:140). He still, however, had to deal with the legacy of the Bumiputra policy.

3.3. Why both these policies presuppose monetary autonomy

The Bumiputra policy was all about building support for the Malaysian state through favoring the underdeveloped Malays, a sort of “infant nationality protection” if you will. Its legacy was a class of Malay businessmen and politicians that expected favorable treatment from the government. To keep this up, the state is dependent on economic growth to give the necessary revenue to keep the supply of handouts going. But more than this, the state needs to be able to protect companies that are expecting bailout from the government if times get hard. And one of the most potent factors in the face of a crisis is the interest rate. It is both an adjustment mechanism for investment rates and consumption and a way to insulate corporations from the negative effects of loose lending policies (Nesadurai 2000:90).

The necessary tools to implement the economic aspect of the Wawasan 2020 plan are essentially the same. Rather than now favoring the Malay nation, the state must use the same tools to favor the industries that are going to bring Malaysia ahead that their big brother in the east had built their success on. Where the Japanese had their “keiretsu”, conglomerates built around a major bank (Gilpin 2001:166-8), Malaysia had its clusters built around political associations. And if a member of the “keiretsu” is in trouble, its brothers must come to its aid. Thus the UMNO was dependent on the tools to be able to do so.

4.0 Money – more than a medium of exchange

An important factor in the Wawasan 2020 plan was to facilitate export-driven growth. If the exchange rate fluctuates wildly it is of course difficult to keep export industries alive. Without the revenues of export, the whole patronage system would also be threatened. This may have been enough on its own to make a fixed exchange rate necessary (Blanchard 2000:411-3).

Secondly, Mahathir’s distrust of the international financial system may have made him lose faith in a floating exchange rate (Mahathir 1999:7-10). A condition for the Mundell-Fleming model to work is that markets adjust exchange rates in a rational manner based on

correct information. But what if they were being deliberately manipulated by ulterior motives? If that was the case, a free-floating currency wouldn't protect against unwanted capital movements and still restrict monetary autonomy (Blanchard 2000:418-20).

I will, however, argue that there was a more directly nationalist factor in play here as well, namely the value of the currency as a national symbol. To understand why this is important, it is necessary to take a look at the importance of the national currency, going beyond its functions in a traditional macroeconomic perspective.

In economics and political economy both, most emphasis tends to be put on money as a medium of exchange, storage of value and a unit of account. It is important, however to remember that money also has other functions – functions that may not appear “rational” in the extremely narrow definition employed by economists. Important in a nationalist context is its importance as a national symbol of extreme potency (Cohen 2003:222).

Consider the attention put into the making of currency notes. Every country that mints its own currency carefully selects the symbolic imagery they want to associate with it. We can look at the Malaysian 10 Ringgit note to illustrate this point. The front is dominated by a large picture of the Malaysian founding father Tunku Abdul Rahman dressed in traditional Malay garb – a strong symbol of Malay nationalism. The back of the note shows the high-tech Putra LRT train, a Malaysia Airlines airplane and a Malaysian International Shipping Company container ship, selected as examples of Malaysian modernization and the Wawasan 2020 program (Bank Negara Malaysia undated)

Figure 6: The RM10 note



(Wikimedia 2007)

This example shows that there is much more effort put into the design of currency notes and the choice of symbolism than what is necessary for their rational-economic role in the economy.

Currency is a well-known instrument for promoting a common identity, as for example in Europe with the Euro (Risse 2003). This creation of a new common identity is also essential to the Wawasan 2020. If currency is employed as such a symbol of nationhood, it falls natural

for the government to be willing to work to make sure that symbol remains one of strength and power. For a policy-maker with nation-building in mind, the stability of the currency can thus become much more important than its effect on the economy alone. Sudden drops in currency exchange rates can possibly appear as a sign of weakness and a wound to national pride, as was part of the motivation for nations adapting the gold standard during an era of nationalism in Europe, and certainly an important reason for Britain to stick to it for a long time. But even modern day countries, particularly governments with a nationalist orientation go to great length to protect their local currencies, especially against substitution for foreign money (Helleiner 1999:140, 147-50).

5.0 The threat that was Anwar Ibrahim

“The house began to pitch / The kitchen took a slitch / It landed on the Wicked Witch in the middle of a ditch / Which was not a healthy situation for the Wicked Witch.”

- The Wizard of Oz (1939 adaption)

In 1998, Malaysia faced two different but connected crises. The first, as discussed in chapter 2.2 was the financial crisis. The second was a political one. Prime Minister Mahathir was being challenged by his deputy, Anwar Ibrahim. As I will show, the conflict between Anwar and Mahathir had been brewing for some time, but even as Anwar tried to capitalize on the crisis to call for reform, it enabled Mahathir to strike the decisive blow. It seems too much of a coincidence that Anwar was sacked from the cabinet literally the day after Mahathir's capital control regime was introduced³ and imprisoned not three weeks later. (Dornbusch 2002:442).

Former deputy prime minister (and finance minister) of Malaysia, Anwar Ibrahim, has come to stand as a main symbol of the so-called Reformasi (reform) movement of the late 1990s. This was in fact not so much a unified movement as it was a general call for democratic and liberal reform voiced by a number of key politicians, emerging NGOs and eventually demonstrators on the streets of Kuala Lumpur in 1998. The term Reformasi itself was borrowed from the movement in Indonesia preceding the fall of Suharto in May 1998, the success of which was doubtless an inspiration for like-minded Malaysians (Abbott 1999:249).

Anwar made himself known in the 1970s when he established the Islamic youth movement ABIM. His student activism earned him a 22-month detention under Malaysia's strict Internal Security Act before being recruited into UMNO by Mahathir in 1982, becoming

³ Dornbusch claims that he was arrested the following day, which is not true. He was ousted from office on September 2, and arrested on September 20 (CNN.com 2002). His point does still seem valid.

a party vice president in 1990, and minister of finance in 1991. He strengthened his position in the classic UMNO way, through maneuvering ABIM associates into positions of power and extending patronage to business associates. Especially noteworthy was his government bailout of the two major English language media channels gaining his supporters control. In the party elections of 1993, he led a group called the Wawasan Team to victory, seizing many of the most important party leadership positions. The accusations of money politics in these elections were so strong that Mahathir had to start investigations against three party representatives (Case 1994:922-29).

Between the 1993 and 1996 elections, Mahathir had become worried with the strengthening power of his deputy Anwar, and the effectiveness with which he displaced his predecessor Ghafar Baba in 1993. A power struggle ensued, in which several of Anwar's supporters were bought off with political appointments by Mahathir and others were removed from their seats or blocked by the same. In local party elections in 1995, Anwar-supporters won a disturbing number of positions. Mahathir moved to constrain party democracy, by passing a resolution effectively banning internal contestation of the party president and his deputy, claiming that this would amount to treachery according to Malay tradition. In addition, several changes to the election system were enacted, among them revoking the right of nomination from local party branches and a complete ban on election campaigning – effectively moving intra-party politics underground. In a final surprise move Tengku Razaleigh, and old Anwar opponent announced that he would lead his UMNO split-off opposition party back into the fold. As a result, the elections apparently strengthened Mahathir's position even if Anwar supporters won the premiership of the UMNO youth and women's movements (Case 1997:397-400, Chin 1997:181-4, Mohamed Jawhar 1996: 125-7).

In the first half of 1998, Anwar was still considered by scholars and commentators to be the most serious threat to Mahathir's rule he had yet faced. Jomo Kwame Sundaram (2006:493) claims that Anwar secured the support of the entire cabinet for his austerity package before Mahathir had arrived for a cabinet meeting on December 3, 1997. The apparent strong hand of Anwar in managing the economy continued to gain him support.

5.1. Anwar's crisis response – the neoclassical way

The IMF's approach to the financial crisis followed traditional lines. Loans were extended to Thailand, Korea and Indonesia in return for concessions on structural reforms and macroeconomic policy. Tightening of both monetary and fiscal policies were at the core,

along with “steps to improve the efficiency of markets and increase competition”(International Monetary Fund 1999a).

Malaysia was never a candidate for receiving IMF financial aid during this stage. The country’s reserves were deemed adequate to handle the matter, and the dependence on foreign loans was significantly less than its neighbours (Nesadurai 2000:74; Camdessus 1998). Even without the promise of aid packages from IMF, starting december 1997, Malaysia implemented a policy package much resembling the fund’s recommendation under the leadership of finance minister (and deputy prime minister) Anwar:

“The centerpiece is a series of preemptive actions to strengthen the financial sector and address emerging problems in financial institutions. The package also includes a rebalancing of the macroeconomic policy mix, with fiscal policy targeted at ensuring a small surplus, while increasing spending to strengthen the social safety net; a significant reduction in credit and monetary growth; and more active use of interest rates to stabilize the foreign exchange market and restrain inflation.” (International Monetary Fund 1998)

The Article IV consultations⁴ between Malaysia and the IMF in 1998 concluded with a strong endorsement by the IMF for the policy measures taken (International Monetary Fund 1998).

The popular view that Malaysia was better prepared for the crisis than its neighbours took a different turn in 1998. Despite Anwar’s measures, half a year later the crisis had worsened considerably – the Kuala Lumpur Stock Exchange (KLSE) turning from being among the best performing in Asia to become among the worst (Nesadurai 2000:78). The massive devaluation of the Ringgit led to an import of inflation (Sundaram 2006:493), and as we can see from Figure 7 in the next chapter, the interest rates imported from the foreign markets were crippling.

A possible explanation for this might be the relationship between what is referred to the “decisiveness” and the “credibility” of the government in handling the crisis. Dash (2003:274-6) describes Indonesia’s main problem as being low credibility on account of its system of

⁴ “Under Article IV of the IMF’s Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country’s economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of directors, and this summary is transmitted to the country’s authorities. In this PIN, the main features of the Board’s discussion are described.” (International Monetary Fund 1998)

crony capitalism. The actors of the international market just didn't believe in their commitment. In addition uncertainty about the process of political succession eroded confidence in leadership. This undoubtedly sounds like the picture now painted of the political situation in Malaysia.

This lack of credibility is what Anwar's "Reformasi" movement capitalized on as they tried to use the crisis to push for further reform. The failure of the first wave of liberal measures was used as a justification to call for even tougher measures, striking at the main thorn in the eye of both foreign and domestic liberals – crony capitalism. After Suharto's resignation in may 1998 and proved it possible, they grew bolder (Acharya 1999:427).

6.0 Mahathir strikes back – abandoning free flow of capital

"As you can see, my young apprentice, your friends have failed. Now witness the firepower of this FULLY ARMED and OPERATIONAL battle station!"

- Emperor Palpatine, Star Wars: Episode VI - Return of the Jedi (1983)

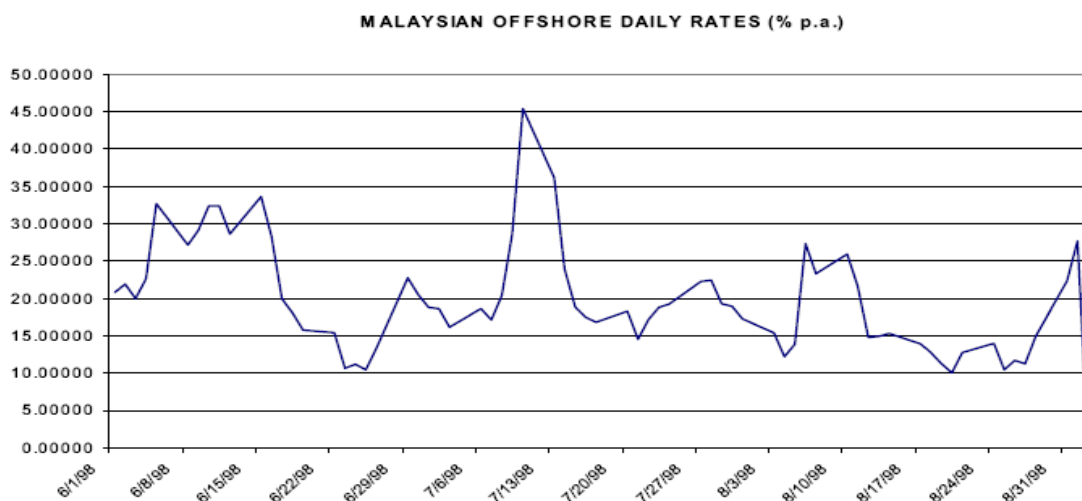
In the end, the crisis didn't become Anwar's final decisive victory. Rather than the necessary springboard for reform, half a year of austerity measures with little apparent effect was used as an example of the futility of liberalizing the economy, only exposing the country further to the mercy of the international markets, perceived by nationalists possibly to be malevolent, but at best indifferent to the suffering of Malaysia (Mahathir 1999:60).

On September 1st 1998 Malaysia's policies were suddenly reversed. Taking back control over economic policies, Mahathir announced a new capital control regime. The following day, Malaysia was shaken when the press reported that Anwar was under investigation for corruption, abuse of power and "unnatural sexual acts". The same day, he was sacked from the cabinet and excluded from UMNO on account of his immoral actions (CNN.com 2002, Fuller 1998a). It is an interesting side note that according to Rudiger Dornbusch (Dornbusch 2002:443), capital controls were invented by the decidedly authoritarian Nazi regime in Germany as a response to massive capital flight in the 1930s.

With a considerable distrust towards international markets, this option seemed less unthinkable to Mahathir than to most mainstream economists. Additionally, the policy facilitated both the discrediting of Anwar's supporters and the possibility to blame domestic economic problems on foreign actors. This explains why Mahathir was willing to go to great lengths to enforce these policies, regardless of the risks (or even predictions of impending doom) stressed by a unitary corps of international economists (Mahathir 1999:7-10).

The new policy package implemented was near a complete reversal of Anwar's policy. Capital mobility was suddenly restricted as much as possible, the Ringgit exchange rate pegged to the USD and both monetary and fiscal expansionary policies were implemented.

Figure 7: Offshore interest rates



(Dornbusch 2001:10)

As shown in the graph above, Dornbusch emphasizes the offshore interest rates for Malaysia to examine how Malaysia was faring in the international loan market and what depreciation of the currency the market expected. This can also be taken as an indication of what interest rates Malaysia would expect to import with a money market completely free of active government policy. As a member of the economist establishment, Dornbusch (Dornbusch 2001:9-11) uses this as part of his proof to show that the capital controls at the point they were introduced were an unnecessary measure, as the markets were already recovering. But the graph actually illustrates quite well the fears that Mahathir was facing. The Malay economic elite had already been hit hard by the instability of the markets and Anwar's refusal to keep interest rates low. It was therefore imperative for Mahathir to show he was doing something to insulate his supporters from a similar situation in the future.

Bailout of Malaysian industry and finance sectors were handed out through state loans to banks, state buyout of subprime loans and a special fund to give aid to select Bumiputra companies.

6.1.and they lived happily ever after.

"To prevent your poisons from spreading, your government has sealed you all within this dome. Believe me, it's the last thing we wanted to do. I do own the company that makes the dome, but that's beside the point."
- Simpsons, the movie

In stark contrast to their admiration of Anwar's austerity package, the IMF, the G7 central bankers and economists worldwide were extremely quick to exact judgment on Mahathir's new policies. The IMF, for example, put it like this:

"Malaysia has done extremely well by integrating into the world economy. It has benefitted enormously from foreign investment. It has benefitted from access to international capital markets. It has benefitted from an extraordinary growth in the volume of trade. It's putting in place controls which will certainly limit access to the global economy. It will certainly reduce the willingness of foreign investors to invest in Malaysia." (Fischer 1998)

Even now, the evidence of whether or not the capital controls made a difference is still inconclusive. What remains clear, however, is that the predictions of impending doom for Malaysia were somehow clearly wrong. Referring back to Figure 2: GDP Growth, we see that already in 1999 Malaysia experienced a growing GDP, and in 2000 they were well ahead of the pack with regards to the other crisis countries.

Economics aside, what is undeniably clear is that Mahathir emerged the victor of the political crisis. Even as Anwar's ousting was turned into mass riots, this was turned to Mahathir's advantage as an excuse for the arrest of a number of key opponents, among them Anwar himself with the help of the much-criticized Internal Security Act (Kyodo News 1998). In 2003, at age 78, after 22 years as Malaysia's Prime Minister, he finally handed the reins over to his successor, Mohammad Badawi.

As I believe this paper has shown, economics isolated from the domestic policy arena doesn't explain Mahathir's choices adequately. Until 1998, an open economy had served Malaysia's economic development extremely well, and it was undoubtedly a bold and risky maneuver he undertook. I will not rule out a concern for international macroeconomic concerns as the deciding factor, but it seems certain that domestic political pressure and the importance of economics to his nationalist projects were part of giving Mahathir the necessary courage to take "the narrow path".

7.0 Appendix

"Facts are meaningless! They can be used to prove anything!"
- Simpsons, the movie

7.1. List of tables and figures

Table 1: Select economic figures for Malaysia	6
Figure 2: GDP Growth	7
Figure 3: Polity IV Authority trends	9
Figure 4: Ethnicity	10
Figure 5: Parliament composition	11
Figure 6: The RM10 note	15
Figure 7: Offshore interest rates	20

7.2. Note on the (lack of) use of Malaysian academic sources

When doing research on Malaysia, it is important to consider the level of academic freedom in the country. Limitations on the right to publish results are frequently imposed, especially in “socially sensitive” areas like the social sciences (Altbach 2001:3; Human Rights Watch 1999). Thus I have found it necessary to exercise a high degree of caution in quoting Malaysian academic sources not published internationally. With one exception they have only been used to quote official policies. Press censorship is also widespread, so press sources have also been considered in this light.

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