ACCOMMODATING GLOBAL MARKETS: MALAYSIA'S RESPONSE TO ECONOMIC CRISIS

By

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Abstract

The East Asian financial crisis has shown how governments in affected countries have had to contend both with the external constraint imposed by global capital mobility and domestic political dynamics when instituting adjustment to the crisis. Some commentators see the reform process in the East Asian states as an outcome of the disciplining behaviour of financial markets that will lead to the complete dismantling of those structures that supported the state-directed developmentalist mode of economic organisation and the emergence of a neo-liberal form of capitalism. Others point out that because the economic systems in place in the East Asian states are societally embedded, their complete dismantling in favour of the neo-liberal model is neither assured nor justified at this point in time. The Malaysian experience shows that despite having to accommodate global markets, the government has tried to maintain the ethnic-based distributive policy that favours ethnic Malays with material entitlements. One reason for this was to ensure the security of state and regime (or political system). A second reason was because the state was not wholly insulated from a key social group that emerged as a result of the ethnic-based distributive policy, namely an elite Malay corporate group. A third reason was economic nationalism, a major component of Prime Minister Mahathir's vision for the country that stressed the building up of Malaysian corporations and conglomerates able to compete with global corporations in a globalised world economy. For these reasons the extent to which a more orthodox or neoliberal adjustment response could be embraced was limited. Two key features of the state in Malaysia facilitated this process of defending national economic arrangements, at least during the period in question. First, the state's access to domestic sources of funds for adjustment allowed the authorities to maintain foreign equity restrictions in strategic sectors like banking. Second, the centralisation of power in the office of the Prime Minister and the subordination of the other branches of the state and of civil society ensured that the ideas, interpretations and interests of Prime Minister Mahathir and his allies ultimately prevailed in the way the crisis was evaluated and adjustment pursued. Despite these domestic constraints, the government has liberalised some aspects of the ethnic-based distributive policy in a move to accommodate global market forces and restore growth. This does not, however, imply a shift in the ideological and policy agenda towards complete embrace of neo-liberal norms and practices. The imposition of capital controls, although announced as a temporary measure to allow space for the government to pursue its preferred course of adjustment, nevertheless indicates that the commitment to free markets is instrumental or tactical. The Malaysian case suggests that movement towards neo-liberal forms of economic organisation as a result of the financial crisis may be limited and is is not inevitable.

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(1) Introduction

The East Asian financial crisis demonstrates how governments in affected countries have had to contend with the external constraint imposed by heightened global capital mobility on the one hand and domestic political priorities and constraints on the other when instituting adjustment to the crisis. Thailand, South Korea and Indonesia accepted IMF assistance and in return pledged to adopt far-reaching neo-liberal economic reforms. Malaysia, on the other hand, opted for a home-grown adjustment strategy. Some commentators see the reform process in the East Asian states, especially those under IMF pupillage, as an outcome of the disciplining behaviour of financial markets and leading to the complete dismantling of those structures that supported the state-directed developmentalist mode of economic organisation. The triumph of the neo-liberal model that is based on allowing the market free rein to allocate economic resources is celebrated (Mallaby, 1998). Others point out that because the economic systems in place in the East Asian states are societally embedded, their complete dismantling in favour of the neo-liberal model is neither assured nor justified at this point in time (Higgott, 1998: 17; Feldstein, 1998: 29).

This paper contributes to this debate by showing through the Malaysian experience with adjusting to the financial crisis how the government sought to maintain as far as possible those national economic arrangements and policies that are deeply embedded in domestic politics and society. The paper concentrates on Malaysia as an interesting contrast to those countries that accepted IMF programmes like South Korea, Thailand and Indonesia on which much of the analysis thus far has centred.[1] The absence of IMF involvement in Malaysia allowed the reform process to unfold in a manner that fully reflected domestic political priorities and constraints. The IMF was never a serious option for Malaysia because Malaysia's external borrowings were relatively low compared to the IMF-assisted countries. More importantly, Malaysian leaders were concerned that IMF conditionalities would involve the eventual dismantling of Malaysia's ethnic-based distributive policy as well as the removal of restrictions on foreign equity ownership in key economic sectors deemed to be of national interest, most notably in financial services (Chen, 1997). Second, the Malaysian experience with crisis adjustment illustrates particularly clearly the tensions between the global market that theoretically stresses the market mechanism and allocative efficiency, especially of capital, on the one hand, and a national market that somewhat deviated from this neo-liberal norm on the other. Although the Malaysian economy has been described as a fairly open economy in which market forces operate, there is also a more regulated sector largely in non-tradeables in which the state controls the allocation of economic resources as well as the creation and distribution of economic rents. The paper shows through analysing the politics of crisis adjustment that these tensions are not easily resolved. State control over economic resources and rents is not only crucial for the success of Malaysia's ethnic-based distributive policy it is also a key element in the politics of patronage that is now entrenched in the Malaysian political economy. Malaysian leaders and policy-makers were therefore expected to protect the state's control over economic resources when fashioning the adjustment response. Third, the paper focuses on the process of adjustment to the present crisis because it is through studying the evolution of the adjustment response that the constraints imposed by global financial markets on national policy-making are clearly revealed. The crisis situation brings into sharper relief the tensions between domestic and external dynamics that governments must increasingly contend with in a globalising world. The Malaysian case illustrates how the external constraint imposed by global capital mobility conditioned the adjustment response through its effect on the Malaysian currency and stock market.

Following this brief introduction, section two of the paper describes the unfolding of the crisis in the region and in Malaysia in very broad terms. Section three presents in greater detail the government's response to crisis, and analyses the reasons why the adjustment response in Malaysia went through three distinct phases in the past year. The paper explains the course of adjustment in terms of three key factors, namely, how the crisis was evaluated by policy makers, the political capacity of the state to institute adjustment, and the constraint imposed by global capital mobility. By way of conclusion, the paper argues that at least in the Malaysian case, the government has tailored the adjustment response in order to maintain as far as possible national economic arrangements. Firstly, the government of Prime Minister Mahathir has been unable and unwilling to fully dismantle the ethnic-based distributive policy that favours ethnic Malays with material entitlements. This is because the political legitimacy of the Prime Minister, government and regime (or political system) is based on ensuring ethnic Malay ascendancy and dominance in both economics and politics through these preferential entitlements. More importantly, adjustment proceeded in a way that served to protect the interests and future of an essentially Malay corporate elite group with close links to the political leadership. Secondly, and related to the first argument, the government appeared unwilling to relinquish state control and influence in selected sectors of the economy deemed to be vital to both national and ethnic Malay interests. At the same time, the government has had to accommodate global market forces to some extent and liberalise some aspects of economic policy as it sought to restore economic growth and to regain its legitimacy among Malaysian citizens in general. Nevertheless, the government's long commitment to an open economy has been sorely tested by the crisis. Capital controls were introduced in September 1998 that sought to insulate the domestic economy from global markets pressures in order to allow the government to pursue its preferred course of adjustment. This clearly illiberal move, although introduced as a temporary means to protect the domestic economy against excessive currency and stock market volatility, indicates the extent to which domestic political considerations in Malaysia exerted a powerful influence on economic policy.

(2) The Unfolding of the Crisis in the Region and in Malaysia

The crisis in East Asia, triggered by the sharp outflow of funds from domestic financial markets beginning with Thailand, can be traced to events well before the floatation of the Thai Baht on 2 July 1997. Structural weaknesses in the real economy in South Korea, Thailand, Malaysia and Indonesia led to their declining competitiveness since the mid-1990s, especially in comparison with countries in Latin America and China. Excessive borrowing in foreign currency by banks and firms in a more liberalised domestic financial environment compounded these structural pressures as over-investment occurred in marginal or unprofitable projects, in real estate and stock market speculation, and in huge infrastructure projects (Radelet and Sachs, 1998; Corsetti *et al*, 1998; Tan 1998a; Jomo, 1998a and IMF, 1997). Investors saw the signs ahead of further weakening of the current account positions of Thailand and South Korea as a result of the largely short-term nature of much of their foreign liabilities (Table 1). Speculative attacks on the Thai Baht began in 1996. Following renewed attack on the currency in May and June 1997, the Bank of Thailand floated the Baht on 2 July 1997. This set the stage for the events that followed in the region over the next twelve months.

The Baht devaluation in turn led to sharp falls in the values of other regional currencies over the next few weeks as capital fled regional economies. Where a liberal regime for capital movements had in the early 1990s led to huge inflows of capital into domestic equity markets, the same liberal regime now facilitated capital flight as currencies fell and investor confidence in these economies plummeted. National governments sought to support their respective currencies through raising domestic interest rates. This, however, had the unfortunate effect of unleashing domestic banking crises. It added to banks' already weak balance sheets by raising the level of non-performing loans. Corporate bankruptcies loomed ahead. The East Asian experience confirms the conventional wisdom that financial sector liberalisation in the absence of the necessary regulatory and supervisory infrastructure to support transparency in bank lending, and proper accounting and disclosure practices invites trouble, particularly in an environment of heightened global capital mobility (Wyplosz, 1998: 17). In the absence of the requisite institutions and practices, lending to politically favoured individuals, firms or projects by banks directly or indirectly controlled by the politically well-connected became a recurring feature in these economies (Tan, 1998a: 9).

The unfolding of the crisis in Malaysia essentially followed the general pattern in East Asia, except that foreign borrowings were relatively low while domestic debt, at 160% of GDP, posed the greatest threat to the economy.[2] Because of its low foreign debt position, its still robust manufacturing sector growth, and the appearance of strong political leadership, many market analysts at the start of the crisis in July and August 1997 saw Malaysia as better able to weather the contagion effect from Thailand. Sentiments have completely changed a year later. Malaysia is now viewed as worse off than other countries in the region, and is expected to take longer to emerge from crisis. Private analysts put 1998 growth at minus 5%, well below the official July 1998 forecast of negative 1-2 %. In the year since 2 July 1997, Malaysia has joined the ranks of battered East Asian economies (Table 2). By August 1998, the Kuala Lumpur Stock Exchange (KLSE), once the best performing bourse in the region, was regarded as the worst performing stock exchange in 1998 (Table 3). By this time, 45% of the 471 stocks listed on the main board of the stock exchange were penny stocks, trading below RM1 (Malaysian Ringgit). Moreover, a Merril Lynch/Gallup survey found more fund managers negative on the KLSE than on any other regional bourse, including Jakarta (McDermott, 1998b).

What accounts for this reversal of fortune for Malaysia and worsening market sentiment regarding its future? Did Malaysian leaders handle the response to crisis badly, or did external factors overly constrain policy-makers in their crafting of adjustment measures? To what extent did the country's ethnic-based distributive policy impose a political constraint on the adjustment response? The following sections attempt to answer these questions by analysing the way adjustment evolved in Malaysia. The absence of IMF involvement allowed the reform process to unfold in a manner that fully reflected domestic political priorities and constraints. At the same time, the external constraint imposed by capital mobility complicated the reform process. This constraint was essentially exercised through the stock market and the currency.

(3) The Unfolding of Malaysia's Adjustment Strategy and the Market's Response

Three distinct phases are evident in Malaysia's adjustment response to the crisis that began in Thailand in July 1997.

- The first phase, between 2 July 1997 and 4 December 1997, was characterised initially by denial that Malaysia would suffer Thailand's fate since domestic economic fundamentals were sound. Dr Mahathir, the Prime Minister, also blamed foreign, particularly western, conspirators for the attacks on the currency and stock market. Minor adjustment measures were subsequently instituted that did not, however, stem the slide in both the currency and the stock market. The high growth strategy adopted by the Prime Minister remained essentially unchanged despite growing signs of its unsustainability.
- From 5 December 1997, the adjustment response shifted into the second phase when a shadow IMF austerity programme, essentially the brainchild of the Deputy Prime Minister Anwar Ibrahim, was instituted. During this phase, interest rates were allowed to rise fairly rapidly to support the currency.

- Six months later, in mid-June 1998, austerity was replaced by expansionary fiscal and monetary policies. Although measures to liberalise existing equity restrictions were introduced, these were limited in scope. This liberalising tendency did not, however, signal a shift in the ideological and policy agenda towards neo-liberal norms and practices. Not only was the 30% cap on foreign equity participation in the banking sector retained, but capital controls were also introduced on 1st September 1998 that effectively severed Malaysia's links with global financial and capital markets. Dr Mahathir and his special advisor and former finance minister, Daim Zainuddin essentially designed the present phase.

<u>The Analytical Framework</u>

This paper attempts to explain the course of adjustment pursued in Malaysia in terms of three factors, namely the way the crisis was evaluated by key policy-makers, the capacity of the state to design and institute adjustment based on this prior evaluation, and the external structural constraint imposed by global capital mobility.

An adjustment response to a crisis is usually preceded by evaluation of that crisis, usually in terms of its causes, what kind of response is required in the short-term, and whether longer-term structural reforms are required. Nelson (1990) suggests that crises are generally evaluated along the following dimensions:

- *Causes. Is the crisis viewed as a temporary shock that is essentially self-correcting, or are its causes regarded as requiring active government intervention to correct?*
- *Nature of the remedy. If active government intervention is needed, what short-run measures are viable to restore balance?*
- *Longer-term appraisal. Is the economy's broad course deemed to be sustainable once short-run stabilisation measures are adopted? If not, what longer-run structural reforms are needed?*

One does not expect both short-term stabilisation measures and longer-term structural remedies to be adopted at the same time. That was perhaps the mistake the IMF made in its policy prescriptions for crisis-stricken East Asian economies such as South Korea and Indonesia (Feldstein, 1998). Nevertheless, the thinking of key policy-makers in Malaysia on the subject would be useful in pointing out whether a shift may be expected in the way economic activity is organised, especially in an increasingly liberal direction. The evaluation of the crisis will incorporate more than just technical answers, which in any case will be difficult to provide in a rapidly evolving situation often involving partial and inaccurate facts. Interpretations and value judgements of key political leaders and policy-makers regarding the pre-crisis situation and future priorities will also shape the way the crisis is evaluated and the response made to it. The ideas held by key members of the policy elite of 'how the world works' are also crucial. These ideas and interpretations are likely to influence the course of adjustment pursued, particularly through their exclusion of alternative interpretations and thus alternative adjustment possibilities. The paper is particularly concerned with whether ideas and interpretations of a neo-liberal persuasion were in the ascendant as this would suggest that the ideational foundations for a more liberal form of economic governance were beginning to emerge in Malaysia.

Ideas and interpretations alone are insufficient in explaining the course of adjustment. Ideas need to be translated into action. This paper focuses on the state since it is through the state that the principal ideas and interpretations about the crisis are translated into action, with the design and implementation of adjustment policy involving the entire state apparatus, of which the government is its executive arm. As the principal political institution intervening between external forces and domestic social forces, the state[3] is centrally involved in the adjustment process. State capacity to institute adjustment is in turn a function of access to material resources, the state architecture, and its relationship with key social groups.[4] The availability of resources is crucial in determining the type of adjustment strategies policy-makers are able to adopt. For instance, the lack of foreign reserves to meet foreign liabilities was a key reason for the IMF response in Thailand, Indonesia and South Korea. In the Malaysian case, the paper concentrates on the extent to which access to domestic sources of funding provided the authorities with alternatives to increasing foreign capital participation in the economy to implement adjustment. As for the state's architecture, the paper is concerned with the degree to which differences between policy-makers, or between different branches of the state, influenced the course of the response. Whose ideas finally prevailed and were ultimately translated into action? Finally, the state's relationship with key social groups also influences the course of adjustment. This relationship is shaped by how deeply rooted national economic arrangements are within society. Ideas and interpretations can be used to either support the prevailing *status quo* or they can be used to alter existing social arrangements if these are perceived to hinder adjustment. The choice between the two will depend on the political costs involved to the ruling elite. For instance in Malaysia, the patronage-based economic system has led to strong links between the state and an essentially Malay corporate elite group. Adjustment strategies are likely to be influenced by leaders compelled to protect those corporate allies that constitute their support base. The links between the state and this elite group go beyond interest-group politics, however, as their relationship is also deeply embedded within the ethnic-based framework governing Malaysian politics and security dynamics. The Malay political elite regards the ethnic-based distributive policy as vital for state and regime security.[5] The state's commitment to furthering the economic interests of the wider Malay community lies within a similar framework and would be expected to be resistant to change. Leaders are therefore likely to be constrained by the need to ensure that key elements of the ethnic-based distributive programme for the Malay community are maintained.

Adjustment will furthermore be constrained by external factors. Capital mobility, considered by some scholars to be a structural variable, will delimit the range of feasible adjustment options available to policy-makers, especially during crisis episodes (Webb 1991; Andrews 1994). The ability of capital to freely exit a market means that developments that lead to a loss of confidence on the part of capital owners or managers will result in falling currency values in a flexible exchange rate regime and/or falling stock prices as capital flees. Foreign capital participation in economic production is also likely to decline. In a globalised financial market, the triggers for capital exit are as likely to emerge from outside Malaysia as much as from within the Malaysian economy. Japan's perceived inability to move forward on banking reforms and the Indonesian crisis were two of the external triggers for capital exit from Malaysia and the rest of the region. The tendency for participants in financial markets to respond in herd-like fashion to signals and available information makes financial markets extremely volatile, particularly in an environment of heightened tensions as crisis situations normally are. Because information is always subject to interpretation by market players, and since interpretations are liable to change at short notice during crises, it follows that markets during a crisis are especially prone to fluctuations as market perceptions of risk and confidence change rapidly. This imposes significant constraints on the type of actions governments may take as they are constantly subject to the scrutiny and interpretations of global financial market players.

Phase 1 (2 July 1997 – 4 December 1997): Denial, Blame and Accommodation

The initial reaction in Malaysia to developments in Thailand was that any adverse effects on the Malaysian economy would be temporary as fundamentals were sound compared to Thailand. This was true to some extent as seen in Malaysia's improving current account and external debt position (Table 1). The reaction at this point did not seem inappropriate, as most market analysts did not view Malaysia in the same light as Thailand.[6] Nevertheless, concerns over weakening fundamentals in the economy[7]exerted downward pressure on the Ringgit and the stock market. The Central Bank of Malaysia (*Bank Negara Malaysia*) attempted to shore up the Ringgit by using its reserves to buy up the currency as well as by temporarily raising interest rates.[8] After spending an estimated US$3.5 billion in external reserves to defend the currency, the Ringgit was allowed to float freely on 14th July (Ong, 1998).[9] The Ringgit declined by about 9% against the US Dollar between the first week of July and the last week of August 1997 (Figure 1). The Kuala Lumpur Stock Market (KLSE) composite index fell by about 26% over the same period as investors reassessed the Malaysian market in the light of the Thai situation and the unsettling trends in the Malaysian economy (Table 4 and Figure 2).[10]

Not only was the problem deemed to be temporary, it was also blamed on external forces. From the end of August, the Malaysian Prime Minister, Dr Mahathir, began his tirade against currency speculators, especially the hedge funds that he accused of causing the fall in currency values. Although

Dr Mahathir is well known for his anti-western rhetoric, he was unusually strident this time around.[11] While some analysts dismissed Dr Mahathir's rhetoric as characteristic, a number of crisis response measures were unveiled by the Prime Minister that suggested that anti-foreign rhetoric was being translated into action. The proposal for a RM60 billion (US$20.4 billion) fund[12] to prop up the stock market though stock purchases discriminated against foreign investors who would have been offered the going market rate for stocks they wished to sell while Malaysian sellers would be offered a premium above the market price. In addition, a ban was imposed on short selling of the 100 blue chip stocks that comprise the Composite Index. A number of new rules were also introduced that made it especially difficult for foreign investors to sell Malaysian stocks they held.[13] These moves had exactly the opposite effect on the KLSE than that hoped for. The stock market fell sharply, bucking the regional trend that saw all other regional bourses except Bangkok posting gains of between 1% and 7 %. The threat by government officials to use Malaysia's Internal Security Act (ISA)[14] to detain anyone suspected of sabotaging the economy, including analysts and journalists writing unfavourable reports on Malaysia further weakened market confidence. It confirmed investor perceptions that the authorities had something to conceal.

Financial markets typically suffer from information asymmetries, whereby lenders know less than borrowers about the latter. Under these conditions, adverse selection is likely to occur, whereby a rise in perception of risk by lenders results in a drying up of the market as lenders stop lending (Wyplosz, 1998: 4-5). Dr Mahathir's rhetoric and actions served to increase the perceived risks by investors of investing in Malaysian stocks, leading to adverse selection whereby investors dumped Malaysian stocks. This was clearly seen in the market's reaction to Dr Mahathir's rather provocative suggestion in Hong Kong in September that currency trading was "unnecessary, unproductive, and immoral" if it was not required for financing trade (Mahathir, 1997a). Traders dumped both shares and the Ringgit amid fears that Malaysia would actually ban currency trading for all but trade-financing purposes despite reassurance from the Deputy Prime Minister that no such drastic move would be implemented. Investors, surprised once by the abrupt restrictions imposed on selling stocks the previous month, had by this time become far more risk averse where Malaysia was concerned.[15] The swift and harsh market response compelled the Prime Minister to tone down his rhetoric, at least for the moment, and to adopt a more accommodative stance towards foreign investors. The curbs imposed on stock market transactions were lifted. Dr Mahathir and his Deputy Anwar Ibrahim met foreign brokers and fund managers in early September to reassure them that Malaysia would not again impose sudden restrictions on stock trading by investors.

Despite toning down his rhetoric, the Prime Minister has continued his criticism of global financial markets over the past year, always drawing attention to the enormous power wielded by hedge funds and their managers to move currency and stock markets in order to make profits. His speech to the World Bank/IMF Meeting in Hong Kong in early September 1997 berated the big funds that "use their massive weight in order to move the shares up or down at will and make huge profits by their manipulations" (Mahathir, 1997a). He has repeatedly alleged a conspiracy to damage the Southeast Asian economies. In Chile he renewed his call to the international community to ban the trading of currencies as commodities, warned against the power of fund managers and banks to impoverish nations through their manipulation of markets, and chided the West for trying to blame the crisis on incompetent Southeast Asian leaders (Mahathir, 1997b). These charges and calls were made at various forums both within Malaysia as well as outside Malaysia, including the Group of 15 Developing States (G-15), the Association of Southeast Asian Nations (ASEAN), the Asia-Pacific Economic Cooperation Forum (APEC), the Asia-Europe Meeting (ASEM) and the Organisation of Islamic Conference (OIC) (Mahathir, 1998a, 1998b and 1998c).

It was clear that through these international forums, the Prime Minister was attempting to build an international coalition among developing and other like-minded states that would pressure the industrial world and the IMF for greater regulation of global financial markets. It was an attempt by a 'middle power' to use international cooperation to "reach into international structures and influence or alter rules and regimes to mediate adjustment" (Ikenberry, 1986: 65). Through these efforts, the Prime Minister was clearly attempting to bring some predictability and regularity to the external environment in which Malaysia must manoeuvre and to ensure some degree of policy autonomy for him and the government to rule in accordance with domestic political priorities. Although the G-15, ASEAN and the OIC have formally called for regulation of global financial markets, including currency trading, the global financial regime that Malaysia prefers to see will require at the very minimum the support of the United States, still the only nation with the necessary structural power to alter existing international rules and regimes or create new ones. Still, the spread of the crisis to Russia and Brazil in August and September 1998, and the clear role played by speculators in that process, appears to have resulted in greater willingness on the part of the international community to at least consider the merits of greater financial market regulation.

Led by Prime Minister Mahathir, the political elite in Malaysia interpreted the crisis as one that was externally caused by currency speculation. Although most market analysts, economists and some members of the political elite, notably the Deputy Prime Minister Anwar Ibrahim, felt that domestic weaknesses had contributed to the crisis in Malaysia, the Prime Minister's ideas prevailed, particularly in the first four months of the crisis. The centralisation of power in the office of the Prime Minister and the subordination of the other branches of the state and of civil society meant that it was Dr Mahathir's personal evaluation of the crisis as caused by external factors that predominated during this period.

The business sector, particularly the corporate allies of political leaders, were also quite happy to subscribe to the Prime Minister's interpretation of the crisis. This not only drew attention away from any past business mistakes that these companies may have made that contributed to their problems, it also meant that state assistance may be forthcoming. Alternative views and interpretations were therefore generally downplayed or ignored. The broad thrust of the high growth strategy that Dr Mahathir had chosen for Malaysia was left virtually intact.

Dr Mahathir's interpretation of the crisis as externally caused by currency speculation had the effect of locating blame away from the policies of the government, notably the Prime Minister's high growth strategy and the ethnic-based distributive policy, both of which had come to rely on the state nurturing an essentially Malay corporate class through privileged access to economic resources and rents. The actions in August 1998 of the hedge funds in attacking the Hong Kong dollar and stock market and their role in the collapse of the Russian rouble reinforced the Prime Minister's interpretation of the crisis as being externally caused by speculators.

These views are, however, also part of the Prime Minister's long-held ideas on the dangers of unbridled market forces, his fears of potentially damaging challenges and obstacles for developing countries issuing from the global environment, and his deep resentment against perceived Western manipulations (Khoo, 1995: 57). They reflected his long concern over loss of policy autonomy by developing states to global market forces that he believed were often manipulated by the governments of western industrial states to their advantage and against the interests of the developing world. During the 1980s, Dr Mahathir had already spoken out against the "powerful commercial and financial centres of the world" and against manipulation of both primary commodity and currency markets (Khoo, 1995: 57-61). His abrupt change in stock market rules that made it more difficult for investors to dispose of stocks reflected his personal evaluation of the present crisis as induced by external manipulation of both stock and currency markets. His remedy was thus to make it difficult for manipulation to take place. The centralisation of power in the office of the Prime Minister at the expense of all other branches of the state meant that it was Dr Mahathir's personal evaluation of the crisis as caused by western machinations that predominated during the initial four months of adjustment from August 1997.[16] Moreover, the weak civil society in the country coupled with the semi-authoritarian political system restricted discourse on the subject. Alternative views and interpretations were generally downplayed or ignored.

Although a number of domestic adjustment measures were instituted through the annual national budget to assuage market confidence that had declined after the earlier debacle, adjustment failed to address many underlying structural weaknesses in the economy that were also of concern to the market

(Table 5). In fact, the adjustment response reflected the Prime Minister's belief that the crisis was a short-term phenomenon, externally induced, and was in no way the result of domestic economic mismanagement. Hence, despite the outward signs of reform, the broad thrust of the high growth strategy that Dr Mahathir had chosen for Malaysia was left virtually intact. Nevertheless, some concessions were made to the views of the Deputy Prime Minister and the Central Bank to restore investor confidence, principally through postponing some big-ticket projects that the Prime Minister personally favoured. Investors were, however, unhappy at the lack of measures to cool down the over-heating economy, especially as interest rates were being kept low relative to levels in the region. The Ringgit fell 3% soon after the Budget was presented in Parliament on 17th October, while the KLSE Composite Index fell 7.22 points. Both the currency and the KLSE had, by this time, declined by 23% and 35% respectively since 2 July.

The market's unhappiness with Malaysia's refusal to raise interest rates to support the Ringgit neatly illustrates the problem of 'short-termism' in financial market behaviour as a result of the different conceptions of the term 'fundamentals' used by different sets of actors. Montes (1998: 29) points out that asset managers regard as fundamentals those "factors that support the one-year to year-and-a-half stability of key asset prices, especially exchange rates". Interest rates therefore matter a great deal. Policy-makers and economists on the other hand take the medium-term (about three years) as their time horizon and regard fundamentals "in terms of the effect of asset prices on real economic variables such as output growth, exports, and employment". Because of the free mobility of capital that works through currency values and stock markets, governments are compelled to adopt a short-term perspective to accommodate portfolio capital movements in adjusting to the crisis, rather than a longer-term horizon. For instance, the market called for higher interest rates in Malaysia despite evidence from the region that high interest rates did not prevent other regional currencies from falling. The government was concerned with the impact high interest rates would have on the real economy in addition to the obvious concern with corporate debt. In fact, the Federation of Malaysian Manufacturers applauded the government's decision not to raise interest rates in October 1997, especially since most manufacturers had borrowed from the domestic banking sector to finance production.[17] The government's decision not to raise interest rates, regarded by the market as influenced by its desire to protect 'cronies' who had borrowed, was also shaped by its intention to protect the viability of the still robust manufacturing sector that contributes some 37% of GDP.[18]

Market fears that the government would bail out politically well-connected individuals and corporations rather than take the opportunity to institute corporate and banking reform were realised in November 1997 when the Securities Commission permitted a controversial stock market transaction. The transaction in question saw cash-rich United Engineers Malaysia (UEM) buying a 32.6% stake in its debt-ridden parent, Renong Corporation at a share price double the prevailing market price without having to make the mandatory general offer to minority shareholders.[19] This transaction, involving RM2.34 billion, was seen as a bailout for Renong's largest shareholders including its executive chairman Halim Saad, a politically well-connected ethnic Malay tycoon. Renong, reportedly struggling with RM4.12 billion of debt,[20] is the former business arm of Malaysia's dominant Malay-based political party, UMNO, and is still presumed to be closely associated with UMNO (United Malays National Organisation). Halim Saad is a long-time protégé of UMNO treasurer and former finance minister, Daim Zainuddin, a Mahathir ally. Although Deputy Prime Minister Anwar promised to investigate the irregularities, the deal was allowed to proceed two months later with only a fine imposed on UEM for contravening disclosure regulations. Despite a two-month suspension of trade in both stock counters, both stocks lost about 30% each of their share prices once trading resumed, requiring another brief suspension of trade. The deal led to fears that healthy corporations, particularly those that had previously received benefits from the government, would be requested by the Prime Minister to bail out troubled companies, in the event jeopardising the former.[21] In a paradoxical move following the UEM deal, investors dumped a number of sound blue-chip stocks for fear that the UEM deal would become a model for rescuing other ailing companies run by political allies. This episode illustrates how linkages between the state and the corporate sector affected the way adjustment to crisis was pursued. Although the authorities could have overturned the deal and denied the company the exemption it sought from making general offers to minority shareholders, the government did not, despite being aware of the adverse market reaction to the restructuring exercise when it was initially announced in November 1997. This was because of the importance of companies like Renong as well as corporate tycoons like Halim Saad both to Malaysia's patronage-based economic system and to the wider goal of creating an ethnic Malay business class.

Linkages between the corporate sector and the state emerged as a result of Malaysia's ethnic-based distributive programme, the New Economic Policy (NEP), instituted in 1970. The NEP was the outcome of ethnic riots in 1969 caused by Malay fears that they would lose their political dominance to the relatively better off minority Chinese community. The NEP led to greater state intervention in the economy in order to achieve its twin objectives of eradicating poverty and restructuring society in order to raise the economic wealth and relative economic position of the politically dominant Malay[22] community. Societal restructuring was to be attained through ethnic preferences in employment, education, corporate ownership, and business. Two important goals were the creation of a Malay business class and the achievement of a target of 30% Malay equity in the corporate sector (Tori, 1997: 212). The NEP was designed not only to ensure a more equitable distribution of wealth for the Malays, but also to ensure Malay political dominance, which had seemed in danger of being eroded by Chinese electoral gains in 1969, through control of economic resources. This was ultimately vital to the stability and legitimacy of the state and regime. Malay control over economic resources also enabled ruling elites to build up a support base individually as well as for the regime through dispensing patronage. Although the NEP was replaced by the National Development Policy (NDP) in 1991 that scaled back ethnic preferences somewhat (Stafford, 1997:569-76), the goal of creating a Malay business community continued to be emphasised and was a paramount goal of the authorities in the 1990s (Tori, 1997: 236). The government's privatisation programme that sought to retrench state involvement in the economy was the primary means through which this goal was achieved.

In effect, privatisation, as with the NEP and NDP, employed selective patronage to create a Malay business class as part of the process of social engineering (Jesudason, 1989; Crouch 1996; and Gomez and Jomo, 1997). The privatisation process, moreover, was not based on open competitive bidding. Instead, bidders relied on political access and influence in the closed tender system (Gomez and Jomo, 1997). The allocation of state-controlled rents through the award of privatisation projects, government procurement, and business licences enabled a class of new rich businesspersons to emerge. These were usually UMNO-linked Malay businessmen, although a limited number of Chinese and Indian individuals aligned with the ruling elite also benefited. Many of these corporate personalities acted as proxies for political patrons though professing to be independent.[23] Their business strategies were essentially similar: indiscriminate expansion largely into import-protected and non-tradable sectors, especially infrastructure, services, property and construction, so long as rents were available that could be captured irrespective of the soundness of the expansion or whether the firms had the requisite business expertise and experience. These new Malaysian conglomerates grew rapidly through using the stock market to engage in reverse take-overs, mergers, equity swaps between firms, and shares-for-property swaps, with the necessary funding provided by government-controlled banks (Gomez, 1994: 293-99). In turn, the patronage system provided political leaders with access to large amounts of funds that could be used in party and parliamentary elections (Gomez, 1996). It also provided key political personalities, notably the Prime Minister and to a lesser extent the Deputy Prime Minister Anwar, with their respective support bases drawn from among the new business elite (Gomez, 1997). These new Malaysian conglomerates were also a key component of Dr Mahathir's economic nationalism that stressed the building up of Malaysian corporations and conglomerates able to compete with increasingly large global corporations in a globalised world economy and to showcase Malaysia development success.

Access to cheap capital during the boom years from domestic banks and the stock market, and to a lesser extent through international borrowing had facilitated expansion of these corporations. The financial crisis not only put paid to new expansion, it also resulted in heavy corporate losses as a result of these borrowings and through depression of stock prices. The banking system was, in turn, weakened through its lending activities to these individuals and corporations as a result of both non-performing loans as well as from the drop in stock prices pledged as collateral. The Renong group[24] is a typical case in point, with the combined losses of its three associated companies alone reportedly accounting for about 5% of total bank loans in the economy or RM22 billion, of which at least 30% were estimated to be technically non-performing.[25] The substantial bank debts of conglomerates such as Renong meant that the banking sector was at risk if these companies were allowed to fail. Morreover, their large size meant that their failure would have wider repercussions on the economy. For these reasons, and because these corporate individuals and their companies were important both to the patronage-based system in Malaysia and to the wider goal of creating an ethnic Malay business class, the government preferred to take steps to ensure their survival even at the risk of displeasing financial markets.

The Prime Minister’s announcement in the last week of November that a special council, the National Economic Action Council (NEAC), would be set up to formulate the country’s response to the stock market and currency crises was insufficient to raise confidence in the Malaysian market that had been damaged by the UEM-Renong affair. Instead, it worsened market sentiment since the Prime Minister’s appointment of his close ally and former finance minister Daim Zainuddin as Executive Director of the council was viewed as an attempt by the Prime Minister to over-ride his Deputy Anwar in whom the market seemed to have greater faith. Moreover, Daim was himself a major corporate player whose protégés were beginning to suffer the effects of the crisis, raising fears over possible conflict of interest and of further corporate bailouts.

Phase 2 (5th December 1997 – May 1998): IMF-style Austerity without the IMF

In the light of continuing fall in the stock prices and the currency, a second reform package was instituted in early December 1997, this time clearly contractionary and addressing many of the concerns of the market (Table 6). The new reform programme was viewed positively by the market, as seen in the gains made by the stock market and the Ringgit after the announcement of the new programme. This time adjustment incorporated clear stabilisation measures employing both fiscal and monetary contraction that were expected to reduce the current account deficit and cool the overheating economy. The package also contained provisions to address the bad loans problem in the banking sector. Political leaders appeared ready to allow non-viable corporations to fail while the Deputy Prime Minister promised that transparency would prevail in public and private transactions. While there was some disquiet over the sharp contraction anticipated as a result of the measures instituted most economists and market players welcomed the adjustment response as an indication that the Malaysian leadership finally recognised the seriousness of the crisis (Pura, 1997c).

Implementation was another issue. There were worries that the Prime Minister was not fully committed to the austerity package given firstly his earlier and repeated denials that national economic policies had in any way contributed to the crisis and secondly his preferred high-growth economic strategy. Many of the deferred projects[26] were the Prime Minister's favourites, while there was every likelihood that Dr. Mahathir's political allies would face corporate bankruptcies as a result of the tighter regulations introduced in the financial sector. Moreover, the austerity package was clearly the brainchild of the Deputy Prime Minister, Anwar (also the Finance Minister) working closely with the Central Bank, rather than the Prime Minister himself. This was a novel event in Malaysia since Dr Mahathir has always initiated major economic policy decisions. Dr Mahathir, however, acknowledged the need for austerity measures in view of the deterioration in the stock market, in the currency value, and increasingly in the financial system.[27] The Prime Minister's support for the new measures was possibly less to do with genuine conviction that they were the correct response than with frustration at his inability to halt the slide in currency and stock values. Malaysia had never before experienced such a situation and the Prime Minister and his policy advisers were probably unsure of a suitable course of action. He may also have agreed to the austerity measures as an interim response while waiting for the crisis task force, the NEAC, to start its work. It is also likely that the Prime Minister's inability to stem the slide in both the currency and stock market, and especially his role in 'upsetting' the markets during the previous three months, strengthened the position of his Deputy Anwar and allowed the latter some leverage in policy design. Whatever the political machinations behind the scene, the second adjustment package clearly represented an alternative reading of the crisis as one that also had its roots in domestic policy mistakes that needed to be corrected. This programme may have represented the beginnings of a more neo-liberal form of economic governance in Malaysia if it had continued. It was, however, short-lived.

Market confidence in the second phase of adjustment was also marred by additional corporate restructuring plans that were viewed as bailouts for the politically well-connected involving state funds. In March 1998, the state oil corporation, Petronas, detailed a plan to acquire the shipping assets controlled by listed company, KPB (*Konsortium Perkapalan Berhad*). KPB, which is 51% owned by the eldest son of Dr Mahathir, was highly leveraged, its debt of approximately RM1.6 billion (US$408.7 million) standing at more than three times its equity level (Lopez, 1998a). Although the assets in question were valued at fair market rates,[28] the purchase by Petronas raised conflict of interest concerns as the corporation comes under the purview of the Prime Minister's Department. In the second episode, a company closely linked to the ruling party, UMNO, received the lion's share of the proceeds from the sale of technically insolvent Sime Bank although it only controlled 30% of the bank. The company, KUB (*Koperasi Usaha Bersatu*) also received a large stake in a lucrative mining company that is presently owned by the state investment fund, PNB[29] in return for not opposing the government-backed rescue of Sime Bank as KUB had allegedly threatened to do (Lopez, 1998b; Chen, 1998). Although both the Prime Minister and his Deputy pointed out that the two deals were commercially viable deals, the market saw it as further signs that the government lacked the resolve to allow poorly run companies, especially those owned by political allies, to fail. The Prime Minister, on the other hand, argued that the use of state funds to assist these ailing companies should not be viewed as bailouts since the companies concerned were not mismanaged, but had only suffered the consequences of the fall in currency and stock values (Business Times Malaysia, 1998). Market analysts, however, regarded these companies as having expanded indiscriminately during the boom years owing to the availability of cheap capital. Sime Bank, for instance, had engaged in highly questionable lending practices.[30] Although the market did not respond as badly to these two corporate exercises as it had done to the earlier UEM-Renong bailout, mainly because private investors were less affected by the former (Jomo, 1998b: 188-89), investors saw them as signs that the government was not committed to corporate reform.

All three corporate restructuring deals had substantial political implications for UMNO despite attempts by the ruling elite to portray them as a vital part of the wider goal of protecting Malay interests amidst crisis. Although the Prime Minister had firm control over the government and the state, his position as President of UMNO, on which his position as Prime Minister depends, was conditional on his ability to dispense patronage widely (Case, 1997: 409).[31] This was easily achieved when the economy was growing at above 8% annually and when the stock market was booming. It was far more difficult during the present crisis with the marked slowdown in growth. Collapse of the stock market, the expected collapse in property prices, and the severe liquidity crunch arising from the precarious position of banks and financial institutions exacerbated the situation. Most of the UMNO-linked conglomerates that had grown out of political patronage were deeply hit by the crisis, in turn weakening the Prime Minister's core support base. Economic crises generally tend to undermine the political bargain rulers typically forge with different segments of society, notably business (Haggard and Kaufman, 1997: 267). The crisis exacerbated the factionalism that had emerged in the party between different party leaders and their respective corporate supporters as each faction vied for state assistance to weather the crisis.

The three bailouts also precipitated dissatisfaction in UMNO, especially among Malays outside the elite circle, many of who privately charged UMNO with being a party for the elites. Many small Malay businesses were badly affected by the crisis, and had been looking toward the government for assistance.[32] Although the government has not been entirely oblivious to their plight, the small business fund instituted for this purpose is limited in terms of the number of individuals it can help and the amount of funds it can provide. Because truly democratic politics in Malaysia's semi-authoritarian political system occur only at the party level, especially in UMNO, challenges to the Prime Minister's position essentially emerge from within UMNO rather than at the parliamentary level (Case, 1997: 393-97). The support of the Malay constituency at large is thus crucial, particularly during a time of deteriorating economic performance in the country. The Prime Minister's roadshows throughout the country in July and August 1998 were clearly designed to garner support for himself and his political allies from both the Malay constituency of UMNO as well as the other ethnic groups in the run-up to both party and parliamentary elections.

Dissatisfaction at the grassroots level emboldened the hand of a group of UMNO members allegedly linked to the Deputy Prime Minister who indirectly challenged the Prime Minister with charges of 'cronyism and nepotism' at the annual UMNO General Assembly held in late June 1998. The Prime Minister overcame this implicit challenge to his authority by making available a selective list of the recipients of more than 170 privatised projects over the years. He also revealed the identities of the recipients of stocks required to be offered to Malay individuals in listed companies as part of the distributive programme. The idea was not only to show that patronage had benefited a wider spectrum of Malay individuals than alleged but more importantly, to reveal that those charging the Prime Minister with practising cronyism and nepotism had themselves gained from political patronage.[33] That challenge effectively arrested, the Prime Minister has since then sought to minimise further challenges to his authority, particularly those allegedly emanating from his Deputy Anwar and his supporters.[34] Speculation that Deputy Prime Minister Anwar will challenge Dr Mahathir for the UMNO presidency, rife in the last few years, had intensified in 1998. Although the Prime Minister's political position may be secure in the short-term, it is too early to speculate on his chances of surviving party elections due in 1999 despite indications that he will not be challenged for the all important post of party president. The more immediate result of the consolidation of power by the Prime Minister in June was that he could go ahead with unveiling the third reform programme which reversed many of the austerity measures introduced in the second adjustment programme of December 1997.

<u>Phase 3 (from June 1998): Adjustment, 'Mahathir' Style</u>

Malaysia entered the third stage in its adjustment response to the crisis from the middle of 1998. The signs of an imminent change in policy direction were particularly clear from April as Dr Mahathir and Mr Anwar sent conflicting signals on appropriate economic recovery strategies. More importantly, Mr Anwar began openly expressing his views that domestic structural problems had contributed to the crisis, thus contradicting the Prime Minister's claim that the crisis was externally induced. For instance, in Anwar's speech to the Council on Foreign Relations in the United States on 15th April 1998, he pointed out that state intervention, "no matter how well intentioned and carefully conceived, is fraught with risks.... Legitimate affirmative action policies can also degenerate into perverse patronage, creating a breeding ground for the rent-seeking leeches which suck the life blood of the economy." (Anwar, 1998). Such strong and open criticism of the Prime Minister revealed the political struggle that went on within the party and state during early 1998 that was arrested only after the party assembly in June.

The impetus for changing the course of adjustment also emerged as fresh economic indicators on first quarter performance revealed a not unexpected contraction of the real economy that vexed the Prime Minister (Table 7). The Prime Minister believed that the austerity measures, notably rising interest rates, had plunged both the economy into recession and corporations, particularly those of his allies, into near bankruptcy. Market analysts, economists and the general public also began to concur with these views. Despite the introduction of austerity measures in December 1997, neither the stock market nor the currency showed any signs of recovery in 1998, except for a short regional rally during the Lunar New Year celebrations in February (Figures 1 & 2). The Prime Minister decided it was time for a home grown approach based on ensuring liquidity availability rather than credit contraction (Sun, 1998a & 1998b, Kamarul and Banoo, 1998 and Lim, 1998). Hence, he was forced to regain control over economic policy that he had temporarily relinquished to his Deputy Anwar since December 1997.

The new measures introduced from mid-June overturned the austerity measures introduced earlier in December 1997. Although Mr Anwar in his capacity as Finance Minister announced the bulk of the new measures in Parliament on 13 July 1998, it was quite clear to political watchers that the Prime Minister this time determined the thrust of the third reform programme. The Central Bank's policy of maintaining high interest rates to support the Ringgit was replaced with a lax monetary policy that led to a sharp increase in liquidity. The switch away from the Central Bank's preferred fiscal and monetary tightening was facilitated by the resignation at the end of August 1998 of the Bank Governor over policy differences with the government. The third reform package also incorporated the recommendations of the crisis task force, the NEAC (Table 8). The new approach not only drew support from the manufacturing industries in the country, a number of market analysts and economists also saw it as the best way to avoid a worsening contraction of the economy. Others, however, were concerned over what they perceived as a too rapid expansion of liquidity, and more importantly, that corporate irregularities and weaknesses were not being adequately addressed.

One of the more significant liberalising measures in the third reform package was that allowing stocks in ailing corporations reserved for Malay individuals under the ethnic distributive programme to be sold to non-Malays and foreigners in order to save these firms. Present rules stipulate that Malay corporate equity should not be less that 30% in any public listed entity while the foreign share could be no higher than 30%. In the new adjustment package, full foreign ownership was also permitted in selected manufacturing sectors (Table 8). Although equity liberalisation had been introduced after the first recession in 1985, particularly in export-oriented manufacturing industry and in other high technology sectors to attract foreign capital, the 30% Malay equity ownership continued to remain a central element of the NEP. Thus equity relaxation is likely to remain limited in the future and reviewed on a case-by-case basis as the 30% Malay corporate equity policy is a crucial tenet of the ethnic distribution programme.[35] The 30% cap on foreign equity in the banking sector, the removal of which many economists and market analysts viewed as necessary to restore the banking sector to health, remained. The 30% limit on foreign ownership of banks appears sacrosanct, and reflects on the one hand Dr Mahathir's economic nationalism. On the other hand, greater foreign equity participation in banks might reduce the space for patronage-based manoeuvres in which banks had played a major funding role previously rents (Gomez and Jomo, 1997: 51).

Many market analysts and economists are, however, doubtful whether the government will be able to raise the RM66 billion funding required for the various programmes in the present package.[36] While the authorities welcome foreign capital participation, it appears that this must be on the government's own terms. Hence the outright rejection of both the IMF option as well as solutions that require raising foreign equity capital participation that give decision-making powers to capital owners in politically sensitive sectors like banking. Greater foreign participation in the Malaysian economy beyond the present *status quo* is moreover rejected by key segments of the Malay public as contravening the "spirit, philosophy and principle of the NEP and the NDP".[37] It is instructive to note that it was only after the politically heated UMNO General Assembly in June that the measure allowing Malay-held shares in ailing companies to be bought by non-Malays and foreigners was explicitly instituted although the idea was initially floated early in 1998 by Mr Daim Zainuddin. Market analysts welcomed the idea while the Malay community had serious misgivings about the proposal.

The government hoped to raise loans without stringent conditionalities from foreign governments and from the World Bank, the Asian Development Bank, and the Islamic Development Bank. External loans from the World Bank (US$1 billion), Japan (US$0.3 billion) and Taiwan (US$4 billion requested) and a planned international bond issue for US$2 billion were expected to provide approximately RM29.2 billion or 51% of the total funding required for the third adjustment programme. The international bond issue was expected to provide the initial funds for banking sector restructuring through the Asset Management Company (to buy bad loans) and the Special Purpose Vehicle (to re-capitalise banks). Unfortunately, a downgrade of Malaysia's credit rating by Moody's Investors Services to two notches above junk bond status forced Malaysia to defer the international bond issue.[38] The stock index, not unexpectedly, fell by 2.5% on concerns over the credit downgrade. The rating downgrades imply that Malaysia will have to pay more for overseas funds.

Although the rating downgrades have been questioned, it is clear that the downgrade coincides with market assessment of the credit risks in the economy (Taing, 1998: 6). The market's assessment of Malaysian risk appears to be significantly shaped by the government's perceived inability to institute the necessary adjustment measures. The year's policy flip-flops coupled with accusations of manipulations and conspiracy hurled against foreigners appear to have influenced market judgement on Malaysia and caused the currency and stock markets to have fallen further than justified by economic fundamentals alone. For instance, yield spreads of global bonds issued by Malaysia's richest corporation, Petronas, were already widening since the beginning of 1998, well before the three-notch credit downgrade in July. The yield spread on Petronas bonds indicated that the market regarded the risk premium for Malaysia to be about 4-5 percentage points above US Treasury bonds, a premium that suggests near-junk status (Table 9).[39] This, of course, made it far more risky for the government to issue sovereign global bonds.[40]

Despite the ratings setback, the authorities have begun the process of addressing banking sector problems. Bankers regard Malaysia's plan to deal with bad debt involving three new agencies to be one of Asia's best. The Asset Management Company (AMC) that will take over non-performing loans is modelled after similar bodies in the US, Sweden and Mexico. Unlike similar agencies set up recently in Thailand, Japan, and South Korea, the AMC has been provided with the necessary legal standing to undertake its task. Both the AMC and the Special Purpose Vehicle set up to re-capitalise the banking sector to meet the BIS recommended 8% capital adequacy ratio have been provided initial seed funding by the government. Nevertheless, their capacity to fulfil their tasks depends on two factors: availability of funds for the next two to five years to clean up the banking sector and whether these agencies will be allowed to act independently even if it involves dismantling the corporate empires of the politically well-connected. Unfortunately, neither the market nor political watchers are sanguine on the last point (McDermott, 1998a).

As for funding, it is increasingly clear that the authorities will tap domestic funding sources, notably the state pension fund, the Employees' Provident Fund (EPF), and the national oil corporation Petronas. The EPF has a total of about RM130 billion in employees' contributions while Petronas has RM30 billion in reserves. Both these agencies are expected to take up government-issued bonds to finance bank restructuring. The National (Muslim) Pilgrims Fund, with accumulated deposits worth RM6 billion, recently offered to buy into corporations involved in national projects to prevent foreign take-overs. In August, the Fund announced plans to buy over the assets of several subsidiaries of the highly indebted DRB-Hicom group, another ethnic Malay conglomerate that showcases the achievements of social engineering and participates in a variety of national projects, including producing the national car (Toh, 1998: 12). Because this highly diversified conglomerate is believed to be strongly favoured by the Prime Minister (Gomez, 1997: 94), the purchase fuels the perception of yet another corporate bailout involving state funds. Access to domestic funds is one reason why the government was able to consider alternatives to freeing up restrictions on foreign capital participation in the economy, at least for the present. It was also the reason why the Prime Minister confidently proposed the RM60 billion fund to prop up the stock market in September 1997 when the crisis first struck.[41] Although the opposition, the trade unions, and the consumers' associations are likely to raise objections to the indiscriminate use of the national pension fund, particularly if the funds are used to save corporate personalities, these entities wield little political power in Malaysia's essentially authoritarian political system. It is only if the Malay constituency of UMNO expresses its disquiet over the use of either the pension or the Pilgrim's fund that the government will be forced to search out alternative sources of funding, especially in view of the forthcoming party elections in 1999.[42]

(4) Conclusion

This paper set out to show through the politics of crisis adjustment in Malaysia how the need to maintain national economic arrangements and policies shaped the way adjustment to crisis was pursued. The Malaysian experience has shown that despite having to accommodate global markets, the government has tried to maintain the ethnic-based distributive policy that favours ethnic Malays with material entitlements. One reason for this was to ensure the security of both state and regime (or political system). The UMNO-dominated government of Prime Minister Mahathir has been unable and unwilling to dismantle the ethnic-based distributive policy that favours ethnic Malays with material entitlements. The political legitimacy of the Prime Minister, government and regime in Malaysia is to a large extent founded on this policy's continuation, regarded by the ethnic Malay community as vital to ensure the community's economic and political dominance (Case, 1995). A second reason was because the state was not wholly insulated from a key social group as a result of the ethnic-based distributive policy, namely an elite Malay corporate group. Adjustment was constrained by the need to ensure the survival of ethnic Malay corporate personalities and 'Malay' corporations built up over the past decade through selective patronage. These individuals and their corporate empires are vital not only because they constitute valuable support bases for the country's leaders, they also represent the success of Malaysia's brand of ethnic-based social engineering as well as showcase national achievements. A third reason was economic nationalism, a major component of Prime Minister Mahathir's economic strategy for the country that stressed the building up of Malaysian corporations and conglomerates able to compete with increasingly large global corporations in a globalised world economy.

For these reasons the extent to which a more orthodox or neoliberal adjustment response could be embraced was limited. Such a response would have involved increasing foreign capital participation in presently restricted sectors to alleviate the capital shortage facing firms as a result of capital outflow from the stock market and in the banking system. It would also have included allowing the market to dictate economic choices in sectors where state control was substantial in order to reduce inefficiencies and restore competitiveness. Allowing foreign concerns to assume control of ailing Malay corporations would have stripped the latter of their Malay identity (and possibly assets) and reverse the government's tangible achievements in meeting the goal of the ethnic-based policy to create a Malay corporate community. Liberalising foreign participation in sectors presently restricted may also have limited future opportunities for wealth transfer through rent-seeking and patronage-based politics. The analysis has also shown that two key features of the state in Malaysia facilitated this process of defending national economic arrangements, at least during the period in question. First, the state's access to domestic sources of funds for adjustment allowed the authorities to maintain foreign equity restrictions in strategic sectors like banking. Second, the centralisation of power in the office of the Prime Minister and the subordination of the other branches of the state and of civil society ensured that the ideas, interpretations and interests of Prime Minister Mahathir and his allies ultimately prevailed in the way the crisis was evaluated and adjustment pursued.

Despite the presence of domestic political constraints, the government has liberalised some aspects of the ethnic-based distributive policy in a move to accommodate global market forces and restore growth. Nevertheless, these limited liberalising tendencies do not signal any ideological or policy shift towards full acceptance of neo-liberal norms and practices. This was demonstrated by the clearly illiberal move in September 1998 to impose capital controls and insulate the domestic economy from a harsh external environment in order to regain some monetary independence. It suggests that the commitment to free markets in Malaysia is instrumental or tactical rather than ideological. Moreover, adjustment has not altered the essential structures of Malaysia's patronage-based economic system, which remain in place. Although the course of adjustment in Malaysia bears the stamp of the present Prime Minister, any other leader, irrespective of any neo-liberal leanings, would have to work within the constraints imposed by both the ethnic-based distributive policy and the politics of patronage that have become entrenched in the Malaysian economy.

Some commentators point to the triumph of the neo-liberal model of economic organisation as East Asian governments, particularly those under IMF pupillage, dismantle the apparatus that supported state direction of their economies (Mallaby, 1998). Others point out that because these economic systems have deep societal roots, their complete dismantling in favour of the neo-liberal model is not inevitable (Higgott, 1998: 17). Although the Malaysian experience is not necessarily representative of the experiences of the other East Asian economies, it does suggest that progress to neo-liberal forms of economic organisation will not be straightforward. IMF-imposed reforms may well make economic transactions in Thailand, South Korea, and Indonesia more transparent, less receptive to rent seeking, and will increase foreign participation in these economies at a faster rate than in Malaysia. Nevertheless, the political difficulties encountered in the reform process in these countries so far suggest that like the Malaysian case, full neo-liberal convergence, if at all, is likely to be a long-drawn affair.

TABLE 1: SELECTED EXTERNAL INDICATORS, EAST ASIA

Foreign Debt in East Asia, 1992-1997

	South Korea		Thailand		Malaysia		Indonesia		Philippines	
	Total (US$ bn)	*Short-term (%)*	Total (US$ bn)	*Short -term (%)*	Total (US$ bn)	*Short -term (%)*	Total (US$ bn)	*Short -term (%)*	Total (US$ bn)	*Short -term (%)*
1992	44.2	--	41.8	*35.2*	20.0	*18.2*	88.0	*20.5*	33.0	*15.9*
1993	47.2	*46.3*	52.7	*43.0*	26.1	*26.6*	89.2	*20.2*	35.9	*14.0*
1994	56.9	*53.5*	65.6	*44.5*	29.3	*21.1*	107.8	*18.0*	40.0	*14.3*
1995	78.4	*57.8*	83.2	*49.4*	34.3	*21.2*	124.4	*20.9*	39.4	*13.4*
1996	102.0	*58.2*	90.8	*41.4*	39.8	*27.8*	129.6	*25.0*	41.2	*19.3*
1997	154.4	*44.3*	100.8	*na*	42.7	*23.9*	131.2	*na*	45.4	*na*

Sources:
World bank, Global Development Finance 1998; Economist Intelligence Unit; Korean Business Review

Current Account Balance/GNP (%), 1992-1996

	South Korea	Thailand	Malaysia	Indonesia	Philippines	Singapore
1992	-1.3	-5.8	-4.0	-2.9	-1.8	11.4
1993	0.3	-5.2	-5.0	-1.4	-5.4	7.6
1994	-1.0	-5.8	-6.7	-1.6	-4.5	17.2
1995	-1.8	-8.2	-9.1	-3.6	-2.6	17.0
1996	-4.8	-8.1	-5.1	na	na	15.2

Sources:
World Bank, Global Development Finance 1998: Corsetti et al (for South Korea and Singapore)

Short-term Debt as a Proportion of Total External Reserves (%), 1992-1996

	South Korea	Thailand	Malaysia	Indonesia	Philippines
1992	Na	69.0	20.2	157.7	98.6
1993	108.0	88.9	24.7	143.8	84.8
1994	118.7	96.5	23.5	146.4	80.2
1995	138.7	111.2	29.4	174.3	68.1
1996	174.4	97.4	39.7	165.7	68.0

Sources:
World Bank, Global Development Finance 1998; Korean Business Review; IMF, International Financial Statistics

TABLE 2: CHANGES IN MAJOR INDICATORS, 30 JUNE 1997 – 3 JULY 1998

	Currencies	**Stock index**	**Stock market**
South Korea	-34.1%	-58.7%	-$111bn *(-71%)*
Thailand	-40.2%	-48.0%	-$40 bn *(-66%)*
Malaysia	-39.4%	-56.0%	-$217 bn *(-76%)*
Indonesia	-83.2%	-35.0%	-$96 bn *(-88%)*
Philippines	-36.1%	-33.8%	-$43 bn *(-58%)*
Singapore	-16.5%	-43.5%	-$91 bn *(-53%)*
Hong Kong SAR	nil	-43.2%	-$223 bn *(-42%)*

Currencies: % decline in currency value against US dollar; Stock index: % decline in stock market index;
Stock market: fall in stock market capitalisation, US$ billion (% fall in italics).
Source: Asiaweek, 17 July 1998, p. 41.

TABLE 3: REGIONAL STOCK MARKET PERFORMANCE, JULY – AUGUST 1998

Stock Index	**10th July**	**17th July**	**24th July**	**31st July**	**14th August**	**Annual Change (Aug97-Aug98)**
Hong Kong	8,639	8,206	8,629	8,257	7,018	-57.8%
Singapore	1,123	1,090	1,095	1,070	1,039	-46.6%
Manila	1,859	1,802	1,787	1,681	1,449	-45.3%
Bangkok	274	274	295	275	248	-61.1%
Jakarta	471	464	486	480	424	-37.2%
Seoul	308	305	344	328	314	-58.7%
Kuala Lumpur	474	429	445	418	364	-60.9%
Tokyo	16,511	16,090	16,561	16,362	15829	-19.3%
Taipei	7,876	7,883	8,040	7,902	7530	-24.7%

Source: Asiaweek, various issues.

Table4: Kuala Lumpur Stock Exchange (KLSE) Indicators, January 1997 – August 1998

	Market Capitalisation RM billion (at month end)	KLSE Composite Index (at month end)	Price Earnings (PE) Ratio
Jan-97	794.00	1,216.72	27.97
Feb-97	854.69	1,270.67	27.97
Mar-97	744.00	1,203.10	29.44
Apr-97	668.83	1,080.17	24.65
May-97	679.21	1,104.83	24.11
Jun-97	653.32	1,077.30	22.67
Jul-97	654.75	1,012.84	22.13
Aug-97	490.17	804.40	15.78
Sep-97	515.85	814.57	15.78
Oct-97	424.77	664.69	12.47
Nov-97	333.69	545.44	9.77
Dec-97	344.43	594.44	10.22
Jan-98	327.00	569.51	9.68
Feb-98	435.72	745.36	12.89
Mar-98	441.41	719.52	14.66
Apr-98	360.73	625.97	14.19
May-98	312.13	538.24	12.53
Jun-98	270.25	456.64	na
Jul-98	na	418.00	na
Aug-98	na	364.00	na

Note: Main board only
Index on 2 July was 1,084.88
Source: KLSE, Investors Digest, various issues.

Table 5: Key Adjustment Strategies Instituted in Phase 1

GDP Growth and External Accounts
(a) Growth estimated at 8% in 1997 and 7% in 1998, compared to 8.6% in 1996.
(b) Large-scale infrastructure projects yet to begin (worth RM65.6 billion) to be deferred.
(c) Suspend the government's 14-year privatisation programme until December 1997, thereby deferring approval of proposed ventures worth RM90 billion.
(d) Current account deficit targeted at 5% of GNP by end 1997, down from the original forecast of 5.5%, and projected at 4% in 1998.
(e) Increase oil production by 50,000 barrels per day to 680,000 bpd to help ease the current account position.
Fiscal Policy
(f) Surplus budget, estimated at 2% GNP in 1997 and forecast at 3.8% in 1998 (3.9% of GNP in 1996).
(g) Corporate tax rate reduced to 28% from 30%.
(h) Across-the-board 2% cut in public expenditure.
Stock Market Support
(i) Raise RM1 billion in government-guaranteed bonds to support the stock market.
Monetary and Credit Policy
(j) Interest rate to be held steady. (3-month interbank rate during this period was 8.2%).
(k) Tight monetary policy to be achieved through other means, notably limiting credit growth. Estimated 1997 credit growth of 29% to be trimmed to 20 % by the end of 1998.
(l) Credit to be directed to productive sectors – manufacturing, small and medium-scale industries, and low-cost housing
(m) Credit ceiling for loans to purchase passenger cars reduced to 70% from 75%.
Tariff Policy
(n) Export incentives
(o) Import restrictions on construction equipment
(p) Import tariff increased on consumer durables that are produced in Malaysia
(q) Import tariffs raised on luxury items
Financial Sector
(r) Classify loan as non-performing if it has been in arrears for 3 months, as opposed to the present 6 months.
(s) Banks to provide information on NPL, exposure by sector, and changes in banks' provisioning for bad and doubtful debts
(t) Increase provisioning for bad/doubtful loans from 1% to 1.5%
Curbing Consumption
(u) Incentives provided to employees to increase their mandatory contribution to pension fund (EPF)
(v) Increase limit on contribution to Bumiputera saving trusts

Source: Anwar Ibrahim (1997), and Ministry of Finance, Malaysia (1997).

TABLE 6: AUSTERITY REFORM PACKAGE ANNOUNCED ON 5TH DECEMBER 1997 (PHASE 2)

GDP Growth and External Accounts

(a) Growth revised downwards to 4-5% in 1998, down from earlier projection of 7%.
(b) Current account deficit to be reduced from projected 4% GNP to 3% GNP at end 1998.
(c) All large-scale infrastructure projects to be deferred, including non-crucial on-going projects.
(d) Flexible exchange rate regime to be maintained. No capital controls.
(e) Outward investments by Malaysians to be deferred.

Monetary and Credit Policy

(f) Interest rate to be determined by market forces. Increase anticipated in view of tight credit policy. (3-month interbank rate during this period was 8.5%).
(g) Credit growth for 1998 revised downwards to 15% from previous target of 20%.
(h) Banks expected to adhere to their credit plans.
(i) Priority sectors in manufacturing, agriculture and services sectors to be provided credit. Restrain credit allocation to unproductive sectors, notably property sector and for consumption.

Fiscal Policy

(j) Cutback in public spending by 18% made up of immediate 10% cut across-the-board in public operating and development expenditure. Additional 2% cut in selective areas. This move brings total public spending cuts thus far to a substantial 20%.
(k) Pay cut of 10% for Cabinet Ministers.
(l) Pay cut of 5% for senior civil servants.
(m) Freeze on salary increments of top and middle level civil servants.
(n) Ministers and civil servants disallowed overseas travel.
(o) Reduction in number of government sponsored students for overseas education.

Financial and Corporate Sector

(p) Safeguards instituted to improve disclosure of information by banks.
(q) New guidelines introduced governing banks' treatment of bad loans that will restrict new loans to ailing, non-viable companies. Additional credit allowed to be extended to viable borrowers suffering temporary cash flow problems owing to currency depreciation. No government interference in banks' decision-making regarding their corporate clients.
(r) Financial institutions requested to merge to create larger entities to increase resilience of the financial services sector.
(s) All bank deposits guaranteed by Central Bank.
(t) No new corporate listings, rights issues and corporate restructuring allowed through the stock market.

Sources: The Star (Malaysia), 6 December 1997; The Star (Malaysia), 7 December 1997; Business Times (Malaysia), 8 December 1997; Business Times (Malaysia), 9 December 1997; Business Times (Malaysia), 10 December 1997;

TABLE 7: SELECTED ECONOMIC INDICATORS, MALAYSIA

Non-Performing Loans		Loans Growth		Growth in Monetary Aggregates			Interest Rates		
					M1	M3		3-mth	Lending
1996	3.7%	1996	27.6%	1996	16.7%	21.2%	1996	7.23	9.18
1997	6.0%	1997	26.5%	1997	4.3%	18.5%	1997	7.78	10.33
Mar-98	9.1%	Dec-97	0.78%	1998Q1	-15.4%	0.1%	Jan-98	9.35	10.44
Apr-98	10.6%	Feb-98	-1.03%	1997Q1	-7.9%	2.2%	Mar-98	10.91	11.96
End 1998*	14.7%	Mar-98	-0.13%				Apr-98	11.00	12.16
End1999*	19.9%	Apr-98	-0.17%				May-98	11.04	11.90
		May-98	-0.16%				18 June 98		12.10

* estimates made by the National Economic Action Council
Q1: first quarter

	Construction Related Production Indicators (% growth)			Production Index (1993=100)	
	Cement & Concrete	Iron & Basic Steel	Construction Products	Total Industrial Production	Manufacturing Production
1995	20.4	12.8	11.7	127.1	131.2
1996	63.7	18.6	21.2	141.1	147.3
1997	21.0	7.8	11.4	156.1	165.6
1997Q1	42.6	8.3	17.3	146.6	152.6
1997Q2	27.6	11.9	14.6	154.8	164.5
1997Q3	13.6	5.5	8.6	160.4	172.7
1997Q4	8.0	5.8	6.0	162.7	172.6
1998Q1	-20.1	-21.6	-14.7	145.0	149.0

	Inflation (% annual change)		GDP Growth (%)	
	Consumer Prices	Producer Prices		
1995	3.4	4.0	1995	9.5
1996	3.5	2.3	1996	8.6
1997	2.7	2.7	1997	7.8
Jan-97	3.2	3.7	1996Q1	9.8
Feb-97	3.1	3.0	1996Q2	9.0
Mar-97	3.2	1.5	1997Q3	9.0
Jan-98	3.4	16.0	1996Q4	10.9
Feb-98	4.4	14.5	1997Q1	6.4
Mar-98	5.1	14.1	1998Q1	-1.8 (estimate)
Apr-98	5.6	15.2		

Source: Bank Negara Malaysia (Central Bank of Malaysia), Monthly Statistical Bulletin, April, May 1998

TABLE 8: THIRD REFORM PACKAGE ANNOUNCED IN STAGES FROM JUNE 1998

GDP Growth and External Accounts (a) Growth projection for 1998 revised from 2-3% (March 1998) to between negative 1-2% (July 1998). (b) Current account surplus of 1% GNP through import contraction. (c) Stem outflow of foreign exchange through foreign workers' remittances by introducing mandatory foreign worker (except maids) contribution to state pension fund, EPF.
Fiscal Stimulus Package (d) Development expenditure increased by RM7 billion in 1998 to fund projects in the following areas: agriculture, housing, education, infrastructure & public facilities, industrial development, rural development, health, poverty eradication, information technology projects, and asset management company (see below). (e) Infrastructure fund established with RM5 billion to revive some critically required large-scale infrastructure projects deferred in the earlier reform packages. Projects revived: mass rapid transit, ports development, highways, water supply, waste and sewerage disposal. Fund will be disbursed through loans or grants. This Fund was established as an off-budget fund. (f) Special funds (already established but which received additional funds): • National housing fund of RM2 billion • Small & medium-scale industry fund of RM1.5 billion • New entrepreneurs' fund of RM0.75 billion. • Export credit fund of RM4 billion
Monetary Policy (g) Monetary policy eased through reducing banks' statutory reserve requirement from 13.5% in February 1998 to 8% in July 1998. This move effectively released estimated RM22 billion into banking system for use as credit to productive sectors. Further reduction to 6% in August 1998. Capital controls allowed further easing to 4% in September 1998. (Expected to decrease further to 2%). (h) Interest rate to be maintained at a level that will stabilise currency while allowing economic growth. Essentially a reduction in interest rates. Central Bank 3-month intervention rate (which determines bank lending rates) set to decline from a high of 11% in February 1998 to 8% in September 1998.
Equity Liberalisation (i) Companies classified as *Bumiputera* (essentially Malay) that are facing financial difficulties are allowed to sell their shares to non-*Bumiputera* (or non-Malay) buyers. (j) Equity and export conditions lifted on all new manufacturing projects, including expansion and diversification, between 1 August 1998 and 31 December 2000. Not applicable to those sectors in which Malaysian companies have adequate capabilities, namely paper packaging, plastic packaging, plastic injection moulding components, metal stamping and fabrication, electroplating, wire harness, printing, and steel services.
Financial & Corporate Sector (k) Stock market restrictions on new listings, capital-raising exercises and restructuring imposed in December 1997 lifted to enable corporations to raise capital. (l) Establishment of Asset Management Company (AMC/*Danaharta*) to purchase non-performing loans (NPLs) and assets from financial institutions so that latter will be free to increase credit provision to economy. The AMC will then rehabilitate the assets and sell them to new investors. Projected to require initial RM25 billion in funds to absorb NPLs. (m) Establishment of Special Purpose Vehicle (SPV/*Danamodal*) to re-capitalise banks. Will inject fresh capital into weak domestic banks while also strengthening core group of stronger banks to face global competition. Re-capitalisation projected to require RM20 billion. (n) Establishment of Joint Public-Private Steering Committee to expedite corporate debt restructuring. Main aim is to ensure access to liquidity for still viable companies but facing debt problems and to ensure those losses are borne evenly by all creditors and borrower. (o) Amendment to bankruptcy laws to allow companies longer protection period from creditors (instead of the present 6-months of court protection) to prepare corporate restructuring strategies. (p) Government assistance to be provided to *Bumiputera* (or Malay) firms that have been well managed and profitable before the downturn.

Sources: New Straits Times (Malaysia), various issues in June and July 1998.
NEAC, National Economic Recovery Plan, 21st July 1998

TABLE 9: YIELD SPREADS OF SOME ASIAN GLOBAL BONDS AGAINST US TREASURY BONDS (BASIS POINTS)

BENCHMARKS (YEAR OF MATURITY)	**1st May**	**30th March**	**29th June**	**13th July**	**28th July**
PETRONAS 2006	205	255	420	405	445
KOREA 2008	-	-	495	460	450
INDONESIA 2006	385	505	840	840	775
THAILAND 2007	375	250	415	400	425
CHINA 2006	135	115	180	185	185
PHILIPPINES 2016	415	310	380	365	360

Note: *100 basis points equivalent to 1 percentage point.*
Petronas bond regarded as benchmark for Malaysian sovereign bond issue.
Source: *The Edge, 3 August 1998, p. 6.*

FIGURE 1: MOVEMENT OF MALAYSIAN RINGGIT (1997-98)

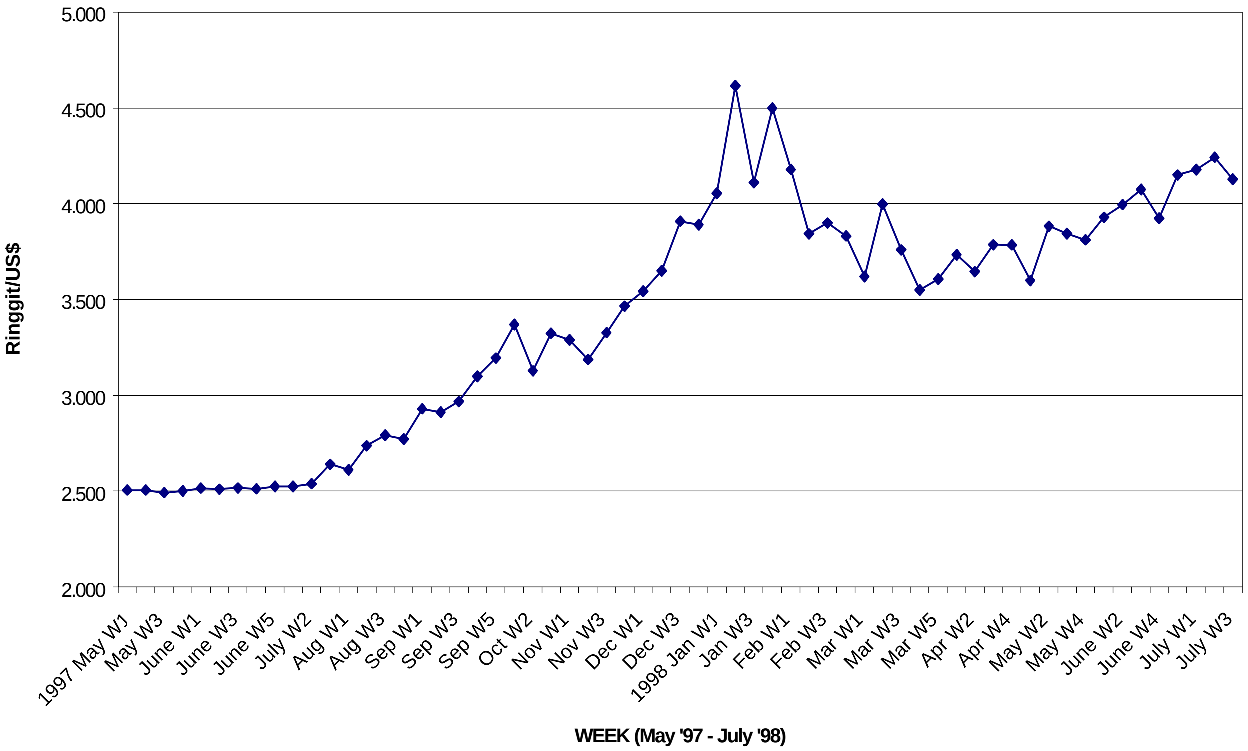
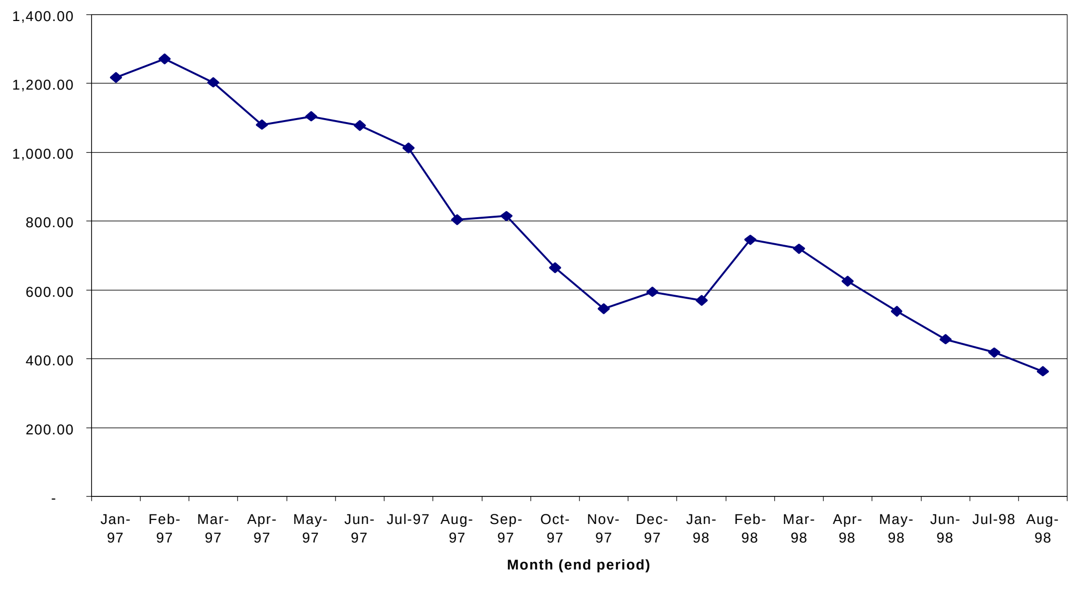


Figure 2: KLSE Composite Index



Notes

[1] A large portion of this analysis has, in turn, concentrated on the shortcomings of IMF-designed adjustment to the crisis, or to a lesser degree, on the merits or necessity of IMF-designed reforms. See for instance, Radelet and Sachs (1998), Sharma (1998), Khor (1998) and Montes (1997).

[2] Jomo (1998b: 181-84) provides a cogent analysis of the structural and macroeconomic weaknesses in the Malaysian economy leading up to the present crisis.

[3] Ralph Miliband (1973: 46-51) defines the state as comprising the following six elements: (a) the government or political executive; (b) the administration including the civil service, the central bank and public enterprises; (c) the coercive apparatus such as the armed forces and the police; (d) the judiciary; (e) sub-central or local governments; and (f) the parliament or legislature.

[4] This approach follows closely John M. Hobson's conceptualisation of state capacity. See John M. Hobson (1997: 10-12) .

[5] The stability of both state structures and of the governing regime is Malaysia's prime security concern, as is common with most developing states. See Mohammed Ayoob (1995: 8) and Mak (1997). The pro-Malay distributive policy is also presented to the other ethnic groups, especially the Chinese, as providing an implicit security guarantee against Malay anger and bitterness with economic inequalities which had previously led to ethnic riots in May 1969 (Case, 1995: 72-73).

[6] See Far Eastern Economic Review (FEER), 24 July 1997, p.; Murray Hiebert (1997) and FEER, 11 September 1997, p. 5.

[7] The growth of electrical and electronics products and machinery exports which account for about 66% of total manufactured exports had been declining sharply since 1995. Foreign investment approvals in manufacturing were lower in the first half of 1997, the high inter-bank rate of 8%, up from 7.3% in March, was expected to raise expansion costs and squeeze earnings, and a property glut seemed imminent.

[8] Reserves fell by 13% between June and July 1997 while the overnight KLIBOR (Kuala Lumpur Inter-bank Offered Rate) was hiked up to 50% in July after which it fell back to between 8.8% to 9% in August and September.

[9] Jomo (1998b: 184) cites a figure of US$8 billion.

[10] Although the KLSE had begun its downtrend since February 1997, the decline in the composite index between end February 1997 and end June 1997 was far less, at 15%, than the loss suffered over a period of about five weeks in July-August.

[11] Dr Mahathir branded foreign currency traders as "international criminals", publicly called Mr George Soros a "moron ... with a lot of money", insinuated that Americans such as Mr Soros were conspiring to sabotage Southeast Asian economies, and accused the IMF of wishing to "subvert" Malaysia's economy (Pura, 1997a).

[12] Equivalent to about 46% of Malaysia's 1996 real GDP.

[13] Sellers were required to deliver physical share certificates to their brokers before selling. The settlement period for stock sales was also reduced to two days from five.

[14] The ISA, originally introduced by the British colonial administration to confront the communist challenge, allows detention without trial for up to two years of any persons deemed a security risk to the country.

[15] A similar reaction occurred when the Prime Minister repeated his message in Santiago, Chile at the end of September.

[16] The control by Dr Mahathir of the government, the top civil service, major sources of business patronage and eventually of the political party, UMNO is described in Case (1997) See also Gomez and Jomo (1997: 2-9).

[17] Comment by the President of the Federation of Malaysian Manufacturers at the Annual Post-Budget Dialogue organised by the Malaysian Economic Association, Kuala Lumpur, 18th August 1997.

[18] The question remains, however, whether the market would have persisted in its call for higher interest rates if the government had adopted a more contractionary strategy during that period in view of the over-heating economy.

[19] Malaysia's Code on Takeovers and Mergers stipulates that companies or individuals purchasing more than 33% of another company's stock must make a general offer to purchase all the remaining stock in the targeted concern at the same price paid. Exemptions are only allowed on the grounds of 'national interest'. In the UEM case, the general offer requirement was

triggered since the Commission deemed that UEM, which bought 32.6% of Renong, was acting in concert with other shareholders, thereby raising their joint stake to 77%.

[20] See Euromoney (1998: 44).

[21] For instance, UEM's additional borrowing to purchase its stake in Renong raised UEM's debt to RM2.7 billion from RM300 million, a development which the Rating Agency of Malaysia said would significantly drain UEM's cash flow (Pura, 1997b: 1).

[22] The NEP employs the term 'Bumiputera" rather than Malay. The term 'Bumiputera' does not refer to a particular ethnic group but represents a constructed social category comprising a variety of ethnic groups said to represent the indigenous population in Malaysia in contradistinction to the immigrant Chinese and Indian population. The term itself, yet to be legally defined, is translated as 'sons or princes of the soil' (Tori, 1997: 213). While the category Bumiputera comprises a variety of ethnic groups, it is nevertheless predominantly Malay, the dominant ethnic and political group in Malaysia, recognised by the British colonial rulers and by the Constitution as the rightful rulers of the country.. Since the mid-1980s, official documents and statistics do not distinguish between Malays and other ethnic groups within the category Bumiputera although information prior to this juncture did. Information is now always presented in terms of Bumiputera and non-Bumiputera, the latter often presented in terms of its major component ethnic groups, namely the Chinese and Indians.

[23] The major business groups and their political connections are identified in Gomez and Jomo (1997).

[24] A succinct history of Renong is found in the Asian Wall Street Journal, 19 January 1998, p.1

[25] See Business Times (Singapore), 22 July 1998.

[26] A number of these projects had already been deferred in October 1997. Among them: the Bakun hydoelectric dam, the Kuala Lumpur Linear City project, the Northern Region International Airport, the mountain resort highway, and Phase 2 of the new administrative centre in Putrajaya.

[27] See Kamarul and Kang (1997).

[28] The purchase price paid was US$220 million, and KPL even loses up to US$80 million in the process. The assets were independently valued before the sale (Toh, 1998).

[29] PNB (*Permodalan Nasional Berhad*) was created to hold blue-chip investments for Malaysia's *bumiputera* or indigenous citizens, largely made up of the country's politically dominant ethnic Malay community.

[30] Loans to stock market speculators accounted for 22% of the bank's total loan portfolio, exceeding the 15% limit imposed by the Central Bank. Nearly RM1 billion was lent to a single individual through Sime Bank's securities brokerage arm to prop up his stock price (Euromoney, 1998: 43).

[31] UMNO is the dominant party in the ruling National Front coalition party (*Barisan Nasional)*. The President and Deputy President of UMNO become respectively the Prime Minister and Deputy Prime Minister of Malaysia. There is no serious threat to the ruling party from opposition parties. Thus, UMNO is virtually assured of providing candidates for the top two leadership positions in the country. It is, therefore, the seat of power in Malaysia.

[32] The National Economic Action Council estimates that the market value of Bumiputera ,or essentially Malay, equity declined by 54% compared to a 50% decline in the value of non-Malay equity and 47% for foreign equity (NEAC, 1998: 98).

[33] The lists were reproduced in all major newspapers in Malaysia. See for instance, Sunday Star, 21 June 1998; and Sun, 22 June 1998. The Prime Minister may have won the immediate battle, but making public the list may eventually cost him the war. Malays outside the elite circle have come to realise that most of the beneficiaries of state patronage were from among the Malay elite. The Prime Minister himself admitted at the UMNO General Assembly that company directors and chairmen, as well as holders of state honours and titles have received the lion's share of these benefits. Continued Malay dissatisfaction at cronyism strengthened by the revelations in the lists is said to be the reason why UMNO lost the safe seat of Arau in a subsequent by-election in northern Malaysia. Although a general election win for the ruling National Front coalition may be inevitable at parliamentary elections that are expected to be called either this year or early in 1999, the ruling National Front coalition is expected to suffer a reduction in its majority.

[34] The resignation of two senior editors from two popular Malay language newspapers was purportedly due to political pressure from the Prime Minister. These two editors were widely seen as Anwar supporters and had recently written editorials calling for political and economic reforms that directly contradicted the Prime Minister's line that Malaysia's economic woes were not the result of economic mismanagement but the result of external manipulations. Their newspapers had also given wide coverage to the government-backed rescue of the shipping firm owned by Dr Mahathir's son. The two editors were replaced by pro-Mahathir individuals. This incident was widely seen by political watchers and by market players as an attempt by Dr Mahathir to remove potential challenges to his presidency of UMNO at the 1999 party elections (Suh, 1998:

26). The sacking of Anwar from all his government posts and from UMNO in the first week of September left the Prime Minister virtually unopposed as the architect of Malaysia's adjustment programme.

[35] The equity requirements in the corporate sector are detailed in the annual Economic Reports of the Ministry of Finance, Malaysia. Higher foreign equity has recently been permitted in sectors like telecommunications (raised from 49% to 61%), fund management companies in the multimedia hub (100%), hotels (51% after five years of operation) and insurance (51%). Statement from the Finance Ministry to Parliament, 11 August 1998. The 30% cap on foreign equity participation in the wholesale and retail industry remains. In the banking sector, the 30% limit remains.

[36] The semi-official think-tank, the Malaysian Institute of Economic Research, questioned the government's ability to provide funding to re-capitalise banks and absorb banks' non-performing loans without foreign capital (Business Times, Singapore, 1998).

[37] Part of a statement made by the Deputy Chairman of the Malay Chamber of Commerce Malaysia in response to the announcement that the government was considering raising the foreign equity limit in the wholesale and retail trade sector to 51% from the present 30%. The announcement was later retracted.

[38] Moody's downgraded Malaysia's long-term foreign currency country notes and bonds to Baa2 from A2 in the third week of July 1998. Standards & Poor's lowered Malaysia's long-term foreign currency sovereign rating to *"BBB"* from *"A-"*. Thomson BankWatch also downgraded Malaysia's sovereign risk rating to BBB from A- while the debt ratings of Malaysia's top bank were similarly downgraded.

[39] Immaculate investment grade paper would trade at about half a percentage point above equivalent US Treasury bonds.

[40] Since the Malaysian government has not issued global bonds, the Petronas bond issue is regarded as the benchmark for sovereign Malaysian bonds.

[41] There is very little information on how much state funds have been used to support the stock market through stock purchases despite the issue being raised in Parliament by the Opposition Leader.

[42] Funding is also expected to come from the easing of the statutory reserve requirement (SRR) on banks. The Central Bank announced in September that approximately RM8 billion would be available from banking institutions as a result of a two percentage point reduction in the SRR from 6% to 4%. This would be automatically channelled towards bank re-capitalisation.

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