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MALAYSIA POLARIZING

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**DRAFT**

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## MALAYSIA 1986

### Summary

Malaysia has an unusually strong basic economic structure for a Third World country. It has a market-oriented economy, good infrastructure, good administration, highly diversified agriculture and natural resources sectors, and a diversified and sophisticated manufacturing sector.

This basic structure was managed in the 1960s and 1970s and with sound policies. These policies were market-oriented, emphasized growth as a prerequisite to redistribution, carried out a gradual and prudent but effective redistribution, and maintained employment and income distribution by focusing on agriculture and light industry. Malaysia's successes with these policies created very high growth, an excellent reputation, and a deep financial cushion.

After experiencing some political tragedies, notably the secession of Singapore and the riots in May 1969 that nearly tore the country apart, both due to ethnic conflicts, the country was governed with a balanced concern for improving the economic status of the politically dominant Malays (bumiputras) and for ensuring the dignity and economic confidence of the economically dominant Chinese.

The Mahathir government has, however, fundamentally shifted policies. Faced with more stringent world economic conditions in the 1980s, it sought to spend its way through the recession. It gave priority to heavy industry, principally through HICOM, which went bankrupt. As a central part of its economic strategy, it invested heavily in a Korean-style trading company, which went bankrupt. It invested heavily in crackpot projects, including most notably an effort to corner the tin market and a billion-dollar commitment to the Carrigan group, which went bankrupt. It engaged in a series of financial machinations and statistical manipulations that gave the government a reputation for corruption and decreased the credibility of its figures.

Politically, the Mahathir government has worsened Chinese-bumiputra strains and followed a policy of appeasement toward Islamic fundamentalism (which throughout Southeast Asia is basically an anti-Chinese social reaction). The result is a drastic reduction of Chinese domestic investment, of overseas Chinese direct investment in Malaysia (the predominant form of foreign direct investment), an outflow of capital estimated by Morgan at \$12 billion since the mid-1970s, and a drastic reduction of capital inflows.

Because the government has responded pragmatically in cutting its budgets and seeking to privatize major state firms, and because the country retains its historic economic strengths, it has retained until recently the full confidence of financial markets. But if the fundamental Mahathir policies persist, the emergence of serious problems cannot be indefinitely delayed. The confidence of Asian financial institutions in Malaysian management has declined radically in the past year.

## The Underlying Political Economy

From its founding, the goals of Malaysia's top leadership have been to consolidate Malay (bumiputra) political dominance, to erode Chinese economic dominance, and while doing so to maintain social stability. Its strategy for doing this has been to encourage rapid economic growth, through relatively market-oriented policies (few quotas outside steel and cement, low tariffs, a competitive domestic market), while using the power of the state to redistribute the growth increment in ways that disproportionately benefit the Malay population. This strategy has been highly successful, but now faces major challenges.

Malaysia's political economy has always been dominated by Chinese-Malay relations. Each of the principal tragedies of modern Malaya and Malaysia pivoted on Chinese-Malay relations: The Emergency, a fight to the death with the Communist Party of Malaya, was a fight with a communist party dominated by Chinese. The May 1969 riots that nearly tore the country apart were Malay versus Chinese riots. And the union with Singapore failed because of ethnic tensions.

The principal successes of Malaysia have also pivoted around ethnic relations. An entrepreneurial urban Chinese industrial sector and a successful, diversified Malay agriculture have complemented one another. The stability Malaysia has enjoyed since 1969 has resulted from an interethnic coalition: the governing Barisan Nasional currently comprises 11 parties, most notably the United Malay Nationals Organization, the Malayan Chinese Association, and the Malaysian Indian Congress. UMNO has convinced Malays that the coalition will maintain Malay political hegemony. MCA and MIC have, at least until recently, convinced a majority of their fellow Chinese and Indians that, given the inevitability of bumiputra political dominance, other ethnic groups can most effectively promote their interests by bargaining from within the coalition rather than by protesting from outside. The country's success in economic growth, and the government's wisdom in redistributing the increment of growth rather than the base of existing wealth, have provided a favorable reality on which the MCA and MIC could appeal to their supporters.

Economic policy has pivoted on ethnic relationships. The core of Malaysian economic policy has the New Economic Policy, a plan for abolishing (mostly Malay) poverty and redistributing national ownership so that the Malay (bumiputra) share would increase from 4% in 1971 to 30% in 1991. This policy was wisely predicated on sharing out the increment of growth from a rapidly expanding national pie. The plan assumed 8% average annual growth of GNP, a target that was nearly achieved for many years. In addition, government offices, college admissions, and jobs in state firms were allocated primarily to Malays, and foreign investors and large firms were required to achieve quotas of bumiputra ownership and employment.

This program achieved remarkable successes during the 1970s. Helped by a buoyant world economy, Malaysia's tin, rubber, coconut pepper, cocoa, timber, oil, and palm oil, and semiconductor assembly

industries enjoyed good prices and frequently substantial growth of volume. Malaysia's ability to serve its markets was enhanced by a more market-oriented economy than that of its neighbors (other than Singapore), by a civil service remarkably able by third world standards, and by a political system that provided stability of leadership, continuity of policy, and representation of all major groups. All major groups became more prosperous. And the increased bumiputra share of ownership did not come primarily at the expense of the Chinese share; instead, it came out of foreign investors' share.

### Economic Policies in the 1980s

During the 1980s, less auspicious economic conditions have coincided with the Prime Ministership of Mahathir. He has fundamentally changed the direction of the Malaysian economy.

Mahathir's economic policies have had four central thrusts: discipline, emulation of South Korea and Japan, financial ploys, and privatization.

Mahathir admired the discipline of the Koreans and Japanese (and implicitly of the domestic Chinese) and, to instill discipline, provided moral exhortation and, more concretely, time clocks. Even the Prime Minister clocks in each morning and out each evening. This part of the Mahathir program seems admirable and has made a noticeable impact on punctuality, if not always on work habits.

Mahathir's "Look East Policy" ostensibly sought to model Malaysia's policies after Japan and South Korea. With considerable flourishes, he created a trading company. Regrettably the trading company had no particular comparative advantage, and it did have a rather bureaucratic attitude toward customers, so it went under. But the central thrust of Mahathir's "Look East" policy was a shift toward heavy industry.

The priority for heavy industry had three primary justifications. One was that the Koreans had a lot of heavy industry. But Korea built a solid foundation of light and medium industry before plunging headlong into shipbuilding, steel, and the like, and even then Korea got seriously overextended (in the late 1970s). A second justification was that Malaysia desperately needed employment and that its more traditional industries could not expand employment in the difficult economic environment of the 1980s. But capital intensive industry is capital intensive, not labor intensive, and hence a peculiar way to expand employment.

The third justification for heavy industry was more sophisticated. Malaysia's export processing zones had become home to a wide variety of industries -- including the world's Third World base of semiconductor production. But these did not combine into a broad, integrated base of Malaysian skills and technologies and it did not spread out of the export processing zones. So, Mahathir argued, the country needed heavy industries which would draw on a variety of these skills and which would knit together and discipline

a wide variety of small shops.

The ultimate example of this theory was the Proton Saga, the Malaysian car. By building a Malaysian car, the country would save foreign exchange, tie together the country's variety of small body shops, battery shops, and the like, and create a critical mass of skills and technologies. In the process, it would force the small shops to meet deadlines and quality standards. All of this would be possible because the statisticians estimated that the market for cars would be just about economic size. This theory worked out the way the others did. The statistics were inflated, even without a recession. A majority of the parts were imported -- and, worse, were contracted for in yen. Mahathir's theorists bemoan their bad luck. And they did have bad luck. They also had peculiar calculations: The car market proved to be 50,000 cars rather than the predicted 120,000. During this same period, Thailand, with nearly four times Malaysia's population, was deciding that it could not afford to build a Thai car.

Malaysia has a large consumer electronics sector that has not quite made it into the export business. A small margin of greater efficiency could have propelled Malaysia into a major role in this sector. Instead, Mahathir's commitments to inefficient heavy industry will necessitate protectionism that will in turn raise costs and may permanently destroy Malaysia's chances for the income and employment that export-oriented consumer industries could provide.

~~The central point in all of this is that the economic logic of the economic policy never quite worked. But there is a logic that works: The Proton Saga plant employs no Chinese. It displaced half a dozen assembly plants owned and largely managed by Chinese.~~

The third arm of economic policy in this period was financial juggling. Bank Bumiputra, created for the express purpose of overcoming Chinese financial advantages and raising up the bumiputras, committed a billion U.S. dollars, through a subsidiary, to a Hong Kong Chinese con man, George Tan, and lost it all.

Malaysia tried to corner the tin market. The tin market collapsed, and two Malaysian banks are still carrying the tin. Aside from the financial cost, precipitating the collapse was also painful because Malaysia's cost of production is \$8,000 per ton whereas Brazil's is \$3,000. Malaysia's loss of market share is therefore disproportionately large.

It is symbolic of the state of Prime Minister Mahathir's strategy that the key institutions founded in connection with that strategy are all in trouble. Multipurpose Holdings, the trading arm of the Look East Strategy, has gone under. HiCom, the Heavy Industries Corporation of Malaysia, explicitly modeled on Korea's Hyundai, has not been able to meet its financial commitments. Bank Bumiputra is saddled with much of the legacies of the Carrian investments and the tin debacle, although the national oil company, Petronas, has been forced to take over much of these losses.

The Finance Minister ordered the Employees Provident Fund (EPF) to support the stock market by shifting from bonds into stocks. He even helped them further by designating which stocks should be purchased. Whenever the EPF purchased a stock, a government firm, Makuwasa, set up by the Finance Minister also purchased the same stock. In addition, whenever a company issued new shares, it was required to give the EPF a portion of the issue at preferential prices. The EPF was in turn required to sell 70 percent of these to Makuwasa at cost. Then the stock market collapsed, in a debacle precipitated by illegal actions of the the head of the Malaysian Chinese Association.

In 1985, Bank Negara told commercial banks to stop counting interest on non-performing loans as income. A large portion of these loans were politically inspired loans made to politically prominent bumiputras. In 1986, the Bank rescinded the order when it became clear that persistence would destabilize the banking system and that the banks were responding with a broad variety of foreclosures.

Because of fears about the financial system, and because the Central Bank has been keeping interest rates on deposits very low to help the banks, deposits have been leaving the banks and loan to deposit ratios have been rising sharply. Much of the money has gone into cooperatives that were supervised by the Ministry of Land Reform rather than the Central Bank. The result was a crisis as part of the cooperative system experienced a run, nearly collapsed, and was suddenly frozen by the government in 1986.

Malaysia's financial sector is an exception to the national legacy of institutions inherited from the British. Unlike the civil service and the military, the financial sector is largely a post-independence creation. It is to a large extent a creature of bumiputra social programs and political patronage. It is weakly managed and the above policies are making it weaker.

Malaysia has one of the Third World's most competent administrations and an excellent statistical system. It is therefore intriguing that official figures showed the 1985 growth rate to be a positive 2.8 percent. (See last year's economic report and Suhas Ketkars' OIS of 5 June 1986.) Official figures provided to Tom Trebat in October of 1986 and used in his preliminary economic report or 22 October 1986, citing recently released Bank Negara figures, showed minus 1.5 percent. A confidential government briefing to senior Malaysian bankers during the last week of August 1986 acknowledged that the 1985 growth rate was minus 2.7 percent, now the figure most frequently used by the Malaysian press. (See, among many others, Malaysian Business, 1 September 1986, page 12.) That represents a swing of 5.5 percent of GNP from the estimates of mid-1986. As was said of Nixon and Watergate, either he knew and that's bad, or he didn't know and that's bad.

Interviews with businessmen, diplomats, scholars, and government officials revealed widespread belief that the accounting of major state and state-related financial institutions no longer reflects the underlying realities. The depth of belief in this is indicated by

the increasing practice of businessmen formally migrating to another country in order to be allowed to withdraw their stake in the Employee Provident Fund before, as they believe, the reality must be faced.

Confronted with the widespread practice of financial manipulation by reports in the Asian Wall Street Journal, Mahathir's government banned the publication for 90 days, rescinded the work permits of its reporters, and put forward a proposal to tighten the Official Secrets Act and impose mandatory sentences for violation of it. Mahathir repeatedly stated that the reports were part of a conspiracy by a Zionist-controlled Western press to undermine largely-Islamic Malaysia.

To explain the country's difficulties, Mahathir has articulated a theory that the Western countries have been deliberately sabotaging Malaysia's development. This theory is a melange of the realities of Western recession, of Washington's selling tin from its stockpile when Malaysia sought to corner the market, and of the Tin Council's unwillingness to countenance Mahathir's schemes, together with a great deal of distortion and demagoguery. Having sold this theory to a large number of his countrymen, Mahathir or his successor will have to cope with the consequences of creating a mass of anti-Western attitudes.

The fourth thrust of Malaysian policy has been privatization. Malaysia has gone further and faster with this policy than most other countries. As with the other thrusts, though, Malaysia's privatization policy has some special twists. It is pressed by a leader, Mahathir, who devoted his whole earlier career to fostering state control of the nation's industry. Mahathir and his closest colleagues promoted the buildup of state firms. They then used the resources of those firms, and the fact that they could use the state firms to employ bumiputras instead of Chinese, as the core of their strategy for creating a political base. Government contracts became huge, and government contracts went primarily to the family companies of leading politicians. A second aspect of the strategy was to provide loans without collateral and privileged access to state land to politically connected bumis prior to and during the property boom. That strategy got Mahathir his present job. It also created a whole new class of wealthy, politically connected bumiputras who support Mahathir.

Now Mahathir is selling off the state firms. Other countries primarily sell off their loss makers. Mahathir primarily sells off the profitable firms. The beneficiaries are the new class of now-wealthy Mahathir supporters.

Along with the foolishness, Malaysia's policy has retained much of the legacy of past good sense. When growth faltered, Mahathir suspended redistribution efforts. He planned a drastic cut in the defense budget. When growth faltered, he also rethought the squeeze on foreign investors; he suspended NEP requirements, announced incentives to attract investment, and toured the world to attract investors. But while he was doing this, the financial shenanigans

were frightening capital out of the country; people were actually emigrating in order to be able to withdraw their funds from the provident fund, which was widely believed to have been milked of its assets. And he gave no quarter to the Chinese, even though the primary domestic investors are Chinese and the primary foreign investors are overseas Chinese.

The resulting capital flight continues. Morgan estimates that between 1976 and 1985 US\$12 billion of flight capital left Malaysia. Proportionate to population or GNP, that is higher than the Philippines or Argentina. When that number is added to the tremendous decline of foreign investment in the last three years, the opportunity cost has been enormous.

The course of economic policy under Mahathir demonstrates clearly the priorities of the leadership. Politics comes first. Economics is an instrument of the political process. Prior to Mahathir, Malaysia was run by an aristocracy with a long-run economic view. Now it is run by nouveau riches who see the economy primarily as a political tool or as a financial con game. This does not mean that economics doesn't count. The basic economic calculations are rational, and the leadership knows that destruction of the economy will eventually destroy the political base too. But the economic logic has a way of becoming tortuous when it encounters higher priority political calculations.

The sound basic structure of the Malaysian economy persists. Unlike the situation in the Philippines under Marcos, the basically open and competitive economy has not been destroyed. This makes problems manageable and damage reversible. But the basic trend of government policy has been toward mismanagement, waste of resources, and weakening of financial institutions.

### Islamic Fundamentalism

Along with the economic squeeze, the 1980s have seen the emergence of Islamic fundamentalism. This is not the fanatical fundamentalism of Iran, but it has changed the tone of Malaysian society. Islamic fundamentalism is a response to bumiputra feelings of poverty, inequality, and racial humiliation. Both in historical roots and in current fruition, it is an anti-Chinese development.

Mahathir has sought both to profit from Islamic fundamentalism and to curb it. Mahathir began his political life as a Malay extremist; the emotional wellsprings of fundamentalism and of his own political rise have much in common. Mahathir has accepted the creation of an Islamic society as the core of his program, and has married his own anti-Chinese sentiments to Islam, but has tried to coopt the most able leaders of the fundamentalist party, PAS, and to curb that party's growth. He has sought to diffuse their thrust by saying that he himself is an Islamic fundamentalist and that the PAS is heretical. He has sponsored a great deal of Islamic legislation, and has banned the publication of a reformist Islamic book by Kassim Ahmad, but has forthrightly opposed much of the fundamentalist

program.

Many Islamic programs, documented in last year's review, have moved forward. The symbols of fundamentalism are omnipresent. A substantial proportion of the female population now wears Muslim costume. Civil servants sometimes refuse to handle documents containing the word "pig." Female medical students refuse to dissect male corpses.

In some areas this has now elicited a backlash. In Sabah, where a previous state leader, Tun Mustapha, had imposed Islam by policies of forced conversion, in April 1985 a backlash led to election of a Kadazan government of Christian inclination. Tun Mustapha nonetheless had himself declared governor. Court controversies ensued, and Tun Mustapha attempted to impose himself through violent demonstrations. Mahathir eventually refused to support Tun Mustapha and, after dithering, admitted the new Sabah government to the national Barisan coalition, but only after serious riots in March and April of 1986. Likewise, in Kedah, the government had to use force to control illegal activities by followers of a fundamentalist preacher and the confrontation left 18 dead in November 1985.

Malaysian Islamic fundamentalism remains a very mild phenomenon by comparison with its Middle Eastern counterparts. It has different social roots and different manifestations. But it is a force for economic mismanagement. Above all, it is a force for ethnic divisiveness and conflict, frightening the Chinese community and thereby reducing domestic and foreign Chinese investment and stimulating capital flight.

### Politics in the 1980s

Mahathir got his start in politics as a Malay extremist. He has moderated his early positions a great deal, and he has learned to speak to each audience in the kinds of words that audience wants to hear. But his period as prime minister has been unique in abrasiveness and confrontations.

Mahathir has engaged in a major constitutional confrontation with the sultans and the king. (See the 1984 review.)

His policy toward Islamic fundamentalism has been to make constant concessions to fundamentalist demands for Islamic laws, Islamic institutions, and Islamic foreign policies, while denouncing the opposition fundamentalist political party, PAS. He presents himself as a true "fundamentalist" and denounces PAS as heretical. He coopts the most effective of the Islamic politicians, most notably including Education Minister Anwar Ibrahim. While his brand of Islamic politics is mild, it is frightening to the Chinese. While he has tried to limit the extent to which the fundamentalists impose their will, he has allowed and encouraged the national political process to become focused not on the issue of how best to develop the nation's economy and foster racial harmony, as before, but on the issue of how best to foster a modern Islamic state.

Mahathir and his colleagues have firmly and repeatedly and eloquently stated that Malaysia is a state for the bumiputras and that the Chinese citizens, who are only slightly less numerous, must accept this.

In recent years, the politics of the ruling coalition have become increasingly tumultuous. The Malaysian Chinese Association went through a major power struggle ending in the victory of Tan Koon Swan. Not too many months thereafter, Tan Koon Swan was convicted of financial fraud and sentenced to jail in Singapore.

Within the United Malay National Organization itself, Mahathir came into increasingly open conflict with his Deputy Prime Minister, Musa. The Deputy Prime Minister, a native of Johore, the most racially integrated and tolerant of Malaysia's states, stood for an emphasis on racial harmony and for more liberal, open politics. His views were incompatible with Mahathir's. This led to an open split in which Musa resigned and fled the country.

Mahathir called an election in July and his Front won overwhelmingly. Mahathir's coalition won more seats. The Islamic fundamentalist PAS won fewer seats. This appeared to vindicate his policies.

However, electoral victory can cover a multitude of sins. In the details of the vote, Mahathir actually won fewer than before. His vital coalition partner, the Malaysian Chinese Association was repudiated by a majority of Chinese voters for the first time in Malaysian history. Candidates for this party mostly won only because of the votes of bumiputras who voted this way against opposition Chinese candidates in order to ensure that Mahathir's coalition would continue in office and persist in anti-Chinese policies.

The Islamic fundamentalist PAS won many more votes than before, but squandered them by running candidates in more constituencies than it could sustain. So Islamic fundamentalist sentiment is running higher than before and will likely manifest itself in more seats after future elections.

There were many districts in which the fundamentalists did worse than expected. Analysis of those districts reveals discouraging reasons for this. PAS had become ambitious and wanted to make inroads into the Chinese community. Therefore, it formed an associated Chinese unit called CCC. This catering to the Chinese angered anti-Chinese bumiputras who reacted by abandoning PAS.

After the election, Malaysian Chinese Association leaders pointed out to Mahathir that their inability to deliver had discredited them and that this was endangering the future of the coalition. They argued that they had to be able to deliver some benefits to their Chinese constituents in order to continue to receive support. Mahathir replied that their problem was that they were weak politicians (a remark that did not entirely miss the mark, but that was not the heart of the problem) and that they would

therefore get less rather than more.

#### Summary

The Malaysian economy retains its fundamental strengths. But Mahathir is severely polarizing Malaysian politics, mismanaging the real economy, squandering increasingly scarce resources, and accelerating the deterioration of its financial institutions. There is risk of a political shock. There is risk of domino-type domestic financial surprises. There is risk that domestic financial developments or international positions as yet unknown could one day affect Malaysia's international liquidity.

The strengths of the economy and its financial cushion leave some room to conduct business, but that business should be very cautious and very short.