Mahathir's Flawed Economic Policy Legacy[1]

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When Malaysian Prime Minister Mahathir Mohamad retires in October 2003, it will be the end of an era. Mahathir's presence in Malaysian politics has been overwhelming. One obvious reason, of course, has been the length of his tenure – Mahathir has been premier since mid-1981, and will have led the government for well over two decades.

Another important reason has been the demise of his rivals, real and imagined. His first deputy, Musa Hitam, left the government in early 1986 after less than five years as Deputy Prime Minister. His Finance Minister until 1984, Tengku Razaleigh Hamzah challenged him for the leadership of the ruling UMNO, and lost narrowly in suspicious circumstances in 1987. His long-time ally, protégé, and heir designate, Anwar Ibrahim, was sacked as Finance Minister and Deputy Prime Minister, and from the ruling party, in September 1998 in a manner apparently intended to irreversibly eliminate him politically. Not surprisingly then, many have observed that, in many ways, Mahathir became a caricature of the 1960s' party and government leader he so eloquently criticized in his *Malay Dilemma*.

But while observers may agree on his greater political authoritarianism over time, his economic policy legacy is far more complicated. One can discern three distinct periods or epochs in economic policy-making. Each phase can be seen as involving responses to a preceding crisis, but also as envisioning a new stage and type of development. While economic policy-making has been far from coherent or even consistent, Mahathir's major policy turns may be seen as pragmatic responses to domestic and international economic crises and challenges – often of his own making. It is this pragmatism, however, that also led to serious entrenched problems in economic policy-making, including cronyism, corporate losses, and wasteful public spending.

It would be too easy and analytically erroneous to dismiss these flaws as simply quixotic or whimsical on the one hand, or only intended to aggrandize those close to him on the other, although there appear to be many examples of both. There is considerable evidence that Mahathir often intervened to help business interests close to him, which has given credence to the popular charges of "cronyism" and "nepotism" against him. It would, however, be a mistake to reduce his many policy initiatives to such motives. There is good reason to believe that he did so due to a mistaken conviction that such interventions have been necessary to create, incubate, and accelerate the emergence of Malaysian "captains of industry," including, but not just, a strong Bumiputera commercial and industrial community.

Greater State Intervention: The Early Years, 1981-1985

Mahathir became Prime Minister as the world economy slowed down in the wake of the second oil price hikes of the late 1970s and the recession induced by interest rate increases after the appointment of Paul Volcker as chairman of the US Federal Reserve Bank in 1980. Primary commodity prices tumbled as external demand for manufactured exports fell. For a year after taking office, Mahathir endorsed Finance Minister Razaleigh's pump-priming efforts to turn the economy around by increasing public spending.

However, after handsomely winning the general election in April 1982, Mahathir embarked on an "austerity drive," cutting government spending and putting state-owned enterprises (SOEs) under closer scrutiny, though not without ensuring generous funding of his heavy industrialization drive – notably the Proton national car project and the Perwaja steel fabrication plant – and other favored projects, mainly in construction. Government sponsorship of heavy industries was construed as part of a second round of import substitution, unlike the first round in the 1960s, which had seen the emergence of foreign (mainly British) owned industries producing consumer goods for the increasingly protected domestic market. Often involving joint-ventures with Japanese firms, Malaysia began borrowing heavily from abroad to finance the heavy industries, primarily from the Japanese government, at low interest rates, as much of the rest of the developing world found itself in the throes of (sovereign) debt crises. The close tie to Japan was associated in the public mind with Mahathir's "Look East" policy to emulate the economic success of Northeast Asia.

This reversal of public sector expansion and increasing government intervention was consolidated and accelerated by Mahathir's 1984 appointment of Daim Zainuddin as Finance Minister – and UMNO Treasurer – to replace Razaleigh after the latter's second unsuccessful challenge to Musa Hitam for the party deputy presidency. Not surprisingly, given the strong association of policy with personality, and Daim's very low-profile operating style, there continues to be continued speculation, to this day, as to how much to attribute to Mahathir as opposed to Daim. However, since Mahathir is not given to delivering speeches that are diametrically opposed to what he believes, there is considerable evidence to suggest that Mahathir probably endorsed and approved the economic policy changes – including apparent policy reversals – associated with Daim, including regressive fiscal (tax and spending) reforms, public expenditure cuts, privatization, deregulation, and financial liberalization. In any case, Mahathir's strong commitment to private enterprise had already been made quite clear by the mid-1970s.

Partial Economic Liberalization, Boom and Bust 1986-1997

Just as the first period was not just one of growing state intervention all round in the form of government spending or regulation, the second period was also not simply a headlong rush to economic liberalization in line with the Washington Consensus. The new investment regime introduced in the mid-1980s sought to reduce the disincentives associated with the 1975 Industrial Coordination Act (ICA) and other regulations associated with the interethnic wealth redistribution objective of the New Economic Policy (NEP). The 1986 Promotion of Investments Act not only sought to encourage export-oriented manufacturing investments, but also reduced the insulation between export-oriented and domestically-oriented production. More importantly, the new investment regime sought to encourage higher value-added industries, skill development, and technology upgrading.

A confluence of factors came together to ensure a decade of rapid growth and structural transformation from 1987 until the outbreak of the regional currency and financial crises from mid-1997. With the rapid buildup of foreign debt to finance heavy industries, the Malaysian monetary authorities allowed the ringgit to depreciate against the US dollar after the second Plaza Hotel meeting of September 1985 agreed that the greenback should float against the yen. Indonesia had three major devaluations from 1983, while Thailand devalued in 1984. Thus, Malaysia's yen-denominated sovereign debt doubled in ringgit terms as the Malaysian authorities also sought to secure export competitiveness through devaluation. As the yen and the currencies of other first generation newly industrializing economies appreciated, Japanese, then Taiwanese and, to a lesser extent, Korean and other industries relocated to Southeast Asia and China, often also to overcome labor shortage problems.

The timing was perfect. All three Southeast Asian economies then experienced a decade of rapid growth before the great collapse of 1997-1998. As Japan and the first generation East Asian newly industrialized economies sought to lower costs by relocating to lower cost production sites abroad, the Southeast Asian trio and China sought to raise growth, industrialization, and employment by reforming policies and offering other inducements to attract such foreign direct investment. The apparent success of such partial economic liberalization encouraged further economic liberalization with more mixed economic results. This initial hubris also encouraged the regime to consolidate what had initially been presented as temporary concussions into a post-NEP Vision 2020 program.

However, Malaysia's strong economic recovery at the end of the 1980s did not head off the banking crisis that had been building up from the 1985 recession, with commodity price collapses and the bursting of property and stock market bubbles. In 1987 and 1988, almost 30 percent of commercial bank loans were designated "non-performing." The 1989 Banking and Financial Institutions Act (BAFIA) and generally stricter prudential regulations in the aftermath of this debacle were to later protect Malaysia from a more severe crisis in 1998. Private interests needed to secure central bank approval to borrow from abroad, e.g., by satisfying the monetary authorities that the borrowed funds would generate foreign exchange earnings to reduce potential currency mismatch problems.

Following economic recovery from the late 1980s, other financial reforms promoted financial liberalization, especially stock market development, as if ignoring the problems of the mid-1980s that had culminated in the banking crisis of the late 1980s. Thus, while more prudent and stricter banking regulation and supervision limited Malaysian exposure to (private) foreign borrowings, Malaysian corporations, especially favored ones associated with "cronies," were generally very highly leveraged. Commercial banks lent generously, inadvertently fuelling property and stock market bubbles, which burst from 1997 with devastating effect. Thus, while the 1997-1998 East Asian crises were mainly due to the reversal of massive short-term foreign bank borrowings, Malaysia's vulnerability was due to the government's earlier success in attracting massive foreign portfolio investments to its stock market.

Unorthodox Economic Interventions, 1998-2003

It has become popular to blame the 1997-98 East Asian crises on cronyism and other related abuses in the region. However, despite the obvious popular appeal of such attribution, it lacks sound analytical and empirical bases, although these problems undoubtedly exacerbated the region's problems and compromised policy responses to them. Failure to recognize the true roots of the crises runs the risk of not learning lessons from the calamity. Policy responses failed to address the deteriorating situation and even exacerbated the downturn. Even now, it is not generally acknowledged that the crises were due to systemic factors exacerbated by financial liberalization. Since the destruction of the Bretton Woods system in 1971, the world monetary and financial system has developed in an ad hoc fashion, with little overall regulation and supervision to check against bias, abuse, and systemic failure.

Although less exposed than Thailand, Indonesia, and Korea, due to its much lower exposure to foreign borrowings despite its more open economy, Malaysia had become vulnerable because of the far greater role of easily reversible portfolio investment inflows in its relatively much larger stock market. With the reversal of confidence in the region, capital inflows into the country were slowly reversed from the end of the first quarter of 1997, before momentum picked up with the floating of the Thai baht from July. The Prime

Minister's quixotic attempts to stem the outflow only exacerbated the rush for the door. To make matters worse, he also seemed overly anxious to protect cronies from the crisis, including some consequences of their own earlier excesses. Such complications exacerbated the growing policy divergence between Mahathir and Anwar, although it is likely that the break became irreconcilable when the Prime Minister suspected his deputy of fomenting a palace coup against him, the plausibility of which has been disputed elsewhere.[2]

Mahathir's September 1998 recovery package was probably too late, flawed, biased (towards those interests he favored) and, arguably, unnecessary. Introducing capital controls 14 months after the beginning of the crisis, after stock market de-capitalization by over three quarters, was not very useful – unless there was likely to be further hemorrhage due to yet another crisis. Yet, it would be unfair to fault Mahathir for introducing radical measures in early September 1998, with the Russian and LTCM crises in August, as no one could have foretold that the US Federal Reserve's lowering of interest rates in September 1998 would finally succeed in strengthening and stabilizing East Asian currencies as well as reducing interest rates from the last quarter of 1998. Nonetheless, the package's basically counter-cyclical thrust (as opposed to the IMF's and the market's pro-cyclical preferences) and the capital flow management emphasis (reversing the earlier commitment to capital account convertibility, considered sacred by economic orthodoxy) were basically correct.

It is now also apparent that the funds and mechanisms created by the government to restore banking liquidity, manage non-performing loans, re-capitalize banks, and restructure the banking system and major conglomerates have been biased and abused to varying degrees, in practice, if not in intent. Billions of ringgit of debt were taken over by the government, with apparently little punishment of the borrowers, ostensibly because some were said to be performing "national service." Previously privatized assets have been "re-nationalized" at well above market prices, again with no apparent penalization. Thus, cronies are cynically said to have been doubly "blessed" – first, when chosen to benefit from privatization and, then, by being allowed to "walk away" virtually unscathed – at public expense.

But such abuses do not detract from the fact that these funds and mechanisms did also serve to restore liquidity, although hardly as much as desired by the authorities. Government spending – as well as good luck, in the form of increased demand for electronics (especially from Korea and Malaysia) and the end of 1998's El Nino drought – also helped ensure a strong economic recovery in 1999 and 2000, although the Korean recovery was stronger, probably thanks to stronger domestic industrial and fiscal capacities and capabilities, despite onerous IMF conditionalities. Although the Thai recovery was less impressive, interest rates there fell below Malaysian rates from the fourth quarter of 1998 despite IMF program requirements. Hence, it is difficult to make an unequivocal case that the strong Malaysian recovery was due to the September 1998 recovery program. But the evidence also does not allow the converse case to be made – contrary to the dire predictions of the market prophets of doom.

Despite the strong recoveries in 1999 and 2000, Malaysia continued to run large budget deficits, ostensibly to sustain the recovery. However, economic growth has slumped since then, owing to continued Malaysian reliance on and vulnerability to external conditions. The end of the Clinton era boom and continued economic lethargy in Japan and much of Europe undermined sustained economic recovery in Malaysia's still very open economy. Until mid-2003, post-crisis policy declarations of domestic-led growth did not go much beyond continued public spending, especially on construction projects, popularly perceived as yet more "jobs for the boys." Meanwhile, the prospects for continued export-oriented growth are increasingly considered to be problematic, with the rise of lower-cost producers with competitive skill endowments, especially in China.

Reflections

A balance sheet for the Mahathir era suggests that he has much to answer for. His penchant for expensive prestigious construction projects is well known, including the new administrative capital of Putrajaya, with the Prime Minister's palatial official residence at its center, the Kuala Lumpur International Airport (KLIA) and F1 Grand Prix race track at Sepang, the Petronas KLCC (Kuala

Lumpur City Centre) Twin Towers and Daya Bumi, among many others. He has also been associated with very expensive speculative failures, most notably the massive speculation on sterling before its collapse in September 1992. Another well-known failure was the costly attempt to corner the tin market in the early 1980s, which resulted in immediate losses of well over half a billion ringgit and incalculable losses due to the collapse of the tin mining industry.[3]

Corporate losses absorbed by the government over the last two decades have also reached new dimensions. The steel corporation Perwaja is probably the most spectacular failure, with losses exceeding RM10 billion by the mid-1990s. Before its acquisition by the Bank of Commerce, Bank Bumiputra Malaysia had been re-capitalized several times at the cost of several billion ringgit. There has yet to be a careful accounting of the losses associated with the privatization and re-nationalization exercises since the mid-1980s. Public assets were sold, at discounts, especially to the politically well-connected, but also to the general public to secure popular support for the policy. When re-nationalized after failing to perform, the beneficiaries were paid well above the market prices to at least cover their costs and expenses. In short, profits and profitable assets have been privatized, while losses and liabilities have been socialized – through "bail-outs" at public expense – with the cronies bearing minimal risk.

Despite this poor track record, it would be unfair to dismiss the Mahathir economic policy regime as an unmitigated failure, not only because there is little convincing evidence that the policies were solely, or even principally, motivated by self-aggrandisement except, perhaps, for some notable exceptions. Many critics, however, would insist that the same cannot be said of his long time ally, Daim Zainuddin – for whom Mahathir should bear responsibility. Nonetheless, Mahathir probably has to bear ultimate responsibility for both the flawed and the abused policies of his regime, which he seems incapable of acknowledging and withdrawing. Also, he has to bear responsibility for policies that were abused despite supposedly noble intentions, as many such abuses have long been well known but have remained largely unchecked.

Many would challenge the desirability of his policy to aggrandize a selected few, ostensibly to accelerate the creation of "captains of industry" and the Bumiputera commercial and industrial community. There is little evidence that the government's additional revenue from privatization has more than compensated the costs of the discounts and other direct and indirect official support to privatization policy beneficiaries. Ironically, for someone who has attacked the "subsidy mentality" among the poor who expected government subsidies and support, Mahathir has not had similar criticisms for cronies and others expecting government intervention on their behalf, e.g., in the wake of the 1997-1998 crisis. In fact, he has publicly defended such "bail-outs" and other public assistance as supposedly being in the national interest and necessary for economic recovery and future development.

Hence, my ambivalence in assessing the Mahathir economic policy legacy. While appreciative of his recognition of the need for investment and technology policy interventions to accelerate Malaysian economic growth and structural transformation (reflected, for example, by the Industrial Master Plans and other such documents),[4] these efforts have been severely compromised by biased, whimsical, and poorly conceived interventions. Such public actions have generated considerable cynicism about and opposition to industrial policy and other interventions, often believed to be intended to benefit cronies. Similarly, while supportive of his willingness to consider and adopt heterodox counter-cyclical policy measures to induce and sustain economic recovery after the 1997-1998 crisis, one cannot defend the bias in and abuse of many such policies, or the failure to adopt appropriate policies to sustain subsequent development instead of merely creating more "jobs for the boys" through fiscal deficits. Sadly for Mahathir, it seems likely that the baby will be thrown out with the bathwater when his economic policy record is subject to critical scrutiny.

It also seems likely that the post-Mahathir regime will revert to NEP-type ethnic preference policies and to neo-liberal economic policies in other regards. The former will be justified as necessary to try to retrieve ethnic Malay political support, but it is probably also reflective of heir apparent Abdullah Badawi's preferred political and financial base. After all, Abdullah will take office with only limited and conditional access to the ruling party's finances, which were reorganized beyond accountability to the entire party leadership after the party crisis in the late 1980s. And insofar as many failures associated with the Mahathir era have been blamed on his public policy interventions, it is quite likely that neo-liberal economic orthodoxy, preferred by financial markets and most academically trained economists, will become much more influential. However, the circumstances of the transition have been such that it may be quite some time before Abdullah will be able to assert himself in terms of public policy as Mahathir's long shadow forces him to look over his own shoulder.

Notes

[1] This is a concise version of my introduction to a new volume (Jomo 2003). I am grateful to Greg Felker and Terence Gomez for their helpful criticisms, comments and suggestions, but bear full responsibility for this final version. Bridget Welsh has also helped me revise and differentiate this version from my contribution to a forthcoming volume on the Malaysian economy published by the World Economic Forum.

[2] See Jomo (2001).

[3] See Jomo (ed.) (1990).

[4] See Jomo (ed.) (1993) and Jomo & Felker (1999).

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