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Backgrounder
Executive Summary

No. 1235 November 16, 1998

STANDING UP FOR DEMOCRACY AND ECONOMIC REFORM IN MALAYSIA

JOHN T. DORI

To counteract the effects of the Asian economic crisis that continue to afflict Malaysia, Prime Minister Mahathir Mohamed instituted anti–free market currency controls and jailed U.S. friend and pro-market reformer Anwar Ibrahim, his former deputy prime minister and minister of finance. To protest these actions, President Bill Clinton should have sought a change in venue for the upcoming Asia-Pacific Economic Cooperation (APEC) forum Leaders' Meeting to be held in Kuala Lumpur, Malaysia's capital. The next-best option would have been to boycott the meeting. But now that President Clinton is planning to attend the APEC meeting on November 17 and 18, he should be prepared to speak out strongly against Mahathir's actions, enunciate a set of economic reform principles based on democratic and free-market values, and present a coherent policy approach to guide the U.S. relationship with Malaysia in the future.

Malaysia, which had opposed the creation of APEC and sought to form another trade bloc that excludes the United States, is an unlikely host for the APEC meeting. APEC was created to promote the expansion of free trade and the creation of a free-trade area in the region by the year 2020. But the currency controls Mahathir introduced in September are a setback to APEC's goal of economic liberalization. In addition, Mahathir will use the APEC meeting to denounce Western values and undermine the leadership role of the United States. The onus of leadership on President Clinton will be to stress that, although the United States values cooperation with Malaysia, it will continue to press for sound economic policies that promote free trade and open markets. He must speak out forcefully against Mahathir's actions and call on him to forge a path toward greater economic and political freedoms in Malaysia.

Areas of Cooperation. Although frictions in the U.S.–Malaysia relationship always have existed, particularly on trade and cultural issues, notable areas of cooperation have been present as well. Malaysia has been a quiet but growing partner of the United States in the preservation of peace and stability in Southeast Asia. And cooperation continues—despite the current chill in relations—on such matters as fighting ter-

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rorism and narcotics trafficking. In addition, economically, Malaysia was the 11th largest trading partner of the United States in 1997, with almost $28 billion in two-way trade. Malaysian imports of U.S. goods provided jobs for over 150,000 Americans in that year alone.

President Clinton can strengthen this valuable relationship by emphasizing that Malaysia must undergo fundamental economic reform to clean up its wobbly banking sector and consolidate and restructure its debt-ridden conglomerates, which prospered over the years from Malaysia's climate of cronyism and corruption. Other reforms, such as creation of an independent judiciary and the implementation of a genuine rule of law, also must occur for the restructuring to be successful.

But the path will not be easy. The Clinton Administration, which failed to issue a prompt and forceful response to Anwar's politically motivated arrest and trial and to Mahathir's anti-market initiatives, has failed to generate a cohesive U.S.–Malaysia policy and has placed the leadership role of the United States in APEC at risk. Mahathir's policies and Anwar's jailing inspired a mass movement of Malaysians who seek increased social and political freedoms. Demonstrations reportedly are taking place throughout that country, leading to the arrest of hundreds. Clearly, the pressures on Mahathir to reform are growing. To regain a position of leadership for the United States at the APEC forum, President Clinton must take a stronger, more public position than he has in the past, one that advances U.S. interests and helps Malaysia to institute democratic and free-market reforms. Specifically, at the APEC forum, President Clinton should:

- **Criticize Malaysia's adoption of counterproductive economic policies.** He should stress that Mahathir's anti-market policies are more likely to deepen Malaysia's economic problems than to solve them. He should point out that there is no substitute for difficult reforms that would prevent Malaysia from being out-competed in the future by its reformed neighbors, such as stricter regulation, greater transparency and consolidation, and the creation of an independent judiciary.

- **Express concern about the treatment of U.S. friend Anwar.** President Clinton should protest Anwar's brutal treatment while in custody and insist that his trial be fair. To symbolize the depth of U.S. concern, Clinton or Secretary of State Madeleine Albright should seek to meet with Anwar and his wife.

- **Link U.S. interests with the goals of Malaysia's emerging democratic forces.** The President should call for greater democratic reform in Malaysia and identify the United States with those who seek political liberalization. As he did in China in June 1998, President Clinton should speak out in support of tolerance and individual liberties.

- **Seek continued strategic cooperation with a Malaysia that is strengthened by economic and political reforms.** The maintenance of deterrence and the preservation of peace and stability in Southeast Asia are common goals of the United States and Malaysia. Thus, the United States welcomes the continuation of military cooperation with Malaysia and believes that a Malaysia strengthened by economic and political reforms would be a worthy partner of the United States in the region.

Because Malaysia is one of Americ's largest trading partners, President Clinton should encourage Mahathir to implement reforms that will strengthen the long-term health of Malaysia's economy and create the basis for a freer society. He should stress that the United States values the quiet improvement of strategic relations with Malaysia that occurred over the last decade, but that Mahathir's actions place that relationship at risk. By reform, President Clinton can promote the economic and political reforms that will help Malaysia emerge from the economic crisis stronger and more competitive.

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Recent anti–free market and anti-democratic actions by the government of Malaysia make that country an unsuitable host for the annual Leaders' Meeting of the Asia-Pacific Economic Cooperation (APEC) forum, which is to be held in Kuala Lumpur on November 17 and 18. These actions include Malaysian Prime Minister Mahathir Mohamed's anti–free market measures that restrict currency trading and the politically motivated jailing of U.S. friend and Malaysia's former Deputy Prime Minister and Minister of Finance Anwar Ibrahim. The correct U.S. response would have been for President Bill Clinton to push for a change of venue for the APEC summit. Failing that, the next-best option would have been to boycott the meeting as a show of U.S. disapproval of actions that set back economic and political freedom in Malaysia. But because President Clinton has announced his intention to attend, at the very least he should be prepared to enunciate forcefully a set of principles that stand up for American values in the U.S. relationship with Malaysia.[1]

As Malaysia's leader for the past 17 years, Mahathir has been active in opposing market-opening proposals advocated by the United States. Nevertheless, he is to host this year's meeting of APEC, whose goal is to create a free-trade zone among its members by the year 2020. In September, Mahathir imposed restrictive currency controls, in part to repudiate Anwar's policies and in part to respond to the effects on Malaysia of the Asian economic crisis. But his measures fly in the face of APEC's U.S.-led free-market goals and are likely to worsen Malaysia's economy. On the political side, judging by recent, unprecedented demonstrations taking place throughout the country, Malaysians increasingly support the democratic reforms advocated by Anwar—which are opposed by his former mentor, Mahathir.

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1. See Edwin J. Feulner, Jr., "Send a Message to Mahathir at APEC Meetings," *The Asian Wall Street Journal Weekly Edition*, November 2, 1998, p. 20.

When he travels to Kuala Lumpur, President Clinton should encourage economic and political reforms in Malaysia that will strengthen its economy and create the basis for a freer society. He should stress that the United States values the quiet improvement of strategic relations with Malaysia that occurred over the last decade, but that the Prime Minister's actions with regard to the economic crisis and the imprisonment of his deputy and heir-apparent place Malaysia's long-term economic and political stability at risk. President Clinton should urge Malaysia to undertake the difficult economic reforms necessary to restore its long-term economic health, such as the stricter regulation of and greater transparency in the banking industry and the painful but necessary reorganization of the debt-ridden corporate sector. President Clinton also should convey a strong sense of U.S. anger over the undemocratic treatment and brutal abuse of Anwar. By encouraging such economic and political reforms, President Clinton will promote a stronger Malaysian economy and improved U.S.–Malaysia cooperation in the future.

MALAYSIA DEVELOPS UNDER MAHATHIR'S LEADERSHIP

Despite recent troubles, Prime Minister Mahathir deserves a great deal of credit for the positive strides he has made for his country. Gross domestic product (GDP) has grown at an average rate of more than 7 percent per year during his 17-year tenure.[2] Economic successes over the past decade have been particularly marked, with GDP growth averaging almost 9 percent—along with reduced inflation, unemployment, and poverty, and an increase in per capita income.[3]

Mahathir, a physician by training, also deserves credit for modernizing Malaysia's economy, transforming it from an exporter of commodities like tin, rubber, palm oil, and petroleum into a manufacturer of such high value-added products as semiconductors, cellular telephones, and electronic equipment. Moreover, he more closely integrated Malaysia into the world economy by moving to ease restrictions on foreign ownership and investment in the mid-1980s. At the same time, he privatized several government-owned enterprises, contributing to the perception that Malaysia under Mahathir was becoming an increasingly promising place to do business.[4]

Mahathir also presided over a stabilization of racial relations in Malaysia. His faithful implementation of the 1971 vintage New Economic Policy—a type of affirmative action program intended to boost the economic, social, and educational fortunes of native Malays—has gone a long way toward reducing income inequalities in an economy traditionally dominated by minority ethnic Chinese. This is an extremely important consideration in a society that is a volatile mix—roughly 60 percent Malay, 30 percent Chinese, and 10 percent Indian—and that in 1969 was wracked by violent racial clashes that left hundreds dead.

MAHATHIR'S HOSTILITY TOWARD THE WEST

As in the case of many other Asian rulers of his generation, the foreign colonial rule of his country has had a profound effect on Mahathir. He consistently has been highly nationalistic in his politics and frequently criticizes the "arrogance" of various Western powers and institutions. The targets of his wrath have ranged from U.S. policy toward Bosnia and Israel's treatment of Palestinians to what he calls "Western values." Not surprisingly, and despite all the good things Mahathir has done for Malaysia and the Southeast Asian region, some of these views have served to complicate and chill relations with the United States.

2. International Monetary Fund, *International Financial Statistics Yearbook 1997*, pp. 144–145.
3. World Bank Group, "Malaysia Country Brief," at *http://www.worldbank.org/html/extdr/offrep/eap/my2.htm.*
4. Justin Fox, "The Great Emerging Markets Rip-Off: Malaysia Awakens," *Fortune,* May 11, 1998, at *http://www.pathfinder.com/fortune/1998/980511/gre1.html.*

Regarding U.S. policy toward Bosnia in the early 1990s, Mahathir was critical of what he judged to be the slow reaction of the United States toward improving the plight of Bosnian Muslims, who were being mistreated in the Balkan powerplay between Serbia and Croatia. But the Clinton Administration was able to defuse this issue successfully by convincing Malaysia to take part in Bosnian peacekeeping operations, thereby turning an area of confrontation into one of cooperation.

The United States was not so successful in assuaging Mahathir's wrath over the creation of APEC in 1989—at the behest of Australia and the United States—to promote multilateral trade liberalization in the Asia-Pacific region. Mahathir apparently suspected that the United States intended to use APEC to dominate Asia economically, after consolidating another trading bloc in the Western Hemisphere in the North American Free Trade Agreement. Mahathir countered by promoting an Asian trade bloc, to exclude the United States, called the East Asia Economic Caucus (EAEC). As Mahathir envisioned it, the EAEC would be led by the largest economy in the region, Japan. After initially considering Mahathir's idea, Japan quickly was persuaded by the United States to oppose a separate EAEC.

Mahathir has also been highly critical of Israel. In criticizing Israel's treatment of Palestinians in 1988, Mahathir went so far as to say that the Israeli regime was as violent as those of Nazi Germany and South Africa under apartheid had been.[5] He stated that Israel was confining Palestinians to ghettos "in the same way that they themselves were treated by Hitler's Germany."[6] Attempting to explain the causes of Malaysia's recent economic difficulties, Mahathir accused Jewish groups (and financier George Soros in particular[7]) of attempting to undermine the economic development of Muslim states.[8]

Mahathir also rails against what he refers to as "Western values." To his mind, it is the height of arrogance for the rich, developed West to preach the superiority of its systems and institutions—such as political democracy—when these selfsame systems and institutions are frequently accompanied by such undesirable conditions as high crime, divorce, illegitimacy rates, racial intolerance, a poor work ethic, and moral decay. He urged Malaysians to shun democracy because, as he put it, "Where democracy is introduced, riots, civil unrest, and killings take place."[9]

Mahathir has accused the West of attempting to impose an overdose of democracy on developing Asian countries to be able to re-colonize them.[10] According to Mahathir, Asian values stress duty toward society and all the concomitant benefits that entails, such as social order, stable families, a solid work ethic, and a beneficent morality long since lost in the West. Mahathir views Japan as the natural leader of the Asian values movement and as a model altogether more worthy of emulation.

5. See "Malaysian Prime Minister Condemns Israeli Atrocities," Xinhua General Overseas News Service, April 13, 1988.

6. "Mahathir Accuses Netanyahu of Ghettoizing Arabs Like Hitler Did the Jews," *Agence France Presse,* May 9, 1998.

7. Ironically, Mahathir's bitterness toward currency speculators—especially George Soros—may have as its origin a case of sour grapes over Malaysia's own botched efforts in the currency markets. In September 1992, Malaysia's central bank, Bank Negara, took big losses betting on the British pound just as Prime Minister John Major was forced, because of the pound's over-valuation, to drop out of the European exchange-rate mechanism, effectively devaluing the pound. Soros was reported widely to have made a fortune on the deal. See "Of Crashes and Conspirators," *The Economist,* August 2, 1997, p. 57. See also Stephen Duthie, "Malaysian Bank Issues Statement on Exchange Loss," *The Wall Street Journal*, April 20, 1993, p. 17.

8. See Abraham Rabinovich, "Unworthy of Comment, Says Spokesman: US Again Criticises Mahathir for Remarks on Jews," *Singapore Straits Times,* October 17, 1997.

9. Quoted in Michael Fathers, "The Big Noise in the East; Malaysia's Prime Minister Thumbs His Nose to Get Attention," *The Independent* (London), December 5, 1993, p. 19.

10. See Philip Sherwell, "Asian Tiger Shows Claws to the West," *Sunday Telegraph,* November 7, 1993, p. 29.

MALAYSIA'S RESPONSE TO THE ASIAN CONTAGION

The Asian economic crisis, which continues to afflict Malaysia deeply, began in Thailand in early 1997 as a monetary crisis. International investors and currency speculators began to question the fundamental health of Thailand's economy because of several factors, including imprudent domestic lending practices, an imbalance between short- and long-term financing, a current account deficit that was unsustainable, and an unrealistic exchange rate pegged to the U.S. dollar. International Monetary Fund (IMF) recommendations that Thailand devalue its currency, the baht, also contributed to the baht's fall by undermining confidence in its value. The Bank of Thailand was unable to support the value of the baht, and in early June ended its dollar peg and allowed the baht to float. The currency fell quickly, leading to an economic contraction.

From Thailand, the crisis of confidence spread in rapid succession to the Philippines and Malaysia. It is difficult to say exactly what caused the loss of confidence in Malaysia's economy. Like Thailand, Malaysia was running a rather large current account deficit, equal to 5.3 percent of GDP in 1997.[11] A current account deficit, which occurs when a country is investing more than it is saving, is not necessarily a bad thing—especially in a growing economy—so long as these investments are productive ones. Unfortunately, in keeping with Mahathir's proudly nationalistic inclinations, a relatively high percentage of Malaysia's investment was in prestige products of questionable utility, such as construction of the world's tallest building in Kuala Lumpur.[12]

To make matters worse, Malaysia had a legacy of cronyism and of loans being extended based on political connections rather than economic merit. Although the situation was not nearly so rampant or pervasive in Malaysia as it was in Indonesia, which had not yet been affected by the crisis, it nonetheless was significant enough to call into question the underlying condition of Malaysia's economy, and especially the ability of its banking and financial sectors to deal with any potential difficulties. Also like Indonesia, Malaysian companies were saddled with a high level of corporate debt. Fortunately, only a relatively small portion of Malaysia's overall debt was external debt owed to foreign investors, who would be much more likely to call in their debts and take their leave of Malaysia at the first sign of economic trouble. But Malaysia's internal debt—that owed to other Malaysians —stood dangerously high at 170 percent of GDP, the highest level in all of Southeast Asia. [13]

So even though the proximate cause of the spread of the crisis to Malaysia is difficult to pin down, it is clear that, in the wake of Thailand's decision to allow the baht to float in July 1997, Malaysia's stock market and its currency, the ringgit, began to show the effects of the crisis. The stock market and the ringgit each would fall by almost 50 percent in the coming months. Foreign investors, fearful of a replay of the Thailand scenario, sold their Malaysian shares and repatriated their funds. And as would happen later in Indonesia, local companies also contributed to the rapid depreciation of the currency by exchanging the ringgit for currencies perceived to be more stable in an attempt to limit their exposure to foreign-denominated debt.[14] Malaysia's economic difficulties have been exacerbated by several factors unrelated to the Asian crisis, such as reduced demand for two of its major exports (electrical equipment and petroleum) and heightened competition from lower-cost countries in the textile sector.[15]

11. Asian Development Bank, *Asian Development Outlook 1998,* p. 94.

12. "Malaysia's misdiagnosis," *The Economist,* August 2, 1997, p. 15.

13. Sheila McNulty, "Mahathir Introduces Strict Currency Curbs," *Financial Times* (London), September 2, 1998, p. 3; Adi Ignatius, "Asia's Bad News; The Region's Economic Woes Are Getting Worse, Not Better. And There's Very Little the West Can Do," *Time,* May 18, 1998, p. 26.

14. "Of crashes and conspirators," *The Economist,* August 2, 1997, p. 57.

Although it was not faring as poorly as Indonesia, the effect of the Asian economic crisis on Malaysia's economy has been significant. The onset of the contagion in the latter half of 1997 drove GDP growth for the year down to 7.5 percent relative to 8.6 percent the year before. After witnessing the economy contract by 5 percent during the first half of 1998,[16] expectations are for it to shrink by at least 6 percent over the entire year[17]—despite the introduction of massive reflationary measures in the summer and fall. Moreover, the dramatic depreciation of the ringgit has resulted in an upswing in inflation, which reached 5.8 percent in the period of May through July 1998,[18] more than double the 2.7 percent figure registered in the same period of 1997.[19] Unemployment has reached 6.7 percent in a country accustomed to labor markets so tight that workers were imported from abroad.[20] And the slowdown in growth has made it increasingly difficult for Malaysia's highly leveraged companies to pay their debts, hampering the stability of Malaysia's already overextended financial system.[21] Banks with already weak balance sheets drastically cut back on credit for fear of extending more bad loans, which slowed economic activity significantly.

The Collision of Economics and Politics

Malaysia's responses to the worsening economic crisis in 1997 and 1998 provided the backdrop for a deepening personal and generational political schism between Mahathir and Anwar, Mahathir's deputy prime minister and minister of finance. Their relationship had been long and complicated over decades,[22] but despite their differences, Mahathir in 1982 persuaded the young student activist Anwar to join the United Malays National Organization (UMNO), the ruling party. Anwar quickly climbed the ladder of success within UMNO, becoming widely known as Mahathir's presumed successor shortly after maneuvering his way into the party vice presidency in 1993.

But their political alliance did not negate their substantial differences in temperament and outlook, which grew deeper as the economic crisis unfolded. Mahathir is a firebrand nationalist, distrustful of outside institutions and powers as a result of indelible memories of colonial subjugation. Anwar, a generation removed from the colonial era, has a more modern, internationalist outlook and considers the United States a friend. Whereas Mahathir emphasizes such national or regional solutions as "Asian values" or the EAEC, Anwar is more open to Western ideas and orthodoxy, such as free trade and open markets. And as one reporter for *The Wall Street Journal* observes,

> While Mr. Anwar tended to take a laissez-faire view, seeing the downturn as a natural weeding out of inefficient companies, Dr. Mahathir smelled a Western plot to ruin Malaysia's economy.[23]

15. *Asian Development Outlook,* pp. 93–94.

16. "Dead Ostrich Bounce," *The Economist,* September 12, 1998, p. 84.

17. See, for example, Chen May Yee, "Malaysia: Against the Backdrop of a Growing Political Crisis, the Government Experiments with Draconian Capital Controls," *The Wall Street Journal Interactive Edition,* October 26, 1998, at *http://interactive.wsj.com/.*

18. "Business: Prices and Trends," *Far Eastern Economic Review,* October 29, 1998, p. 90.

19. International Monetary Fund, *International Financial Statistics,* September 1998, p. 59.

20. Seth Mydans, "Malaysian Chief Ousts Deputy Who Opposed Him on Economy," *The New York Times,* September 3, 1998, p. A3.

21. International Monetary Fund, "IMF Concludes Article IV Consultation with Malaysia," Press Information Notice (PIN) No. 98/31, April 27, 1998.

22. For an excellent detailing of the twists and turns in the relationship between Mahathir and Anwar, see Ian Johnson, "Intimate Enemies: How Malaysia's Rulers Devoured Each Other and Much They Built," *The Wall Street Journal,* October 30, 1998, pp. A1, A11.

Early sources of tension between the two can be traced to Mahathir's decision to place Anwar in charge of the country as acting prime minister during an unusual two-month vacation he took in mid-1997. In a move that angered Mahathir, Anwar proposed that the Association of Southeast Asian Nations (ASEAN) undertake a critical policy of "constructive interventions" in response to Hun Sen's July 1997 coup in Cambodia. Such a suggestion contradicted ASEAN's long-standing policy of non-interference in one another's internal affairs. Another contentious issue Anwar undertook in Mahathir's absence was the steering of an anti-corruption bill into law, curtailing the power of Malaysia's large conglomerates, which traditionally had been Mahathir's allies.[24]

The appropriate response to combat the economic crisis was an ever-increasing source of tension between the prime minister and his deputy. As had been the case in Thailand, Malaysia's immediate response to the attack on the ringgit was to intervene in the currency market to defend it. In this early phase of the crisis, Mahathir was preeminent, and his answer to stemming the weakness in the ringgit and the stock market was to impose limited currency controls in August 1997. These controls, designed to halt speculation on the ringgit, limited to $2 million the amount of currency Malaysian banks could swap overseas in non–trade related deals.[25] The controls backfired, however, leading investors to abandon the stock market and to a further weakening of the ringgit. The government quickly repealed the exchange controls.

During this initial government response to the crisis, interest rates at first were tightened, perhaps in a bow to the monetarily and fiscally austere Anwar. When the stock market continued its retreat, however, this policy was reversed and rates were eased, setting the stage for a Mahathir-inspired response that combined currency controls with an "easy money" policy, an omen of things to come. The government soon reversed this policy, however, because low interest rates were acting as a downward drag on the ringgit.

Anwar Ascendant. With the government's policy veering back and forth, Anwar stepped forward to try to stem the crisis. Anwar's recommendation was for an IMF-inspired policy of fiscal austerity and high interest rates. Such a policy was anathema to the distrustful, anti-Western Mahathir, who, in ruling out the possibility of receiving IMF assistance for Malaysia, said Malaysians "would rather live in poverty" than receive help from the IMF.[26] But despite Mahathir's palpable distaste for Anwar's IMF-inspired austerity plan and his continued insistence on blaming currency speculators for Malaysia's plight, Mahathir eventually was persuaded to go along with the so-called virtual IMF plan.

Anwar moved forcefully to implement the plan, cutting government spending by 18 percent and allowing interest rates to rise in an attempt to attract foreign investment and bolster the value of the ringgit.[27] Anwar ultimately implemented other reforms, including tightened provisioning, disclosure, and transparency standards; accelerated mergers of finance companies; the creation of a deposit guarantee; reduced reserve requirements to improve liquidity flows; and increased spending to strengthen the social safety net.[28]

Although Anwar's reforms were laudable for their economics, they also laid the foundation for his own political demise. His austerity plan—consisting of high interest rates, reduced government spending, and tighter restrictions on

23. Johnson, "Intimate Enemies: How Malaysia's Rulers Devoured Each Other and Much They Built," p. A1.

24. *Ibid.*, p. A11,

25. "Malaysia Tries to Curb Speculators," *FX Manager,* August 8, 1997, p. 7.

26. "Mahathir Says Malaysia Will Not Accept IMF Help; Criticises Speculators," *AFX News,* May 11, 1998.

27. Johnson, "Intimate Enemies: How Malaysia's Rulers Devoured Each Other and Much They Built," p. A11.

28. International Monetary Fund, "IMF Concludes Article IV Consultation with Malaysia."

lending—greatly reduced liquidity, with the result that the economy contracted by 2.8 percent in the first quarter of 1998.[29] Moreover,

> despite a 26 percent lending rate, the highest in Malaysia's history, the currency dropped to its lowest level ever against the U.S. dollar—4.88 *ringgit* compared to 2.5 *ringgit* when the crisis started in July last year.[30]

This situation did not please Mahathir's business supporters, who, as is the custom in Malaysia, had become accustomed to receiving cheap loans and government contracts in return for their political support. But Anwar's tight money and fiscal austerity policies effectively shut off the spigot of easy money.

Another disturbing development from Mahathir's perspective was the raft of statements emanating from Anwar's camp decrying "cronyism, collusion, and nepotism,"[31] the very same charges that eventually forced Indonesia's President Suharto from power in May 1998. In June, Anwar delivered a speech promoting a concept he called "creative destruction," which would "cleanse society of collusion, cronyism, and nepotism. The result will be a leaner and revitalized market economy, based on fairness and competition on a level playing field...and all citizens have equal access to capital and resources."[32] Presumably, these were not words Mahathir wanted to hear from his deputy and presumed heir, especially with the memory of Suharto's recent demise so clearly etched in his mind.

Turning the Tables on Anwar. Apparently frustrated by Anwar's economic program and fed up with his seeming insolence, Mahathir embarked on a series of steps that would shift the economic and political balance of power back in his favor. In June, Mahathir appointed Daim Zainuddin, former minister of finance and close Mahathir loyalist, to the newly created post of minister of special functions—with authority over economic matters. This move clearly was intended to limit Anwar's influence as minister of finance.[33] Simultaneously, Mahathir was laying the groundwork for a political—and ultimately legal—challenge to Anwar. This campaign culminated in Mahathir's tacit approval to the publication of an anonymous tract called *50 Reasons Why Anwar Cannot Be Prime Minister.* Based on tenuously documented charges that had been circulating for months, the book purported to lay out Anwar's unfitness for high office because of his participation in a series of sexual trysts with a bevy of alleged partners ranging from prostitutes to wives of friends to men. Whereas in months past Mahathir's policy had been to discount the claims against Anwar, suddenly he was choosing to take them seriously.

Anwar's influence was trimmed in July with the introduction of a stimulus package that largely "overturned...Anwar's tight fiscal policies by lowering interest rates and boosting government spending on big, expensive projects."[34] Then two pro-Anwar newspaper editors were pressured to resign from government-controlled newspapers in August. On August 28, the announcement came that Malaysia's economy had contracted 6.8 percent in the second quarter. Following on the heels of a 2.8 percent contraction in the first quarter, the news meant that Malaysia now was officially in recession, despite the implementation of Anwar's plan. The next day, the governor and deputy governor of Bank Negara, Malaysia's central bank,

29. S. Jayasankaran, "Protégé to Pariah: How Anwar Ibrahim Lost Favour with His Former Mentor," *Far Eastern Economic Review*, September 17, 1998, pp. 13–14.

30. *Ibid.*, p. 14.

31. Anwar Ibrahim, "A Wave of Creative Destruction Is Sweeping Asia," *International Herald Tribune*, June 2, 1998, p. 8.

32. *Ibid*.

33. Jayasankaran, "Protégé to Pariah: How Anwar Ibrahim Lost Favour with His Former Mentor."

34. Seth Mydans, "Malaysian Chief Ousts Deputy Who Opposed Him on Economy."

resigned. Both had been supporters of Anwar's austerity measures, reportedly resigning over policy differences with Mahathir.[35]

Currency Controls and Anwar's Ouster. On September 1, the nature of these policy differences became clear when Malaysia implemented sweeping foreign exchange controls and fixed the currency at 3.80 ringgit to the U.S. dollar. In explaining his extraordinary decision, Mahathir remarked, "The free market system has failed and failed disastrously."[36]

According to officials of Malaysia's central bank, the foreign-exchange controls were intended to contain speculation on the ringgit and to minimize short-term capital flows, thereby allowing Malaysia to reclaim control of monetary policy and insulate its economy from further effects of the economic crisis.[37] Specifically, the foreign-exchange controls did the following:

- Banned the trading of ringgit instruments among offshore banks;
- Required that ringgit held outside the country be repatriated within one month or lose its value;
- Required that all trade be conducted in foreign currency;
- Limited the amount of ringgit with which travelers can enter or leave Malaysia;
- Required central bank approval for non-Malaysians to convert ringgit into foreign exchange; and
- Mandated that foreign investors selling Malaysian equity shares not repatriate their proceeds for one year.[38]

By fixing the currency rate, on the other hand, Mahathir hoped to stabilize the monetary system and allow the central bank to lower interest rates —thereby sparking renewed economic activity— without the threat of lower rates placing downward pressure on the ringgit.

With the economy foundering and Mahathir increasingly fearful of his deputy's political intentions, Mahathir asked Anwar to resign on September 2. When Anwar refused, Mahathir fired him from both his official offices, those of deputy prime minister and minister of finance. The next day, Anwar was expelled from UMNO, with court papers surfacing that accused him of everything from sexual indiscretions to corruption to treason. Mahathir would claim that Anwar was removed from office for "moral misconduct" and not because of any economic or political differences.[39]

Mounting Popular Protests. Anwar took to the streets, leading a series of demonstrations criticizing "corruption, cronyism, and nepotism" in Malaysia's government and adopting the "Reformasi" mantra of the anti-Suharto movement in Indonesia. Mahathir moved quickly, arresting Anwar on September 20 for disturbing public order after the latter had led a peaceful rally of 50,000 followers in Kuala Lumpur. The fact that Anwar could attract a crowd of 50,000 followers speaks volumes about the undercurrent of dissent bubbling just beneath Malaysia's political landscape. Demonstrations reportedly have taken place across the country. Many of the demonstrators are young and desire greater political freedom. Others are appalled at Mahathir's treatment of his own deputy and wonder what is to prevent them from being treated in the same manner. But whatever the motivation of Anwar's followers, the demonstrations prove two things: First, that Malaysia's economic prosperity had bred the development of

35. Sheila McNulty, "Policy Rift Seen as Malaysian Banker Resigns," *Financial Times* (London), August 29, 1998, p. 3.

36. Quoted in Sheila McNulty, "Mahathir Introduces Strict Currency Curbs."

37. See, for example, "Malaysia Imposes Controls on Trading in Its Currency," *The New York Times*, September 2, 1998, p. C2.

38. Sheila McNulty, "Mahathir Introduces Strict Currency Curbs"; and Sandra Sugawara, "Malaysia Moves to Shield Itself from Speculators," *The Washington Post*, September 2, 1998, p. A28.

39. Jayasankaran, "Protégé to Pariah: How Anwar Ibrahim Lost Favour with His Former Mentor."

an increasingly wealthy and informed populace that was beginning to seek new freedoms; and second, as proved in Indonesia, political repression may be tolerated when economic times are good, but latent hostility and discontent quickly make themselves known when times turn bad.

Abuse and an Unfair Trial. Mahathir had Anwar arrested under the draconian colonial-era Internal Security Act (ISA), which allows for indefinite imprisonment without trial or even the possibility of legal challenge. A few days after his arrest, Anwar was brought to court, his eye blackened and his arm bruised—strongly suggesting mistreatment by his captors. Anwar was charged with five counts each of sodomy (a crime in Muslim Malaysia) and corruption. He eventually was released from ISA detention and remanded into custody without bail. Moreover, the government added additional sex charges on November 1. Anwar faces at least three trials, which are expected to last more than eight months.

Several disturbing signs have called into question Anwar's ability to receive a fair trial. For example, Mahathir has stated publicly that Anwar is guilty and should be convicted,[40] in addition to labeling his former deputy a "sodomite." Mahathir's potential impact on the trial is no small consideration in a court system that, although once genuinely independent, effectively has been brought under Mahathir's control ever since a 1988 purge of six out of ten Supreme Court judges.[41]

The first trial had an inauspicious start on November 2 amid conflicting allegations that U.S. and other diplomats seeking to observe the supposedly open trial had been turned away. Then Mohamed Said Awang, the director of the police intelligence unit known as the Special Branch, revealed in an astounding open court admission that a 1997 Special Branch report submitted to Mahathir concluded that the sexual charges against Anwar were "false and baseless," the product of a conspiracy designed to discredit him.[42] This revelation—from the prosecution's lead witness, no less—adds tremendous credence to Anwar's consistent claim that the charges against him are politically motivated and brought at the behest of Mahathir himself.

HOW MAHATHIR'S ECONOMIC PLAN IMPERILS MALAYSIA'S FUTURE

Despite Malaysia's growing political distraction, Mahathir proceeded with his plan for Malaysia to spend its way out of its trouble. He reduced reserve requirements for banks drastically in order to increase liquidity by increasing the supply of money available for lending. He relaxed bank regulations by easing the definition of non-performing loans to allow shaky banks to lend still more. And in late October, he unveiled the 1999 budget, a huge stimulus package calling for a deficit equal to 6.1 percent of GNP.[43] The new budget greatly ramps up spending on infrastructure projects that, along with the other reflationary measures, are expected to introduce a tremendous amount of liquidity into the economy.

At first glance, an examination of Malaysia's key indicators for the period since the imposition of currency controls appears to indicate progress. For example, the ringgit has stabilized at a rate of 3.80 to the dollar, allowing for more orderly economic planning and debt repayment. The stock market

40. See Keith B. Richburg, "Malaysian Loses Bid to Block Trial; Judge Denies Rights Groups Observer Status," *The Washington Post,* November 3, 1998, p. A. 10.

41. See, for example, Ho Wah Foon, "Malaysian Judiciary Seen Buckling Under Government Pressure," *The Reuter Library Report,* July 10, 1988.

42. See Michael Sheridan, "Police Witness Turns the Tables on Mahathir," *Sunday Times* (London), November 8, 1998; Keith B. Richburg, "Malaysia's Ex-Deputy Premier Target of Smear Campaign, Police Report Says," *The Washington Post,* November 7, 1998, p. A22; and Alex Spillius, "Anwar May Be Victim of Plot, Says Police Chief," *The Daily Telegraph* (London), November 6, 1998, p. 18.

43. "Spend and Spend," *The Economist,* October 31, 1998, p. 44.

has not only stabilized; it also posted a gain of more than 30 percent. The ringgit's fixed exchange rate has permitted interest rates to be lowered without threatening the currency's value, thereby encouraging the resumption of economic activity. And the government actually predicts GDP growth of 1.0 percent next year.

This progress is illusory, however. The ringgit may be pegged *officially* at 3.80 to the dollar, but the black market rate remains at the pre-peg level[44]—suggesting that confidence in the currency has yet to improve. Moreover, stock market gains have been buoyed artificially by the new regulation prohibiting foreign investors from repatriating the proceeds of their stock sales for a year. Investors, faced with a choice of keeping their funds in the market or placing them in increasingly questionable banks, chose to stay in the market.[45] Additionally, there is a great likelihood of a mass exodus of foreign investors from the stock market once this one-year period has expired. And the various controls that have been imposed will make potential future investors wary of investing in Malaysia at precisely the time in which investment is needed most. Indeed, this is already proving true as investment has all but dried up, leading Malaysia to rethink the wisdom of its policies.[46]

Long-Term Danger

Mahathir's drastic expansion of credit is by far the most serious long-term threat to the stability of Malaysia's economy. In large part, its current difficulties can be attributed to imprudent lending and excessive building. Now Mahathir proposes to overcome the effects of the economic crisis by massively increasing credit and going on a building binge. So, even though it is entirely possible that Mahathir's plan will succeed in sparking GDP growth next year, any such growth will be inflation-induced and of poor quality. Moreover, his plan runs the distinct risk of sparking runaway inflation in years to come. Inflation, in turn, could lead to increased demand for imports, and eventually to a high current account deficit, [47] one of the precipitating factors in Malaysia's current dilemma.

Moreover, Mahathir is not undertaking reforms to consolidate debt and strengthen the banking sector. In fact, just the opposite seems to be occurring, as evidenced by Mahathir's relaxed definition of non-performing loans and his willingness to bail out such politically connected conglomerates as Renong, the beneficiary of a $2.76 billion government package.[48] By continuing cronyism and putting off much-needed reforms, Mahathir places Malaysia at a competitive disadvantage with neighbors that are instituting reforms and emerging from the financial crisis stronger.

FORGING A STRONGER RELATIONSHIP WITH A REFORMED MALAYSIA

Trade Concerns

Malaysia is an important country to the United States. In economic terms, Malaysia was the eleventh largest trading partner of the United States in 1997, with almost $28 billion in two-way trade. Close trade relations are important to both countries: For Malaysia, trade with the United States represented nearly 20 percent of its total trade in 1997; and for the United States, exports to Malaysia provided jobs for more than 150,000 Americans.

44. Arjuna Ranawana, "At the Money Controls: No Major Currency Problems—So Far," *AsiaWeek,* October 30, 1998, p. 81.

45. "Dead Ostrich Bounce."

46. "Malaysia Uneasy Over 12–Month Rule," *The Wall Street Journal*, November 11, 1998, p. A14.

47. Chen May Yee, "Malaysia: Against the Backdrop of a Growing Political Crisis, the Government Experiments with Draconian Capital Controls."

48. For a detailed discussion of the Renong bailout, see Arjuna Ranawana, "Rescue Mission," *AsiaWeek*, October 30, 1998, pp. 79–81.

Strategic Relations

Malaysia is important to the United States for the pursuit of U.S. interests in Southeast Asia. Geographically, it is close to sea lanes that are vital to global trade and Asia's economic health. Strategically, U.S. cooperation with Malaysia promotes a sense of stability in the region and helps to deter potential outside aggressors, such as China.

Despite Mahathir's verbal attacks on the United States, he has proved that he is willing to work with the United States when common interests dictate. During the Cold War, this common interest was opposition to communism. Following a lengthy and cordial meeting with President Ronald Reagan during a January 1984 visit to Washington, D.C., Mahathir signed a then-secret agreement to strengthen military ties by instituting joint exercise and training arrangements.[49] U.S.–Malaysia security cooperation grew under the Bush Administration. Under the terms of a 1992 agreement, U.S. Navy ships gained access to repair facilities in Lumut Harbor, an important consideration in the wake of the U.S. departure from Subic Bay in the Philippines. Thus, the Reagan and Bush Administrations were successful in engineering a subtle shift in Malaysia's foreign policy during the 1980s, marking one of the quiet but more notable achievements of U.S. diplomacy in Southeast Asia.

Initially, security relations with Malaysia were cordial for the Clinton Administration, as evidenced by the signing of a $720 million contract in June 1993 for Malaysia to purchase eight F/A–18D Hornet attack fighter aircraft, which became the most capable aircraft in Southeast Asia. But the purchase marked the high-water mark of security cooperation between the United States and Malaysia; relations since that time have become more prickly, although cooperation has continued on issues such as fighting terrorism and narcotics.

What Is Needed

Considering the economic and geo-strategic importance of Malaysia to the United States, it is in the interest of the United States to formulate a feasible relationship with Malaysia that allows continuing cooperation where common interests dictate but still stands up for American principles of economic and political freedom. Such a relationship may not be possible if Mahathir persists on his present course, but the decision lies largely in his hands. If Mahathir insists on pursuing insular economic and repressive political policies, then he is likely to set back or even sacrifice the positive strides that have been made in U.S.–Malaysia relations in recent years.

Although the fate of Malaysia's future lies to a great degree with Mahathir, the United States also has the responsibility to encourage Malaysia to move in a direction that would allow the relationship to progress. On this score, the Clinton Administration does not receive high marks. As with its policy toward the entire Asian economic crisis in general, the Clinton policy toward Malaysia has been passive—as though the Clinton Administration were paralyzed by indecision.

On the economic side, U.S. Secretary of the Treasury Robert Rubin did speak out against Malaysia's imposition of currency controls at the opening of the annual meetings of the IMF and the World Bank on October 2, 1998.[50] That same day, however, the Clinton Administration extended a $100 million agricultural credit to Malaysia, boasting that the credit would improve "Malaysian access to foreign exchange,"[51] thereby enabling Malaysia to prolong its experiment with the very currency controls that Secretary Rubin would deride as economically unsound. And the Admin-

49. For more information about this agreement, which was kept secret at Malaysia's request, see "Dockyard for US Ships 'Won't Threaten Security,'" *The Straits Times,* May 16, 1992, p. 21.

50. See, for example, David E. Sanger, "Rubin Urges More Disclosure in Global Finance and Making Investors Pay Bailout Share," *The New York Times,* October 2, 1998, p. A10.

51. "U.S. Extends $100 Million Credit Guarantees to Malaysia," News Release of the U.S. Embassy in Kuala Lumpur, October 2, 1998.

istration has been only elliptical in its criticism of the corruption and cronyism that is at the heart of the economic crisis in Malaysia specifically and in Asia generally.

On the political side, too, the Clinton Administration has the responsibility to speak out in support of American values, at the very least because of Anwar's questionable detention and the beating he endured while in custody. The Administration's response has been particularly disappointing in this regard. After Anwar appeared in court bruised and battered on September 29, the Clinton Administration waited until October 2 before Secretary Rubin and, subsequently, Vice President Al Gore expressed deep concern over Anwar's treatment and the apparent degradation of political freedom in Malaysia.

The Clinton Administration now needs a policy that fosters Malaysia's development as a more suitable partner for the United States in Southeast Asia. Such a Malaysia would be characterized by increased democratic and free-market reforms, and perhaps more fully in agreement with U.S. economic and political principles.

It is quite possible—and perhaps likely—that the United States will be unable to persuade Mahathir that his insular economics and repressive politics are counterproductive and that progress for Malaysia lies on the road of reform. In that case, the resumption of a strong partnership with Malaysia may have to await his successor. This may not necessarily be a long wait, if Suharto's lessons about society's intolerance of corruption and cronyism in difficult economic times are any guide.

U.S. policy toward Malaysia, then, should be one that seeks to advance U.S. interests by helping Malaysians to realize democratic and free-market economic reforms. Such a policy would maximize the chances of improved relations between the United States and Malaysia in the long run if short-term relations prove more problematic.

In order to promote such a U.S.–Malaysia policy while in Kuala Lumpur for the APEC Leaders' Meeting, President Clinton should:

1. **Criticize Malaysia's adoption of counter-productive economic policies.** President Clinton should stress that Mahathir's recovery program may bring short-term relief, but that it is bound to cause renewed—and perhaps deepened—problems over the long term. He should point out that there are no substitutes for the difficult reforms Malaysia eventually must undertake or risk being out-competed by its reformed neighbors. Such reforms should include stricter regulation and greater transparency in Malaysia's banking sector and reorganization and consolidation of its corporate sector. More fundamentally, President Clinton should stress a greater emphasis on the rule of law, which will be required if Malaysia is to overcome its legacy of cronyism, corruption, and nepotism. And the application of the rule of law will require the restoration of a genuinely independent judiciary.

2. **Express concern about the treatment of U.S. friend Anwar.** Both in private conversation with other leaders and in public, President Clinton should express the U.S. concern with the brutal treatment of Anwar. The President should urge that Anwar's trial be fair, and that an impartial inquest be conducted into his alleged beating while in government custody. President Clinton or Secretary of State Albright should seek to meet with Anwar and his wife to demonstrate U.S. concern for his well-being.

3. **Link U.S. interests with the goals of Malaysia's emerging democratic forces.** President Clinton should explain that Americans identify with Malaysians who yearn for greater democratic reform. As he did in China in June 1998, President Clinton should speak out in support of tolerance and individual liberties. He should speak out against the "Asian values" argument, calling it a subtle justification for authoritarianism, and explain that democracy is compatible with the Asian way of life. The President also should urge Malaysia to repeal the anachronistic Internal Security Act and implement genuine political reforms. And he should encourage Malaysian students to

come to the United States so that they can witness firsthand the fruits of economic and political freedom and return to their country with that vision.

4. **Seek continued strategic cooperation with a Malaysia that is strengthened by economic and political reforms.** To maintain a policy of deterrence and to preserve the peace and stability in Southeast Asia are goals that both the United States and Malaysia share. The United States welcomes the continuation of military cooperation with Malaysia and believes that a Malaysia strengthened by economic and political reforms would be a much more deserving partner of the United States in Southeast Asia.

CONCLUSION

After 17 years under Mahathir's rule, Malaysians increasingly are desirous of economic and political freedoms. Having closely observed the ouster of Indonesia's president, Suharto, Mahathir has seen the result of economic corruption and political repression. He has the opportunity to learn from Suharto's mistakes and implement genuine economic and political reforms before it is too late—both for him and for Malaysia. If he chooses to wall off his country, insulating it from the rest of the world with currency controls and anti-Western rhetoric, Mahathir will do irreparable harm to Malaysia and the Southeast Asia region.

Malaysia is the eleventh largest trading partner of the United States, located astride trade routes vital to Asia's economic health, so the United States has a strong interest in helping Malaysians to realize a democratic and prosperous future. When President Bill Clinton goes to Malaysia for the APEC summit this month, he should urge Malaysians to undertake genuine economic and political reforms to help their country to emerge from the Asian economic crisis stronger and more competitive. Should this occur, the United States may also gain a stronger partner in this important region.

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