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Incumbent Governments and the Politics of Crisis Management

with ANDREW MacINTYRE

Almost by definition, crisis settings are ones in which all options are unattractive and the optimal policy response is either unknown or sharply contested.[1] Yet even if we must have sympathy with policymakers struggling under adverse circumstances, it is also clear that their actions—or inaction—are highly consequential. When countries enter a zone of vulnerability or when crises break, markets are highly sensitive to indications that the government is unwilling or unable to act in a decisive, coherent fashion. Political developments can serve as a trigger or focal point that shifts expectations in adverse ways. Politics can also affect the course of adjustment once a crisis hits, and thus mitigate or compound its severity. This chapter explores the effects of three factors that might be considered political early warning indicators for countries vulnerable to crisis (table 2.1): electoral and non-electoral challenges to incumbent governments; inefficiencies in the government's decision-making processes; and features of business-government relations that might impede a government's ability to act. To what extent were these political risk factors present in each case and what influence did they have on both the onset and initial course of the crisis? In taking this inventory, this chapter also stands back to address a particular controversy about the link between politics and economic performance in East Asia. Are democracies

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1. This chapter draws in part on Haggard and MacIntyre (2000).

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Table 2.1 Political constraints on crisis management: The incumbents

	Thailand	South Korea	Malaysia	Indonesia
Government in office, dates in office (onset of crisis[a])	Prime Minster Chavalit Yongchaiyudh, 11/1996-11/1997 (7/1997)	President Kim Young Sam, 2/1993-2/1998(11/1997)	Prime Minster Mohammed Mahathir; first assumed office 7/1981[b], most recently elected 4/1995 and 11/1999 (7/1997)	President Suharto. First assumed office 3/1966; most recently elected (indirectly) 3/1993 and 3/1998, resigned 5/1998 (widened exchange rate band 7/1997, floated 8/1997)
Political challenges				
Electoral	Six-party coalition government with recurrent threats of defections	National presidential elections in 12/1997	Substantial electoral victory for ruling coalition in 1995; general elections not required until 4/2000, but UMNO Party elections in 6/1998	Indirect presidential election in 3/1998
Non-electoral	Antigovernment demonstrations in early 11/1997	Some limited strikes and demonstrations in sensitive sectors (Kia workers, central bank employees)	Minimal	Student demonstrations from 2/1998; protests against price increases and large-scale riots in Jakarta 5/1998; mounting social violence 1-5/1998
Decision-making process	Parliamentary, six-party coalition	Presidential, unified government but executive-legislative and intraparty splits	Parliamentary, coalition government, but UMNO dominant	Authoritarian, highly concentrated
Government links to business	Close links between legislators of all parties and business	Some evidence of corruption involving executive and legislators (Hanbo), intense lobbying by distressed firms	Close to politically favored groups	Close links between executive and cronies and family businesses

a. Onset of crisis is the date exchange rates were allowed to float.

b. Mahathir succeeded Hussein Onn after the latter's heart operation in July 1981, and was elected in the April 1982 general elections.

more prone to the risks just outlined, as defenders of "Asian values" have implied, or do authoritarian regimes suffer from similar or even greater disabilities?

Political Sources of Uncertainty

The question of how electoral cycles affect government policy and the real economy has been a central theme of political economy for some time (for a recent synthesis, see Alesina, Roubini, and Cohen 1997). In the next chapter, we address the policy consequences of actual changes in government, and what sorts of oppositions gained from the crisis. But impending elections and non-electoral challenges, in the form of demonstrations, strikes, or riots, can also weaken the ability of incumbent governments to make difficult decisions.[2] Moreover, the prospect that a political challenge—again, either electoral or non-electoral—will result in a change of government can itself generate political uncertainties; this is particularly likely when there are substantial differences in the policy positions of incumbents and their challengers or simply uncertainty about what a change of government might bring.[3]

A second source of uncertainty about the course of policy lies in the decision-making process itself, in which a trade-off can arise between decisiveness and credibility (Tsebelis 1995; Haggard and McCubbins 2000; MacIntyre 1999a, 1999b). This trade-off is related to the nature of institutional checks and balances in the decision-making process, or more specifically the number and preferences of different veto gates.[4] A decision-

2. Critics of early political business cycle approaches argued that if voters were fully rational, they would see through politicians' efforts to manipulate the economy for short-term electoral ends and react accordingly, both in the market and at the ballot-box (see Alesina 1994 for a review). Yet despite this objection, incumbent governments facing electoral or non-electoral challenges may nonetheless be prone to delay policy actions that impose short-run costs, for the simple reason that their time horizons are too short to capture the benefits. Such hesitation is particularly plausible if we consider not only electoral challenges, but extra-parliamentary actions that can also threaten the survival of the government.

3. Such uncertainty will be especially great when the change of government is irregular (e.g., through a coup) or when there is a change of regime (e.g., from authoritarian to democratic rule). Recent cross-national statistical work by Leblang (1999) and Mei (1999) has shown that changes of government (Leblang) and elections (Mei) increase the propensity to financial crisis, even when controlling for a variety of other determinants.

4. A veto gate is an institution that has the power to veto a policy proposal, thus forcing a reversion to the status quo. Veto gates can include the president, legislature, a second chamber of the legislature, a committee within a legislature, or the courts; in authoritarian governments, they may include the military. The preferences of these veto gates may be more or less closely aligned; thus, the president and legislature may represent distinct veto gates, but may either be of the same party (unified government) or of different parties (divided government).

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making system with few checks on executive decisions—a single or very few veto gates—has the advantage of being decisive. Policy can be changed easily, but precisely for that reason may not be credible, and can even become erratic (MacIntyre 1999a, 1999b). By contrast, a system with multiple veto gates has the advantage of checks and balances that force deliberation and bargaining. It will be slow-moving and less decisive. At the extreme, such systems can generate outright stalemate. Such an outcome may be desirable if the policy status quo is favorable, but can be highly costly during crises when there is strong pressure for policy change.

A final source of uncertainty about the course of government policy arises out of the nature of business-government relations. We have seen the ways in which these relationships generated vulnerability over the longer run. But business lobbying complicates economic policymaking in the short run as well, particularly where governments have a history of responding to business pressures or the interests of particular firms.

How did different types of governments—democracies, dictatorships, and varieties of each—fare in managing the crisis?

There can be little question that the two democracies—South Korea and Thailand—both experienced difficulties responding to the crisis and that some of these difficulties can be traced directly to features of democratic rule, including electoral pressures and divided decision-making processes. In Thailand, a weak coalition government proved slow in reacting to early warning signals before the crisis struck and had difficulty formulating a coherent response once it did. In Korea, impending presidential elections split the ruling party, created tensions between the executive and National Assembly, and made the government particularly sensitive to lobbying. However, as will become evident in chapter 3, the democracies also had an advantage over their authoritarian counterparts, including the ability of oppositions to mobilize support and new governments to take office and initiate reform with electoral and legislative support.

As one would expect, semi-democratic Malaysia and authoritarian Indonesia initially faced fewer political constraints. The absence of meaningful electoral or non-electoral challenges and concentrated decision-making structures seemed to position them to respond decisively to the crisis. In fact, these purported advantages of authoritarian rule proved illusory, particularly in Indonesia, and for at least three different reasons. First, the advantages of decisive decision-making were more than offset by the erratic behavior of chief executives. In Malaysia, Prime Minister Mahathir exacerbated his country's problems by mounting a campaign against international "speculators," thus encouraging the very behavior he was decrying. In Indonesia, Suharto's commitment to reform in the initial IMF program was followed almost immediately by derogations that called that commitment into question.

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A second closely related source of uncertainty centers on the role of the private sector and particular firms. All four governments faced challenges to policymaking as a result of business lobbying; the findings of this chapter thus extend the conclusions of chapter 1 that the nature of business-government relations was implicated in the onset and depth of the crisis. But authoritarian governments were no more immune to appeals from privileged segments of business than their democratic counterparts, and arguably were less so. Political challenges to authoritarian leaders made it even more imperative that they maintain links with privileged private sector supporters, while the absence of democratic accountability and the lack of transparency made it difficult for oppositions and interest groups to monitor these relationships. In both Indonesia and Malaysia, commitments to reform ran into particularly strong business resistance.

However, the greatest source of uncertainty in any authoritarian regime centers on the question of succession. In Malaysia, divisions within the policymaking apparatus reflected deeper political divisions within the government and a succession battle between Mahathir and his deputy prime minister, Anwar Ibrahim. In contrast to Indonesia, Mahathir's control over a strong party apparatus allowed him to organize political support, reassert his authority, and pursue an unorthodox response to the crisis.

In Indonesia, the very concentration of authority in Suharto made the system vulnerable both to his discretion and any signs that his rule might be in jeopardy. The absence of institutionalized mechanisms to generate mass support and manage opposition—as existed in Malaysia—ultimately generated profound political uncertainty. When serious opposition emerged, the very fate of the regime, and the property rights associated with it, were at stake. It is no accident that the authoritarian regime facing the most extensive political challenges, and ultimately undergoing the most wide-ranging political change, was also the country that experienced the deepest policy uncertainty and the most profound crisis.

Thailand

By late 1996, Thailand was coming off a remarkable economic boom, prolonged by the inflow of foreign capital. As real GDP growth slowed in 1996, two issues were of particular policy concern—the widening current account deficit (growing from an already-large 8.1 percent of GDP in 1995 to 8.4 percent in 1996), and unease about the health of the recently liberalized financial sector. Although the baht had been tested at the time of the Mexican crisis, these factors fueled growing speculation against the currency in the second half of 1996 (Bhanupong 1998; Warr 1998). But Thai authorities failed to address either of these problems in a credible

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way, clung to a strategy of defending the pegged exchange rate, and ultimately fell victim to a massive speculative attack on 2 July 1997.

We have already seen how political links between members of the government and financial institutions generated severe moral hazard problems earlier in the decade. These problems did not go away, but broader constitutional weaknesses compounded them. All of the democratically elected governments before the crisis—Chatichai, Chuan, Banharn, and Chavalit—rested upon shaky multiparty coalitions, made up of internally weak and fragmented parties that not only provided access for private interests but made policymaking extraordinarily contentious (Hicken 1998, 1999). Governments were constructed from a pool of approximately a dozen parties, and cabinet instability was a chronic problem. As leader of the governing coalition, the prime minister was vulnerable to policy blackmail by coalition partners threatening to defect in pursuit of better deals in another alliance configuration.

In September 1996, Banharn's government collapsed after key coalition partners deserted him. After what was widely regarded as the country's dirtiest election, Chavalit's New Aspiration Party (NAP) narrowly emerged as the largest party in Parliament (*Far Eastern Economic Review*, 26 November 1996, 16-22). Chavalit proceeded to construct a six-party coalition made up of most of the parties from the previous government. Nonetheless, he also signaled that he would appoint a cabinet built around an "economic dream team" of highly respected technocrats, most notably Amnuay Viruwan as minister of finance, to address the country's mounting economic difficulties.

The biggest area of concern in the financial sector was not the banks themselves, but the finance companies (Pakorn 1994; Yos and Pakorn 1999; Alba, Hernandez, and Klingebiel 1999; Overholt 2000).[5] On 5 February 1997, the first Thai company (Somprasong Land) defaulted on a foreign loan repayment. Late in the month, it was announced that the largest of the finance companies, Finance One, was seeking a merger with a bank to stave off collapse. By the end of February, Financial Institutions Development Fund (FIDF) assistance extended to 14 companies and totaled Bt50 billion (Nukul Commission 1998, para. 343).

In the face of widespread fears of an impending financial implosion, Finance Minister Amnuay and Central Bank Governor Rerngchai Marakanond suspended trading of financial sector shares on the stock exchange on 3 March and went on national television to announce a series of emergency measures designed to reassure nervous markets.[6] These mea-

5. By the end of 1996, Thailand's 91 finance companies (25 were pure finance companies, and 66 performed both finance and securities functions) accounted for nearly 25 percent of total credit and were suffering from the end of a prolonged property boom and mounting nervousness about unhedged foreign liabilities.

6. The two key elements of the policy intervention were a requirement that all banks and finance companies make much stronger provision for bad loans and an announcement that

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sures did little to reassure financial markets. Underlying the market's nervousness were doubts about the health of other finance companies and banks as well as about the government's ability to follow through with its restructuring plans.

Such fears proved well founded. The original Ministry of Finance report showed that 18 finance companies and 3 banks faced difficulties, but the list was trimmed following direct intervention from the prime minister (Nukul Commission 1998, para. 368). Several senior members of Chart Pattana, the second largest party in the coalition, had controlling interests in some of the 10 targeted institutions. They succeeded in vetoing the plan and ensuring that no action was taken against the 10 companies. Moreover, the very fact that they were permitted to remain open meant that—as with the Bangkok Bank of Commerce—the central bank had to provide liquidity to keep them afloat in the face of runs by creditors and depositors.

The management of the financial market problems in March constituted a critical juncture in the development of the larger crisis in Thailand. Both Thai and foreign analysts expressed concern about the scale of the bad loan problem (e.g., *Far Eastern Economic Review,* 13 March 1997, 61-62; Overholt 2000); it was not unknown. Even the modest path they opted for—lifting capital adequacy provisions and singling out the weakest institutions for immediate attention—were effectively vetoed by other members of the ruling coalition, some with direct stakes in the institutions. Rather than risking the collapse of his new government by alienating Chart Pattana, Chavalit preferred to gamble on compromise and delaying measures.

The finance minister's inability to follow through on the modest plans he had outlined had a corrosive effect on investor confidence. Moreover, there were debilitating costs to delay. At the same time as the government was pumping money into insolvent finance companies to keep them afloat, the central bank was also spending down reserves to prop up the exchange rate and avoid any substantial increase in interest rates. This was clearly not a sustainable strategy, and in mid-May the baht suffered its heaviest assault to date.

Amnuay had encountered resistance with respect to macroeconomic policy as well. The question of if and when to adjust the exchange rate involved judgments about timing; as pressures on the rate mounted, the central bank argued that it was risky to float, and Amnuay ultimately deferred on the issue. The need to make fiscal adjustments, by contrast, engaged the cabinet. As in the past (Pasuk and Sungsidh 1994), coalition partners successfully reversed Amnuay's efforts to trim more pork from

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ten of the weakest financial companies would have to raise their capital base within 60 days (*The Nation*, 4 March 1997).

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the budget, and he resigned from the government on 19 June. Within two weeks—on 2 July—the baht was cut loose.

The onset of the crisis did not, of itself, guarantee effective action. Upon taking office, Amnuay's successor, Thanong Bidaya, announced the suspension of 16 finance companies (including 7 of the original 10), giving them 30 days to implement merger plans (*Bangkok Post*, 6 August 1997). At the same time, however, the prime minister announced that no further finance companies would be closed, and that the government would guarantee the closed finance companies loans and deposits. Both measures had profound implications for the FIDF, to which the remaining finance companies increasingly turned for support. Not only did Chart Pattana succeed in preventing the closure or merger of the 16 finance companies, it also managed to persuade the central bank to continue injecting liquidity into the institutions.[7]

A week later, on 5 August,[8] Thanong announced that a further 42 finance companies would be suspended. However, charges of corruption and conflict of interest surfaced with respect to the committee given the responsibility of reviewing the finance companies' rehabilitation efforts. This resulted in further delays until a new chairman, Amaret Sila-on, the respected head of the Thai Stock Exchange, was appointed to oversee the process in August (*Bangkok Post*, 26 August 1997).

With the deadline for deciding the fate of the suspended finance companies looming, lobbying intensified. By mid-October, Amaret had resigned, claiming that he was being undercut by forces within the government (*Bangkok Post*, 12 October 1997).[9]

Developments were equally unpromising in other policy areas. Within a week of announcing the IMF program on 14 October, the government reversed a decision to raise gasoline taxes. Minister of Finance Thanong resigned, stating succinctly that the country needed a "genuinely independent, credible economic team which is accepted by the public, monetary institutions both domestic and foreign and the International Monetary Fund and World Bank" (*Far Eastern Economic Review*, 30 October 1997, 60). In downgrading Thailand's credit rating on 24 October, Standard & Poor's argued explicitly that "patronage-based politics increasingly has impaired the ability of technocrats to manage ongoing financial stress, while Thailand's fragmented political landscape offers little prospect of

7. In late July, it was revealed that loans to the 16 finance companies equaled about 10 percent of GDP (*Bangkok Post*, 14 August 1997).

8. The IMF's $17.2 billion package was unveiled in Tokyo on 11 August.

9. Further concessions were soon made to Chart Pattana and the finance companies, including an indefinite extension of the deadline for their restructuring and the conversion of previous government loans into equity. Chart Pattana also succeeded in guaranteeing that two new restructuring agencies would not be independent of the government.

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cohesive government in the near term'' (*Far Eastern Economic Review*, 6 November 1997, 21). The international financial institutions had come to quite similar conclusions.

By this stage, as we will see in the next chapter in more detail, the crisis was forcing broader political realignments. On 3 November, on the eve of a special session of Parliament called to approve six executive decrees that were central to the economic reform effort, Chavalit resigned, paving the way for a new government under the Democrat Party.

Politics in Thailand exerted a powerful influence over both the onset and initial management of the crisis. Intracoalitional politics delayed action on the budget, and politicians with direct and indirect interests in regulated financial institutions prevented an effective resolution of their mounting problems. These political failings contributed to the onset of the crisis directly by weakening confidence in the Thai financial sector, and deepened it once the devaluation occurred by further delaying adjustment and generating uncertainty about the capacity of the government to act.

South Korea

South Korea[10] did not face Thailand's current account difficulties, but like Thailand it did face a number of problems associated with the end of a domestic investment boom. This boom was concentrated not in real estate but in manufacturing, and within manufacturing in heavy and chemical industries dominated by the largest *chaebol* (Haggard and Mo 2000). Rather than attention focusing initially on the insolvency of banks and finance companies, it was the weakness of several large *chaebol* that triggered concerns about bank solvency.

As in Thailand, a number of vulnerable companies lobbied aggressively for government support. As in Thailand, pressures from business were compounded by broader political factors, including in South Korea the impending presidential election scheduled for December and the fragmentation of the ruling party; in combination, these factors blocked the passage of an important set of financial reforms and contributed to a more general uncertainty about the capacity of the government to respond to the crisis.

Any account of the onset of Korea's financial crisis must begin with the political effects of the Hanbo scandal. The government made no effort to save Hanbo's management; the firm was effectively nationalized through the injection of new money (*Far Eastern Economic Review*, 20 February 1997, 16-17; 13 March 1997, 16-17; 24 April 1997, 19; *Business Korea*, February 1997, 13). But when two more of the top-30 *chaebol* folded—Sammi in March and Jinro in April—the government adopted a

10. A more detailed account of the events of 1997 is contained in Haggard and Mo (2000). For the World Bank's input into the structural adjustment process, see World Bank 1998c.

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more concerted response to the problem. On 18 April, 35 commercial and state banks announced an "anti-bankruptcy" pact that allowed them to continue to lend to troubled borrowers.[11] The government supplemented the program by injecting liquidity into the banking system through the purchase of nonperforming assets by the Korean Asset Management Corporation.

Market response to the plan was positive, and the stock market rallied sharply. However, beginning in July, Korean financial and foreign exchange markets entered a period of marked uncertainty, and the government's management of the Kia bankruptcy was clearly a major cause.

The Kia crisis broke on 23 June, when Kim Sun-Hong, chairman of the group, appealed to the government for assistance in persuading creditors not to call maturing loans. On 15 July, the group's creditor banks placed it under the anti-bankruptcy pact (Ministry of Finance and Economy, *Economic Bulletin*, August 1997, 22-23). A highly politicized battle ensued over the future of Kia. Refusing to resign, the group's chairman quickly denounced the initial support package as inadequate and mobilized support for the company from suppliers, employees (who were substantial shareholders), and the public at large through a "Save Kia" campaign (*Korea Newsreview*, 26 July 1997, 16).

Because of the high concentration of both the financial and corporate sectors, and the extraordinary leveraging of the latter, the difficulties of three or four major groups affected the entire banking sector. In August, the government announced an additional $8 billion of support for the banking system (*Korea Newsreview*, 30 August 1997, 24-25). But it also signaled impatience with the campaign Kia was waging. The entire anti-bankruptcy pact was becoming a source of uncertainty, and the government began to send stronger signals that it wanted Kia's creditors to let the firm go bankrupt (*Korea Newsreview*, 2 August 1997, 27).

The Kia management was unwilling to submit to court receivership (*pasan*), however, under which existing management would be replaced, and exploited an important loophole in Korean bankruptcy law—court "protection" or "mediation" (*hwa ui pob*)—to avoid it.[12] One powerful weapon the government maintained in pushing the creditors toward the receivership option was the threat that the government would not guarantee the foreign obligations—$687 million—of the firm if it sought court protection (*Korea Newsreview*, 27 September 1997, 25-26). On 29 September,

11. Banks would continue to extend credit to any top-50 *chaebol* at risk and defer debt payments for 90 days if the company was "basically sound" and came up with a "self-rescue" package of measures including layoffs, sale of assets, and organizational consolidation.

12. Under Korean law, firms may file for court "protection" or "mediation." Under this procedure, management maintains its rights and, if three-fourths of creditors agree, debt payments can be postponed and new credits extended. Banks may have an incentive to go along with this option, because court receivership implies liquidation and certain losses.

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the creditors delivered an ultimatum that no further credit would be extended. Nonetheless, it took a full month, until 22 October, before the government intervened to definitively settle the Kia issue by ousting management and effectively nationalizing it (Ministry of Economic Affairs, *Economic Bulletin*, November 1997, 25-28; *Far Eastern Economic Review*, 6 November 1997, 65).

The Korean banking system had thus been through a string of corporate bankruptcies and was already in deep distress when the shock from Hong Kong hit in the third week of October. Foreign banks refused to roll over short-term foreign credits to Korean financial institutions and pressure on the exchange rate mounted, culminating in the floating of the exchange rate on 21 November.

While the Hanbo scandal, the anti-bankruptcy pact, and conflict over Kia were taking place, the government faced an additional set of problems in strengthening financial regulation. In the wake of the Hanbo scandal, the president initiated a Financial Reform Commission. The fate of this reform effort also influenced foreign perceptions of the government's capacity to act; to understand its fate requires further explication of the government's political weaknesses in 1997.

Following the Hanbo scandal, Kim Young Sam distanced himself from the party and the nomination process.[13] Lee Hoi Chang captured the nomination on 21 July, and appeared on his way to an easy victory in December. However, his popularity plummeted when it was revealed that his two sons had avoided military service. The party began to fragment.[14] In the meantime, Kim Dae Jung's electoral chances were improving not only as a result of the crisis, but through an unlikely alliance with conservative candidate Kim Jong Pil.

In sum, the political background to policymaking before the crisis includes a severely weakened president and a divided ruling party headed by a candidate desperately trying to differentiate himself from the incumbent. Although National Assembly elections are not concurrent with the presidential elections in Korea, ruling party legislators were disinclined to take any actions that would damage the party in the run-up to the presidential elections.

In the meantime, the Financial Reform Commission had moved ahead with its institutional reform proposals. These included increasing the independence of the Bank of Korea (BOK) from the Ministry of Finance and Economy (MOFE) and stripping regulatory powers out of both the BOK and MOFE and forming an independent regulatory agency. With strong bureaucratic opposition to the reform and few politicians seeing

13. The Korean Constitution prohibits re-election of the president.

14. Another presidential hopeful, Rhee In Je, left the ruling party and launched his own campaign on 13 September, taking many of Kim Young Sam's supporters with him.

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any gain from it, the ruling party and opposition agreed to postpone the legislation until after the elections.

The question of financial reform resurfaced in late October, in part at the insistence of the IMF. At the end of the second week of November, the package of financial reform bills was headed for passage. However, one of the contentious and unresolved issues was whether the Financial Supervisory Board (FSB), which would consolidate a number of existing regulatory agencies, would fall under the control of the prime minister or of the minister of finance and economy, where the National Assembly believed it would have more oversight powers (*Korea Herald,* 14 November 1997). In addition, the labor unions representing the Bank of Korea and the four agencies targeted for elimination were opposed to the consolidation, undertook a number of protest actions, and threatened to strike (*Korea Herald*, 15 November 1997).

In principle, the ruling party could have passed the bills over these objections. But Lee Hoi Chang's supporters were rightly concerned about the political cost of doing so. They wanted to secure opposition support for the legislation in order to defuse it as a campaign issue (*Korea Herald,* 17 November 1997). The opposition had few incentives to cooperate. If they signed on, they would be associated with potentially costly reforms that affected Kim Dae Jung's labor constituents. If they postponed their assent, any negative economic effects would be laid at the feet of the president and the ruling party. For markets already increasingly unsettled by a number of other developments, failure to pass the reform legislation was but one additional piece of bad news.

With the financial reform legislation blocked in the National Assembly, Finance Minister Kang Kyung Shik turned his attention to drafting short-term policy measures that would address the weakness of the financial sector and the turmoil on the foreign exchange markets without recourse to the IMF. The centerpiece of Kang's plan was $10 billion of support from foreign central banks, but the United States argued that Korea should work through the IMF (Cho and Pu 1998, 114-15). With economic policy in a shambles, the president decided to replace his economic team.

The effects of this sequence of events on the markets are unmistakable. The won plunged to the maximum limit of 2.25 percent for three consecutive days beginning on the 17th, the day after the National Assembly postponed the financial reform legislation. On the 19th, it only took 10 minutes for the won to reach its limit, triggering the closure of the foreign exchange market (*Korean Herald*, 20 November 1997). On the 21st, the won was cut free.

Much analysis of the Korean crisis has focused on the response of the markets to the first IMF program in early December, and whether its failure was due to the design of the program (as critics of the Fund argue), to the revelation that reserves were completely exhausted (as Fund

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officials hold), or to politically generated uncertainty (see Graham 1998 for a review). Particular attention has been given to remarks by Kim Dae Jung that were interpreted to suggest that he would renegotiate the terms of the IMF program. In the two days following these remarks, the won fell nearly 10 percent against the dollar. The decline was only stopped—and then only briefly—when the three main candidates signed a joint pledge to honor the IMF agreement. Despite this political commitment, the program had to be supplemented by a new agreement and new resources on Christmas Eve (*Far Eastern Economic Review*, 25 December 1997 and 1 January 1998).

However, these events were only the last in a long series that had affected investor confidence in the second half of the year. Contrary to the often-repeated assertion that no one foresaw the crisis, prominent market analysts were expressing serious doubts about Korea and its banking system before the Thai crisis broke in July. First, there was substantial uncertainty about how the government would respond to the failure of major firms, which invited the test posed by Kia. These uncertainties were compounded by a larger political milieu, which made it difficult for the government to act. By November, it is doubtful that passage of the reform legislation would have been able to reverse Korea's fortunes. However, the failure reflected a more fundamental stalemate in Korean politics of which investors and analysts were perfectly aware. Only with the election of Kim Dae Jung did expectations stabilize and the government gain the ability to initiate much-needed reforms.

Malaysia

From the end of the mid-1980s recession in 1986 through the first half of 1997, the Malaysian economy accumulated an enviable record of economic growth with budget surpluses and consistently low inflation. In retrospect, there were several signs of vulnerability, but it is important to stress that none of them appeared particularly severe (Jomo 1998a; Athukorala 1998). On the external front, the ringgit did show signs of real appreciation that were reflected in a large current account deficit. Between 1994 and 1997, external debt tripled—with a particularly rapid increase in short-term foreign borrowings. However, overall debt remained modest when compared with GNP (45.6 percent), its maturity structure did not appear particularly troubling (76.1 percent in medium- and long-term debt), and debt service ratios were extremely modest (5.7 percent of exports) (*Bank Negara Annual Report 1997*, 51).

A second concern was that Malaysia was experiencing symptoms of a bubble. As we have seen, the rapid expansion of credit in late 1996 and early 1997 was increasingly channeled into the financing of purchases of property and shares, and in March 1997 the central bank moved to curb

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speculative excesses by placing ceilings on bank lending to property and shares. But the banking system seemed to many observers less vulnerable to crisis than in South Korea and Thailand because of the strengthening of prudential regulation in the mid-1980s (Chua 1998, but see also Jomo 1998a, 183). Before the Thai crisis, analysts were speaking approvingly of a "soft-landing," as the economy began to gradually slow in comparison with the torrid pace of 1995 and 1996.

Following the attacks on the Thai baht in May, the central bank briefly defended the ringgit but quickly gave up the effort. For the remainder of the year, the ringgit continued a steady, and largely uninterrupted, fall. Given the relatively favorable starting point, why did Malaysia fare so poorly?

Although regional contagion clearly bears substantial responsibility for Malaysia's troubles, the country's problems were compounded by a series of political factors that created substantial uncertainty about government intentions. These events began with Mahathir's "war on the speculators" in the second half of 1997, a series of self-fulfilling prophecies that soured foreign investors on the country. Mahathir's speech of 20 September 1997 to the joint annual meetings of the IMF and World Bank in Hong Kong, in which he attacked "speculators" and called for a ban on "unnecessary, unproductive, and immoral" currency trading, received wide publicity (Mahathir 1998). However, this speech was not an isolated event: from July until December, the prime minister engaged in a running battle with the markets.[15] After each speech, the foreign exchange and stock markets responded negatively.

Fiscal policy also became a source of uncertainty. Following a meeting of the UMNO's supreme council on 4 September, Mahathir deferred several large infrastructure projects, and the budget unveiled on 17 October by then-Deputy Prime Minister Anwar Ibrahim combined slowed spending growth with a small corporate tax cut. But in November, Anwar announced that the government would assume responsibility of the Bakun dam from the project's main developer, the Ekran group, the first major sign that the government would step in to assist politically connected groups. In early December, the prime minister declared that a

15. His first attack on the foreign exchange markets came on 28 July, and already hinted at the possibility that the government might impose controls. On 3 August the central bank limited ringgit sales for noncommercial purposes, and on 27 August the Kuala Lumpur Stock Exchange (KLSE) moved to stop short-selling of 100 blue chip stocks (*Far Eastern Economic Review*, 18 September 1997, 65). Mahathir's comments continued even after the hostile response of the markets to the Hong Kong speech. In Chile on 30 September, Mahathir argued for a new non-US dollar peg because the dollar was "unstable" and later spoke against raising interest rates to defend the ringgit (*Financial Times*, 2 October 1997; *Far Eastern Economic Review*, 9 October 1997; *Straits Times*, 28 October 1997).

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RM$10 billion road, rail, and oil-pipeline project linking northeastern Malaysia and Thailand would, in fact, go forward (Economist Intelligence Unit, *Quarterly Economic Report*, 1st quarter 1998, 15-19).

In early December, Malaysian economic policy took a completely new turn. Closely identified with Anwar, this new direction amounted to "an IMF package without the IMF." The government cut spending dramatically, delayed "non-strategic" construction projects, deferred capital imports of several major state-owned enterprises, and canceled controversial overseas investments *(Bank Negara Annual Report 1997*, 111-12). Anwar also signaled to the banking community that firms facing fundamental difficulties should not be kept afloat artificially and that prudential regulation would be tightened. Most dramatic among these measures was a plan to consolidate the country's vulnerable finance companies as a prelude to restructuring the entire banking sector *(Bank Negara Annual Report 1997*, 113).

Two further elements of the Anwar package are noteworthy because they underscore emerging policy differences within the government that would widen over time. First, Anwar stated that Malaysia remained committed to a flexible exchange rate and that further controls on capital flows would not be forthcoming. Second, the program coincided with the end of the effort by the central bank to restrain interest rates. Anwar did not control monetary policy, but he defended the central bank and warned that interest rates would rise, as they did beginning in December 1997.

The 5 December program seemed to mark the ascent of a relatively orthodox policy stance. However, just before its announcement—on 20 November—Mahathir created a contending center of economic policymaking authority in the National Economic Action Council (NEAC). The NEAC was chaired by Daim Zainuddin, a former finance minister who was an architect of the high-growth strategy of the late-1980s and early 1990s and highly influential within the party. Daim's position as treasurer of the UMNO meant that he was closely connected both to the UMNO's business interests and to the new class of entrepreneurs who had benefited from privatization and other government policies in the 1990s.

The NEAC generated substantial uncertainty over economic policymaking authority. Anwar was made deputy chairman of the council, but this undermined his authority as finance minister, given that the NEAC was vested with the authority to develop plans to overcome the crisis. On most controversial issues, the final NEAC report was at odds with the Anwar approach (National Economic Action Council 1998). The council argued that a fiscal stimulus (to which Anwar would be converted) and lower interest rates (to which he was not) were necessary for recovery, thus calling into question the already tenuous independence of the central bank. Throughout April and May, a more or less open conflict raged on interest rate policy between Mahathir and Daim, on the one hand, and Anwar and Central Bank Governor Ahmad Don, on the other. The NEAC

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also deemed assistance for firms hurt by the crisis as wholly appropriate, undercutting Anwar's focus on the risks of moral hazard and corruption.

With the elevation of Daim to cabinet status on 24 June, the debate between the two sides was effectively resolved in Daim's favor. Monetary policy eased from July to deal with the ballooning crisis in the financial sector, and Anwar launched a number of important new institutions for recapitalizing the banks (Danamodal), acquiring, rehabilitating, and disposing of assets (Danaharta) and restructuring corporate debt (chapter 4). Beginning in June, the government accelerated its efforts to raise foreign funds to finance these efforts, seeking support from Japan, Taiwan, Singapore, and the World Bank. However, the plan to float US$2 billion of bonds for Danaharta was shelved when international agencies cut Malaysia's credit ratings. Standard & Poor's claimed nonperforming loans had reached 30 percent of total loans—roughly double government estimates—and was concerned with the lack of transparency in the restructuring process. Moody's also expressed concern over the growing conflict between Mahathir and Anwar (*Far Eastern Economic Review*, 13 August 1998, 10-13).

On 27 August, the central bank issued its second quarter report on the performance of the economy, and the news was uniformly bad: During the second quarter, GDP shrank by 6.8 percent. On 1 September, Mahathir imposed capital controls and fixed the exchange rate (see appendix 2.1). On 2 September, Mahathir removed Anwar from office (*Far Eastern Economic Review*, 17 September 1998, 10-14).

Why did the Malaysian government pursue such a zig-zagging policy course that appeared to undermine confidence and ended with the imposition of capital controls? The answer certainly does not appear to lie in the electoral cycle or a strong opposition. The ruling Barisan Nasional (National Front) government took over 65 percent of the popular vote and 84.3 percent of seats in the 1995 general elections, and new ones were not scheduled until 2000. Moreover, a number of well-known restrictive features of the Malaysian political system, including an erosion of judicial autonomy and tight government control over the formation of independent political and interest groups, allowed it to manage any dissent that might arise in the wake of the crisis (for overviews, see Case 1996, Crouch 1996, and Milne and Mauzy 1999).

Rather, the pattern of policy emanates from two closely related political factors. The first was the government's particularly strong commitment to the Malay private sector. Mahathir had staked his political status on a new approach to inter-ethnic redistribution that centered on the development of *bumiputra* firms through privatization. Unfortunately, these firms, as well as non-*bumiputra* firms with close political connections with the government, were heavily concentrated in trading and services, finance, property, and construction—in sum, in the nontraded sectors most vulner-

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able to the shocks that occurred in 1997-98. The recommendations of the NEAC and the imposition of capital controls were designed not simply to provide an overall stimulus but to protect these favored companies.

But issues of economic policy also became linked to conflicts within the party over leadership and succession. To understand how requires a closer look at UMNO politics. The UMNO had long exercised dominance within the party system. Internally, the party leadership exerted its power over the party machinery through its control of nominations, appointments, and campaign financing, as well as economic rents. However, the UMNO also had democratic features that required the leadership to court support at the party's base, particularly when leadership challenges and succession struggles emerged.[16]

The immediate background to the political crisis of September 1998 can be traced to the triennial party elections in March for local policy leadership positions.[17] Despite some discontent, Mahathir prevailed; 105 division chiefs were returned without challenge, and only 12 incumbents were voted out.

This vote should have signaled the power that Mahathir continued to hold over the party, but the fall of Suharto in May and the continuing problems in the economy emboldened Anwar and his supporters to issue a more direct challenge to the prime minister in anticipation of the UMNO General Assembly. In a series of speeches, Anwar raised the issue of "corruption, cronyism, and nepotism" in an increasingly pointed fashion, including before foreign audiences (Economist Intelligence Unit, *Country Economic Report: Malaysia and Brunei*, 3rd quarter 1998, 13). While agreeing with Mahathir that the sources of the crisis were primarily external, Anwar also underscored the importance of domestic policy change—increasing transparency, improving corporate governance, and battling corruption.

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16. Intra-party political conflicts under Mahathir were not new, and had from the beginning of his administration focused on dissent over executive powers and corruption. A split between Mahathir and Deputy Prime Minister Musa Hitam was resolved by the latter's resignation in 1986 (Gill 1998a, 1998b; Crouch 1996, chap. 7 and p. 116), but was followed immediately by a challenge from Hamzah Razaleigh for the presidency of the party in 1987. In a preview of Anwar's challenge, Razaleigh charged that Mahathir had centralized decision-making power and used those powers to distribute government contracts and business opportunities to a narrow range of favored cronies.

17. The party is organized into roughly 4,500 branches that elect leaders to represent them at the divisional level; divisions correspond with parliamentary districts. These divisions select the delegates to the UMNO General Assembly, which in turn chooses the president and deputy president of the party (who, given the Barisan Nasional's electoral dominance, have historically been the prime minister and deputy prime minister, respectively). Positions as division chief are also coveted as a stepping stone to electoral office. The races naturally engage local rivalries, but also provide an opportunity for expression of discontent within the party. In 1998, this discontent centered in part on the role of Islam in society but also on the deteriorating state of the economy and corruption (*Far Eastern Economic Review*, 9 October 1997).

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Anwar emphasized issues of poverty alleviation and social justice, citing the Koran (LIX 7), "in order that (they) may not (merely) make a circuit between the wealthy" (*New Straits Times,* 19 June 1998).

The General Assembly belonged to Mahathir. He undertook an extensive defense of his pro-*bumiputra* policies. Appealing to his expanded business constituency, Mahathir argued that allegations of cronyism and nepotism were being used by foreigners to ensure the failure of the New Economic Policy (*New Straits Times,* 18 June 1998). He also seized the corruption issue from his opponents by publishing lists of the companies and individuals who had been beneficiaries of a number of important government policies.[18] The lists encompassed large swaths of the Malay and Chinese private sectors, and included a number of Anwar supporters and even his father.[19]

The outcome of these political battles had immediate policy consequences. Anwar's authority on economic policy was formally undercut by the elevation of Daim Zainuddin to the cabinet immediately following the UMNO General Assembly. The release of the new stimulus package was timed to coincide with the UMNO General Assembly, and the government pressed the central bank to ease monetary policy in early July. In late August, the central bank governor, Ahmad Mohamed Don, resigned under pressure, setting the stage for the concentration of all economic policymaking authority around Mahathir. Following Anwar's exit, Mahathir announced that he would take over the Finance Ministry himself, and he appointed close associates to the central bank.

In the first year after the crisis broke, Prime Minister Mahathir succeeded in drawing attention to weaknesses in the international financial architecture and the benefits of capital controls. However, his interpretation of events conveniently ignores the ways in which he himself contributed to Malaysia's difficulties. The "war against the speculators," uncertainty about both the general direction of policy and the locus of decision-making authority, and close government links to favored firms all compounded the country's economic difficulties.

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18. These included a list of public works and infrastructure projects that had been let to private companies; individuals who had been allocated company shares under the Special Bumiputra Share Allocation between 1993 and 1997; and recipients of public transport licenses, haulage permits, and government contracts (*New Straits Times*, 21 and 22 June 1998).

19. The assembly also marked the onset of the personal attack on Anwar. A short book by a journalist, Khalid Jafri, entitled *Fifty Reasons Why Anwar Cannot Be Prime Minister*, was distributed widely to assembly delegates, and included a range of charges from sexual impropriety to corruption. Although Khalid was later charged at the insistence of Anwar's supporters, his detractors called for investigation of the charges raised in the book. Given the harshness of Malaysian libel laws and subsequent testimony at Anwar's trial, it is difficult to avoid the conclusion that the UMNO leadership acquiesced to the personal attack on Anwar.

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Indonesia

Of all the countries swept up in the Asian financial crisis, Indonesia's case is the most dramatic, particularly given the fact that key macroeconomic indicators provided few early warnings of impending collapse (Soesastro and Basri 1998; Hill 1998; Radelet and Sachs 1998a, 1998b). The current account deficit was substantial, with evidence of overvaluation, but the deficit was less than half of Thailand's and with no telltale signs of capital flight or speculation against the currency before the fall of the baht. Nonetheless, the Indonesian rupiah suffered by far the steepest depreciation of all the crisis currencies, and in the real economy the largest fall in output.

Indonesia did not show the signs of an asset bubble or overinvestment visible in South Korea or Thailand. Nor is there a case to be made that the external crisis originated in the financial sector, as was at least in part the case in Thailand and Korea. Indonesia's banking sector had a number of serious weaknesses, but through the third quarter of 1997 these issues were not seen as pivotal for overall investor confidence. And yet by the fourth quarter of 1997 the situation had changed dramatically, and the Indonesian banking system was on the verge of complete collapse.

Indonesia's distress is made even more puzzling if we consider that Suharto's initial approach to the crisis appeared both more decisive and coherent than the Chavalit or Kim governments' and more cooperative than the bellicose policy pronouncements of Prime Minister Mahathir (MacIntyre 1999a). In contrast to Thailand's costly and futile effort to defend the baht, Indonesia's response to regional contagion was to quickly widen the band within which the rupiah traded, and when this proved inadequate, to initiate a float. When the rupiah continued to fall, the central bank adopted an extremely tight monetary stance—well before going to the IMF—in a bid to support the currency. This policy had severe consequences for the already-fragile banking sector.

Suharto's independence day speech in mid-August provided a sober assessment of the country's problems, and was followed by the creation of a special crisis management team headed by the widely respected technocrat Widjoyo Nitisastro. A wide-ranging set of policy measures followed in September (Soesastro and Basri 1998, 9-10).[20] In early October, two months after floating the rupiah, the government turned to the IMF. Although the negotiations were not without conflict, Indonesia was able to conclude an agreement much more rapidly than the Thai government.

The broad thrust of IMF advice with respect to macroeconomic policy was standard. But the Indonesian government also agreed to a wide

20. These included a tightened fiscal stance through the reconsideration of a number of costly infrastructure projects, the announced intention to address emerging problems in the financial sector, and tariff cuts.

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variety of banking and structural adjustment measures, a number of which cut directly against crony and family interests. On 1 November, the government closed 16 small banks, several controlled by relatives or cronies.[21] On 3 November, major tariff cuts were announced in industries affecting crony firms. The government opened a number of previously closed sectors to foreign investors and lifted some restrictions on foreign participation in the stock market. The administration also promised a review of the strategic industries falling under the portfolio of technology minister B.J. Habibie and agreed to abide by the WTO's dispute settlement procedure with respect to its controversial national car project, controlled by one of Suharto's sons.

There is now a consensus that some elements of the early reform package, including the bank closings, suffered in their implementation if not their basic design. Yet whatever the wisdom of the policy course Indonesia charted in the early months of the crisis (see, inter alia, Radelet 1998; Radelet and Sachs 1998a; McLeod 1998a, 1998b; McLeod and Garnaut 1998; Hill 1999; Lane et al. 1999; World Bank 1998b, 1999b), it is impossible to explain the depth of Indonesia's economic difficulties without examining the political context. Uncertainty initially centered on the question of whether the government was in fact willing to confront crony privilege, but a range of more fundamental political problems subsequently arose, including uncertainty about Suharto's health, an (indirect) election, succession problems, and mounting political and social protest.

The difficulties with the international financial institutions began almost immediately after the Fund program was signed, as Suharto took rearguard actions to protect favored individuals. The first troubling signal came on 1 November, when amidst the flurry of IMF-related initiatives Suharto quietly signed a decree giving the green light to fifteen big-ticket investment projects that he had postponed in September in the name of fiscal restraint. Not only were a number of these projects of dubious economic rationality, but all of them involved relatives or close cronies (Soesastro and Basri 1998, 20).

The management of the bank closing and provision of liquidity support also called into doubt the government's commitment to reining in crony privileges. In a curious public relations event, the decision to close the 16 banks was challenged at a press conference by Suharto's second son, Bambang Trihatmodjo, and his half-brother, Probosutedjo. The two even

21. Given that these structural and banking sector reforms were later criticized heavily, it is important to underline that they conformed quite closely to the preferences of senior economic technocrats within the government. They both agreed with the Fund's overall diagnosis and saw in the crisis an opportunity to press forward with a number of reforms that they had sought for some time. More important, the policy measures sent an important *political* signal that Suharto was prepared to impose costs, even on crony and family businesses.

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went so far as to file lawsuits against the minister of finance, Mar'ie Mohammed, and the governor of the central bank, Sudrajat Djiwandono. Given that these were close family members, their actions naturally raised questions about Suharto's intentions. The decision to close the banks was ultimately confirmed, but Bambang was able to circumvent the closing of his Bank Andromeda by acquiring the license of another bank, Bank Alfa, and shifting the assets of the closed bank to it. Probosutedjo persisted in his efforts to save Bank Jakarta, claiming that it was initially closed because of failure to pay adequate bribes to central bank officials (Economist Intelligence Unit, *Quarterly Report: Indonesia*, 1st Quarter 1998, 19, 27).

The integrity of the Bank of Indonesia was challenged further by the management of the central bank's special liquidity credit facility designed to support ailing banks. Not only did the facility undermine monetary policy, but crony banks consumed the bulk of the emergency liquidity credit. The Salim group's Bank Central Asia (BCA) soaked up Rp35 trillion (roughly US$7 billion in late 1997 prices) of support, equivalent to more than 500 percent of its capital (*Jakarta Post*, 1 October 1998). Crony banks not only borrowed disproportionately but also exchanged rupiah for dollars and siphoned them out of the country. The central bank was in effect financing speculative attacks against itself (Cole and Slade 1998, 64).

If the events of November and early December called the government's commitment to reform into question, the next 5 months raised deeper political problems. The question of succession, and the dependence of the entire economy on the person of Suharto, became painfully apparent in early December when rumors began circulating regarding the 76-year-old president's health. His office canceled a trip to Kuala Lumpur to attend an informal Association of Southeast Asian Nations (ASEAN) meeting of member heads of state scheduled for 14 December, purportedly because of fatigue, but in fact because of a stroke. Throughout December, the rupiah and stock market were both highly volatile in response to rumors about Suharto's health (Fisman 2000).

However, January proved the pivotal month. A series of events pushed Indonesia onto a trajectory that diverged sharply from those of the other crisis countries.[22] The year opened badly for all Asian currencies, but the president's presentation of the draft budget on 6 January again raised fundamental issues of credibility. In the week before the budget speech, pressure on the government was intense, between those seeing it as a key test of the government's commitment and a chorus of voices from the private sector pressing for a relaxation of fiscal policy (*Jakarta Post*, 4 January 1998). Social pressures were also beginning to mount.

The handling of the budget remains controversial, and some have criticized the IMF and the World Bank for undercutting the government by

22. Fisman (2000) shows that rumors concerning Suharto's health had particularly significant effects on the share prices of politically connected firms.

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suggesting their unhappiness both with the budget and the implementation of the wider reform program (*Washington Post*, 8 January 1998). However, this criticism rests on the dubious assumption that the international financial institutions could have controlled the market reaction to the budget. The budget was not expansionary, but it rested on a number of unrealistic assumptions, particularly with respect to oil prices and the exchange rate, and projected growth and inflation rates that were wildly optimistic. The reaction was not limited to the foreign media and exchange markets. Ordinary citizens also lost confidence in the currency and began panic buying of basic foodstuffs and commodities.

The framework of the first IMF program clearly required reconsideration; negotiations for a new program began on 11 January. The IMF had already come to the conclusion that fiscal policy would need to be revised to accommodate the crisis. However, at the same time, the international financial institutions and creditor governments were increasingly concerned about Suharto's commitment, and believed that the only way it could be demonstrated was through a program that was highly comprehensive in its scope.

The second IMF program was signed by the president himself (the previous program had been signed by the central bank governor and minister of finance) and was widely circulated (the first program was held secret). The program included a 50-Point Memorandum of Economic and Financial Policies that covered virtually the entire structural adjustment agenda of the World Bank, including such controversial issues as an end of government support to the national car project and a gradual phasing out of subsidies on a number of basic foodstuffs. As if the public signing of the letter of intent was not enough—resulting in the now-infamous photograph of Camdessus appearing to stand over the president with arms folded—Suharto was also subject to intense foreign pressure through other channels. In January and February, Suharto received a succession of high-level delegations and telephone calls from a number of G8 leaders urging him to implement the program.

The ease with which the second program was negotiated should have itself given the international financial institutions pause. Even more than the first one, the program cut deeply into the patronage networks Suharto had built up; the government agreed to essentially all of the IMF's proposals. A number of critics of the program, including some Indonesian technocrats, felt that the international financial institutions had overplayed their hand and that the Fund should have concentrated more narrowly on the measures required to restore external balance. But these criticisms assume that some different policy package would have had a markedly different effect, when in fact the problem Indonesia faced was increasingly political as much as economic.

The first problem—too often discounted in authoritarian systems—was electoral. Although the outcome of the indirect presidential election in

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the People's Consultative Assembly in early March was never in doubt, the meeting became a focal point for diverse opposition forces. It was crucial for Suharto that this opposition and any divisions within the party be tightly controlled, and that he receive a mandate not only for himself but for his vice presidential running mate. The choice of Habibie, with his long history as an opponent of the technocrats and advocate of industrial policy, naturally created consternation among foreign investors; the rupiah sank to its lowest point to date the day after his candidacy was announced. But the choice also raised the prospect of a contested succession were Suharto's health to fail.

With opposition to the IMF mounting—from the private sector, academics, and increasingly vocal opposition politicians—it became important for Suharto to avoid any appearance that he was a tool of foreign interests. In speeches before the People's Consultative Assembly (MPR), he suggested that the Fund program was not working, that some of the measures might be unconstitutional, and that consideration should be given to instituting a currency board. Although the IMF was not opposed to currency boards in principle, the conditions for putting one in place in Indonesia were clearly absent. Fund officials feared that preoccupation with the idea would simply divert the president's attention from the program, which was already witnessing a number of areas of slippage (Johnson 1998, 28-29). On 6 March, the IMF suspended disbursement of the second $3 billion tranche and on 10 March, the day of Suharto's formal election, the Asian Development Bank and World Bank followed suit.

An important side effect of the political turn of events in February and March was a quite visible diminution of technocratic influence and independence, and an ever greater concentration of decision-making authority in the president. Central Bank Governor Soedrajat had been fired in mid-February, and in early March the head of the new bank restructuring agency was replaced, raising questions about its independence. However, the new cabinet announced on 14 March was a particular shock, including family members (daughter Tutut, as minister of social affairs, was seen as particularly influential; Schwarz 1999, 351) and cronies (Bob Hasan as minister of trade and industry, and Fuad Bawazier at the Ministry of Finance). Ginanjar Kartasasmisa was made the coordinating minister of the economy and subsequently developed a good relationship with the international financial institutions (IFIs) and creditors, but his reputation at the time was as an economic nationalist.

The importance of the election to the conduct of policy was revealed in its aftermath. Suharto quickly initiated efforts to mend fences with the IFIs, in part by dropping the currency board idea. The new negotiations began in mid-March and, unlike the finalization of the second letter of intent, involved more extended working group discussions between officials of the IFIs, Germany, the United States, Japan, and the Indonesian

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government.[23] The third IMF program included greater attention to the problems of banking and corporate restructuring and privatization, as well as greater emphasis on institutional questions, such as strengthening the capacity of the central bank, developing new bankruptcy laws and courts, and augmenting the mechanisms for monitoring the program (Johnson 1998, 30-34).

As before, the program faced slippage on several fronts, and as before many had to do with resistance from cronies and family (Johnson 1998, 33). But the government also began to face an increase in protest, not only against rising prices and shortages but also against Suharto's rule itself (Forrester and May 1999). The combination of increasingly organized opposition and widespread social violence gradually shifted the attention of government from the conduct of economic policy to political survival.

A first wave of social violence had come in January and February when panic over food prices and supplies was taken out on Chinese shopkeepers in a number of smaller towns in Northern Java and elsewhere. These actions were spontaneous, unorganized, and did not have an explicit political objective. Beginning in February, however, a student movement began to gain momentum, and by the time of the MPR meeting in March, a handful of prominent opposition politicians, including most notably Amien Rais, openly argued that the economic crisis could not be resolved without political change.

One important policy component of the third IMF program concerned subsidies. On 1 April, prices of sugar, wheat flour, corn, soybeans, and fish meal were increased, with the intention of lifting them altogether by 1 October. Subsidized prices for rice and soybeans, which weighed heavily in the consumption basket of the poorest, were also set to increase on that date. The management of fuel and electricity prices was left less precise; both were to increase gradually while allowing some differentials for rural and poor households. Yet quite inexplicably, the government announced a very steep increase in fuel and gas prices on 4 May. Although the price increases were partly reversed (with the IMF's blessing), they spurred spontaneous social violence in several parts of the country and led student protests to spill off the campuses to which they had previously been confined. The killing of four students outside Triskati University in Jakarta on 12 May triggered a wave of uncontrolled rioting. In addition to its social toll—over 1,000 dead—the events of 13-14 May led to another round of bank runs and a sharp fall in the rupiah. Indonesia under Suharto had become ungovernable.

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23. Those discussions were structured around five sets of issues: monetary policy (in particular, developing some simple, credible rules for its conduct), banking reform, the budget, structural reform, and external debt restructuring. The inclusion of the last issue, which had previously been avoided by both the IFIs and the government on moral hazard grounds, was an important innovation of the new program.

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Conclusion

Governments' policy choices cannot be held altogether blameless in explaining the depth of the crisis. But the critique of policy, and by extension of the IMF, typically makes one or more important mistakes: It assumes that the adjustment programs were in fact implemented; it attributes adverse economic developments to policy, when markets were responding directly to political developments; and it bases its critique on a counterfactual world in which the government enjoys the capacity to smoothly implement some alternative (presumably superior) program. In short, it assumes not only an alternative program, but an alternative government. Each of these assumptions are quite obviously problematic; collectively, they serve to underestimate the independent role that political factors play in the onset and initial aftermath of currency and financial crises.

A comparison of these four countries also allows us to isolate some differences in the initial response to the crisis. First, it is quite clear that Indonesia fared worse than other countries in the region. Much less attention has been given to the fact that Malaysia's economic decline was much worse than might have been predicted given initial conditions, which included a less fragile banking system and a more favorable external position than either South Korea or Thailand.

In both Malaysia and Indonesia, autocratic leaders exploited their discretion to isolate technocratic advisors and pursue policies that contributed to market uncertainty. In both countries, but particularly in Indonesia, favoritism and responsiveness to cronies undermined the credibility of policy. Over time, these problems were compounded by issues of political succession. Malaysia's more institutionalized political and party system made these problems manageable but in Indonesia they were debilitating. Protest over deteriorating economic conditions was gradually compounded by opposition to the regime itself.

Democracies also had difficulties in undertaking timely adjustments. In South Korea, these difficulties were primarily associated with the electoral cycle, but also with the apparent influence wielded by ailing *chaebol.* In Thailand, the problems appeared more deep-seated, as the party system generated yet another weak and unstable government that appeared captured by business interests. As will be seen in chapter 3, the Thai public also drew these connections between institutional arrangements and the crisis and supported passage of a wide-ranging constitutional revision as a result.

But as we will see in the next chapter, the democracies had the important advantage of broad social support and procedures that specified how failing incumbents could be replaced by governments with alternative programs. Despite its authoritarian features, the Malaysian political system also provided mechanisms through which the prime minister could

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organize party and electoral support. In Indonesia, by contrast, the crisis was deepened by fundamental political uncertainty that was only partly resolved by the transition to a new government. It is to these new governments, and the link between the crisis and political change, that we now turn.

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Appendix 2.1
The Political Economy of Malaysia's Capital Controls

with Linda Low

The imposition of capital controls by Malaysia ignited a controversy over the merits of capital account liberalization (Krugman 1998c, 1998d; Bhagwati 1998a, 1998b; Wade and Veneroso 1998). As of mid 2000, the evidence on the economic effects of the Malaysian controls remained inconclusive. On the one hand, the controls gave the government some latitude with respect to macroeconomic and particularly interest rate policy. The country's export sector enjoyed advantages from the fixing of the ringgit as other currencies in the region began to appreciate in 1999. The stock market also responded positively.

On the other hand, Malaysia's recovery has been no more rapid than those of other countries in the region, and perhaps slower. The government appears to have paid a price for its ability to attract foreign investment, and over the course of 1999 it gradually backed away from the controls. Whatever the merits of selective controls as a means of limiting the destabilizing effects of short-term capital inflows, the Malaysian case does not provide convincing evidence that controls made a substantial difference as a tool for crisis management.

The controls also had a neglected political and foreign policy dimension. The controls followed a long-standing pattern of Prime Minister Mahathir using a nationalist foreign policy to consolidate political bases of support. The controls proved particularly costly for Singapore-based investors who had purchased Malaysian stocks in the offshore market, and generated a substantial controversy between Singapore and Malaysia on the issue. The ability to pursue the control option and avoid recourse to the IMF also rested on Malaysia's ability to secure alternative sources of international finance through an intense diplomatic effort. These dimensions of the controls raise interesting questions about their replicability.

The Control Package

The most dramatic elements of the Malaysian controls were the fixing of the exchange rate at RM3.80 to the US dollar[24] and the effort to end offshore trading of the ringgit. In 1994, Malaysia experimented with administrative regulations to control short-term capital flows. But the very effectiveness of the controls and additional restrictions imposed in August 1997 helped

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24. More precisely, the rate was set in a trading band from RM3.77 to RM3.83.

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spur the growth of the offshore ringgit market. The gross size of the offshore market, located primarily in Singapore, was between RM25 and RM32 billion (as much as $10 billion, depending on the exchange rate used), although these numbers exaggerate its size once short and long positions are netted out (*Straits Times*, 4 September and 21 October 1998; *Financial Times*, 7 October 1998).

The offshore ringgit market was not subject to direct controls or ''window guidance'' from the Bank Negara Malaysia (BNM). Rates on ringgit instruments could diverge substantially from those in the onshore market, creating both opportunities for speculation and difficulties for the conduct of Malaysian monetary policy just as some greater stimulus was needed. In May 1998, for example, hedge funds closed out substantial short positions in ringgit in Singapore, with the effect that 1-month offshore ringgit deposits were yielding up to 40 percent—in comparison with only 11 percent onshore (Economist Intelligence Unit, *Country Economic Report: Malaysia and Brunei*, 3rd quarter 1998, 20).

Following the imposition of controls, any ringgit outside the country after 30 September 1998 was no longer legal tender. The most immediate effect was to force firms and individuals holding ringgit to repatriate them.

Complementing the capital controls, the central bank injected liquidity into the financial system and relaxed prudential controls in the banking sector. The central bank urged commercial banks to meet certain lending targets (*Financial Times*, 14-15 November 1998) and limited the spreads that they could charge (*Financial Times*, 7 October 1998). A revision in the rules governing provisioning changed the definition of nonperforming loans from 3 to 6 months, reversing a reform that had been instituted in 1997 (*New Straits Times*, 2 September 1998). Prime Minister Mahathir explicitly argued that the controls would permit banks to show greater forbearance toward ailing corporates (*New Straits Times*, 2 September 1998).

Economic Effects and the Course of the Controls

Table A2.1 provides some evidence on the effects of the controls on interest rates and the stock market. Interest rates fell swiftly following the imposition of controls, and lending resumed, confirming the core macroeconomic objective of the controls. The controls also had a dramatic short-term effect on the stock market. The September package was announced as the Kuala Lumpur Composite Index (KLCI) was hitting new lows, suggesting that a strengthening of stock prices might have been at least one motive for the move. The stock market rose an astonishing 38 percent in the 3 days following the announcement of controls, although this might have resulted from strategic buying by government-controlled funds as well as from the return of offshore money. Since the controls, the KLCI index has steadily gained ground.

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Table A2.1 Interest rates, exchange rates, and stock market index (January 1997-March 2000)

	1-week interbank[a]	1-month interbank	3-month interbank	Exchange rate	KLCI
1997					
January	7.21	7.30	7.33	2.492	1,227.99
February	7.33	7.27	7.32	2.486	1,254.90
March	6.96	7.32	7.35	2.477	1,234.61
April	7.03	7.34	7.36	2.502	1,121.10
May	8.45	7.79	7.77	2.506	1,083.16
June	7.71	7.93	7.92	2.516	1,094.91
July	9.43	9.07	8.31	2.575	1,035.88
August	6.85	7.64	7.73	2.749	904.27
September	6.59	7.56	7.66	3.017	809.88
October	7.65	8.39	8.47	3.288	766.20
November	7.93	8.97	9.18	3.378	637.99
December	10.89	8.98	9.15	3.783	577.66
1998					
January	13.00	9.82	10.03	4.369	542.12
February	11.43	11.05	11.11	3.812	714.27
March	10.75	11.05	11.21	3.736	716.56
April	10.53	11.05	11.02	3.725	648.66
May	9.86	11.02	11.02	3.797	570.72
June	10.29	10.95	11.14	3.993	476.65
July	9.56	11.00	11.05	4.150	431.90
August	9.17	10.97	10.06	4.194	340.47
September	6.91	10.02	8.17	3.803	370.89
October	6.19	7.67	7.36	3.798	394.07
November	6.16	6.96	7.01	3.797	465.35
December	5.82	6.62	6.62	3.796	540.78
1999					
January	5.53	6.33	6.48	3.799	595.17
February	5.28	6.22	6.36	3.799	558.76
March	5.44	6.03	6.37	3.799	514.20
April	4.00	4.30	4.62	3.799	601.97
May	3.18	3.15	3.50	3.799	739.31
June	3.05	3.06	3.36	3.799	779.55
July	3.05	3.03	3.33	3.800	826.40
August	3.00	2.98	3.23	3.799	741.15
September	*	2.86	3.14	3.800	721.97
October	*	2.76	3.12	3.800	730.03
November	*	2.80	3.13	3.799	729.77
December	*	2.85	3.14	3.799	765.58
2000					
January	*	2.82	3.14	3.800	906.43
February	*	2.77	3.10	3.800	993.16
March	*	2.76	3.09	3.800	941.92

KLCI = Kuala Lumpur Composite Index

a. Not quoted with effect from September 1999.

Source: Reuters.

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Table A2.2 Foreign investment in Malaysia: MIDA approvals, foreign direct investment, and net portfolio investment (RM million)

	MIDA approvals	FDI[a]	Net portfolio investment
1997			
July	n.a.	983	−3,932
August	n.a.	976	−5,347
September	n.a.	863	−7,038
October	n.a.	855	−3,158
November	n.a.	897	−4,198
December	n.a.	1,403	1,521
Total	n.a.	13,432	−29,067
1998			
January	n.a.	802	213
February	n.a.	642	4,092
March	n.a.	795	1,179
April	n.a.	884	−1,261
May	n.a.	866	−571
June	840	926	1,463
July	592	1,001	−1,382
August	392	991	−387
September	6,038	1,088	−1,899
October	1,214	2,777	−366
November	1,748	899	−398
December	424	1,003	43
Total	17,100	12,672	−2,206

n.a. = not available

a. FDI, foreign direct investment, is defined here as equity investment and purchase of real estate in Malaysia and abroad and loans drawn down from or to nonresidents, excluding retained earnings.

Sources: White Paper on Status of the Malaysian Economy, 6 April 1999, 45, 56; Malaysian Industrial Development Authority, *Annual Report 1998*.

Assessing the effects of the controls on capital flows has become more difficult as the government has become less forthcoming with data. Table A2.2 shows that investment approvals by the Malaysian Industrial Development Authority (MIDA) increased immediately after the controls were announced, but this reflected in part an effort to signal continued openness to foreign direct investment (FDI) by accelerating approvals. Actual investment seemed to surge, but these figures are also potentially misleading because much of the new investment could be traced to a small number of very large takeovers. For 1998 as a whole, Malaysia appears to have fared somewhat worse in attracting FDI than its counterparts, although this only partly reflects the effects of the controls, given that

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Table A2.3 Flow of funds through external and special external accounts (15 February, 1999 to 2 June, 1999)

Date	Net flow* (RM million)
5 March	−21.7
10	18.5
17	21.2
24	37.3
31	74.2
7 April	62.4
14	398.1
21	424.0
28	554.1
5 May	1,089.3
12	1,436.3
19	2,063.7
26	2,372.5
2 June	2,831.3

a. Cumulative portfolio inflow.

Source: National Economic Action Council data, reported in *Straits Times*, 9 June 1999.

they were not introduced until September.[25] In the first half of 1999, MIDA increased its approval of foreign projects slightly over the previous year, but applications for the period were only 35 percent of total applications in 1998 (*Asian Wall Street Journal*, 25 August 1999). In mid-2000 MIDA again admitted that foreign direct investment for the first four months of 2000 had fallen relative to 1999 (from RM1.94 billion to RM1.64 billion) (*Reuters* report at http://business-times.asia1.com.sg/5/news/nmsia06.html).

As table A2.2 shows, net portfolio investment was strongly negative in the second half of 1997. It turned negative again after the middle of 1998, despite the controls, although at much reduced pace. According to NEAC data (table A2.3), the relaxation of the controls in 1999 reversed this trend (*Business Times*, 9 and 10 June, 23 August 1999). In the first

25. According to the United Nations World Investment Report, FDI in South Korea and Thailand increased dramatically between 1997 and 1998 (up 87 percent to $7.0 billion and 81 percent to $5.1 billion, respectively) in comparison with a decline in Malaysia from $5.1 to $3.7 billion (*Asian Wall Street Journal*, 24 September 1999). A World Bank source report offers somewhat different numbers for the same period—from $6.4 billion to $8.9 billion in Korea, $3.8 billion to $7.0 billion in Thailand, and $3.7 billion to $1.6 billion in Malaysia (Claessens, Djankov, and Klingebiel 1999, table 9). Even if the figures differ, the trends are in consensus.

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Table A2.4 Malaysia's exit tax on foreign capital
(15 February, 1999)

Funds brought in before 15 February 1999	
Principal withdrawn	Tax (percent)
Within 7 months	30
Within 7 to 9 months	20
Within 9 to 12 months	10
After 12 months	0
Profits withdrawn	
During 12 month holding period	0
After 12-month holding period	10
Funds brought in on or after 15 February 1999	
Principal	No tax
Profits	
Withdrawn within 12 months	30
After 12 months	10

Source: Asian Wall Street Journal, 5-6 February 1999.

half of 2000, portfolio flows resumed in anticipation of Malaysia being reinstated into relevant regional stock indices. This development obliged portfolio managers to buy Malaysia stocks to rebalance index-based funds.

If the record with respect to capital flows is mixed, the government's own actions suggest a growing recognition of the costs of the controls. When the controls were first announced, the government exempted dividends. But large dividend payments by several foreign companies led the government to impose a cap on distributed profits. Not surprisingly, the foreign business community reacted negatively to this new restriction, and as early as December 1998 evidence began to surface of a reevaluation of the controls within the government (*International Herald Tribune*, 23-24 January 1999; *Asian Wall Street Journal*, 26 January 1999). In early February, the government instituted an exit tax in place of the earlier controls. The new measures included a graduated tax on capital gains designed to favor longer-term inflows (see table A2.4).

In August 1999, the government announced it would reduce the 10 percent exit tax on profits from portfolio investments made after 15 February 1999 (*Asian Wall Street Journal*, 13-14 August 1999). As the 1 September deadline approached, speculation mounted about how much foreign investment would choose to leave (*The Economist*, 21 August 1999, 63). On the first 2 days after the lifting of the controls, an estimated $400 million left the country—more than 40 percent of inflows since February—and the stock market fell more than 6 percent. But this outcome was below more apocalyptic estimates and had only a temporary effect on the recovery of the stock market (see table A2.1).

In sum, the controls, ushered in with great fanfare, appear to have had only ambiguous economic effects. On the plus side of the ledger, the

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controls did grant the government some leeway in the conduct of macroeconomic policy. The fixing of the exchange rate arguably contributed to the amassing of a large current account surplus—nearly 14 percent of GNP for 1998 as a whole—and boosted reserves to $31.7 billion by August 1999 (*Business Times*, 23 August 1999). However, the path of Malaysia's recovery with controls does not appear substantially different than Thailand's, which pursued a more orthodox policy course. Interest rates in South Korea and Thailand have also fallen back to pre-crisis levels, and the exchange rates in both countries have stabilized and even appreciated since September 1998. Perhaps most telling in assessing the merits of the controls is the fact that the government itself found them constraining and finally relaxed them.

The Foreign Policy of Capital Controls

More than any other Southeast Asian political leader, Mahathir has used foreign policy as an instrument for consolidating domestic political support (Aziz 1997, Zainuddin 1994). One way of doing this is through nationalist gestures aimed at the West, including such measures as a short-lived "buy British last" policy, Mahathir's boycotts of the Asia Pacific Economic Cooperation (APEC) leaders' meeting in Seattle in 1993, and the threat to pull out of the Asia Europe Meeting (ASEM) over Europe's policy with respect to Burma. Mahathir has also attempted to forge alternative international coalitions and alignments. These include his long-standing overtures to the Islamic world, the "Look East" policy—which sought both to emulate Japan and South Korea and to forge deeper economic ties with them (Camroux 1994)—and the proposal for an East Asian Economic Caucus (EAEC), which would wield influence over the APEC agenda and develop a wider voice for developing Asian countries on the world stage.

The imposition of capital controls exhibited characteristics of both of these strategies. On the one hand, the controls targeted "speculators," including institutional and individual investors in Singapore. The capital controls created new bilateral issues between the two countries, exacerbated other conflicts of longer standing, and spilled over into intra-ASEAN relations. At the same time, Mahathir was crafting a new Look East policy in the wake of the crisis, seeking to put together a coalition of lenders, the most important being Japan, to provide an alternative to the IMF.

Singapore-Malaysia Relations: Financial De-coupling

Following the imposition of controls, banks and institutional investors had to manage outstanding ringgit positions, which had been contracted at exchange and interest rates prevailing before 1 September. Following guidelines set by the Singapore Foreign Exchange Market Committee,

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offshore banks netted out exposures with each other at the rate of RM4.00, instead of the pegged rate of RM3.80 to the dollar. Forward contracts were settled according to the forward curve prevailing at that time (*Asian Wall Street Journal*, 10 September 1998). Those with net positions in ringgit still ended up with losses, but this market solution did allow an orderly unwinding of contracts for those wishing to exit the ringgit.

The central objective at the controls was to close the foreign exchange market. The question of how to handle longer investments held by Singapore investors in offshore shares proved much more complicated; understanding it requires some exposition of how the offshore market evolved. While other institutions and firms were quickly separated following the end of Singapore's partnership with Malaysia (e.g., airlines), the Stock Exchange of Singapore (SES) continued share listings until 1989, when the Kuala Lumpur Stock Exchange (KLSE) ceased to allow joint listings of 180 Malaysian companies on the SES. This move was followed in 1990 by the creation of a Singapore over-the-counter (OTC) market in Malaysian shares, known as the Central Limit Order Book (CLOB).[26] Around the time capital and exchange controls were introduced in September 1998, there were about 200,000 CLOB account holders with some S$2 billion involved.

The existence of the CLOB had both advantages and disadvantages for the KLSE and for Malaysia more generally. On the one hand, the CLOB gave Malaysian shares a bigger market and more liquidity by providing a convenient way for Singaporeans to invest in the Malaysian market through their own brokers. Had the KLSE directed Malaysian companies not to accept transfers of Malaysian shares executed on the CLOB, it could have closed the market.[27]

On the other hand, the existence of the CLOB also had certain drawbacks for Malaysia. First, the arrangement enabled Malaysians to disguise their purchases and sales. Malaysians who bought stocks on the KLSE (in ringgit) and sold them on the SES (in S$) could keep those proceeds outside Malaysia, providing a relatively easy way to transfer money out of the country. This became an attractive option whenever there was pressure on the bilateral exchange rate between the two countries. There were also tax motives for Malaysians to hold their shares offshore.

26. The CLOB system maintained a computerized order book that matched buy and sell orders. Once the broker entered an order, it was recorded at the SES, which checked the order book and matched it with orders. The Malaysian stocks were not listed on the main SES board or the second board, Stock Exchange of Singapore Dealing and Automatic Quotation (SESDAQ).

27. The KLSE had the opportunity to close the CLOB on several earlier occasions, particularly after the SES went fully scripless in 1994. At that time, the KLSE could have stopped the plan that the SES had devised to register CLOB shares, which was to have Singapore investors hand their Malaysian share certificates to local brokerages, which would have deposited them with the Malaysian Central Depository (MCD) on investors' behalf.

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Malaysia claimed that the CLOB also took business away from Kuala Lumpur brokers. The Malaysian White Paper of 6 April 1999 claimed that Malaysia had lost RM10.5 billion (S$4.8 billion) in forgone revenue since the CLOB was set up in 1990, a contention challenged by stockbrokers in Singapore. Nonetheless, it was true that the CLOB market was made up entirely of Singapore brokers, with Malaysian brokers simply agents with whom the shares were lodged. This practice ended with capital controls, because new rules prevented Malaysian brokers from dealing in securities on behalf of a client if there was reason to believe the transaction involved an exchange not recognized by the KLSE. As a result, both Malaysian and Singaporean investors were forced to take their Malaysian shares out of the CLOB and transfer them directly to a Malaysian stockbroker or open an account in Malaysia to deal directly; as we will see below, the terms of such a transfer became highly contentious.

A final issue was the Malaysian claim that the existence of the CLOB facilitated the short-selling of Malaysian shares, with implications for the currency. Malaysians moving profits out of ringgit, and downward pressure on the KLSE generated by selling in Singapore, had the effect of turning the market in equities into an additional source of pressure on the ringgit itself. The SES countered that CLOB investors were net buyers of Malaysian shares in the 20 months before 1 September 1998 (*Business Times*, 9 April 1999), and had doubled their holdings of Malaysian shares since the onset of the crisis. On each of the 15 days when the KLCI recorded dramatic falls between 21 August 1994 and 21 March 1999, SES figures showed low volumes of trading of KLSE stocks; the sell-off of KLSE stocks could not have been said to originate from Singapore. Moreover, the size of CLOB as a percentage of KLSE market capitalization had declined steadily since January 1990, falling to only 3 percent by the time the controls were imposed.

Singapore insisted that the closure of the CLOB was not a big loss to its financial sector, although the curbs constituted "a step backwards" in ASEAN's efforts to liberalize trade and finance (*Straits Times*, 13 October 1998). The actual cost of the controls, however, was not borne primarily by brokers but rather by the Singaporean investors holding frozen CLOB shares. Daim Zainuddin initially signaled his interest in a quick resolution of the issue, but concerns quickly centered on the possible effects of large sales on the KLSE. If Singaporeans were free to dispose of their shares as they wished, and decided to sell en masse because of heightened concerns about liquidity or the security of their shares, then prices in Kuala Lumpur would fall. The question of price also became politicized.

One suggestion was for the state investment arm, Khazanah Nasional, to buy over the shares at prices that prevailed in September 1998. A succession of such proposals, all effectively expropriations of Singaporean investors, followed. One of the first came from Malaysian-based Singapore

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businessman Akhbar Khan, an associate of Daim, who made a series of offers to CLOB investors. Each involved either freezing sales for some period or selling to Khan's new firm, Effective Capital, at a discount or with steep fees (*Asian Wall Street Journal*, 27 April 1999). Other offers followed, all effectively confiscatory.[28]

The issue quickly became politicized when Mahathir said Singaporeans should accept Akhbar Khan's offer (*Straits Times*, 4 May 1999). According to Mahathir, Singaporeans ''were responsible for the fall in share prices'' in 1998 and did nothing to help revive prices when they fell. It was therefore not morally right for them to benefit from price increases (*Asian Wall Street Journal*, 5 May 1999).

After consulting a queen's counsel, the SES broke its silence on the Akhbar Khan offer in May (*Business Times* and *Straits Times*, 6 May 1999), arguing that it lacked demonstration of financial ability, was not unconditional, and lacked relevant price information; in short, the offer document did not meet normal Singaporean or international standards (*Business Times* and *Straits Times*, 13 May 1999). Despite this finding, Deputy Prime Minister Lee Hsien Loong was explicit that the Singapore government had no responsibility for insuring CLOB shares (*Straits Times*, 7-8 May 1999). Lee further revealed that the Singapore government was unwilling to make the CLOB shares a sovereign issue between the two governments.[29]

The matter remained stalemated until February 2000, when the Singapore and Kuala Lumpur exchanges reached a ''comprehensive solution'' to the CLOB issue, which was based on two options for investors (table A2.5; *Straits Times*, 26 February 2000). The first option allowed a migration of the shares to individual accounts for trading, but on a staggered basis rather than all at once. The second option required that trading be frozen until 2003. Both solutions involved the payment of a substantial ''transfer fee'' (1.5 percent on assets released more than 13 months; 1 percent on those held until 2003), to which Singapore investors objected strenuously.[30]

Malaysia's nationalist response to the economic crisis has indirectly affected bilateral relations with Singapore on a variety of other historical issues as well (Ganesan 1998; Lee Kuan 1998). The most intractable remains

28. E.g., another Malaysian company owned by a Negri Sembilan prince proposed listing a unit trust outside of Malaysia (*Straits Times*, 22 May and 22 June 1999), and Telekom Malaysia and UEM, a firm with close links to the ruling party, also submitted proposals to the KLSE (*Asian Wall Street Journal*, 9-10 July 1999).

29. Mahathir had initially wanted to include the CLOB issue along with others in bilateral negotiations in December but changed his mind in March 1999 when the issue was left to the KLSE and SES to negotiate (*Straits Times*, 7 May 1999).

30. The Securities Investors Association of Singapore (SIAS), formed in 1999 with 50,000 members, argued that the Singapore Exchange should pay the transfer fee because investors were effectively assured by the exchange that the CLOB was legal.

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Table A2.5 February 2000 solutions to the CLOB controversy

	Scheme A (amended effective capital)	**Scheme B** (agreement between central depositories of KLSE and Singapore Exchange)
Acceptance closing date	31 March 2000	Within 32 months of 31 March 2000
Plan	CLOB shares released to individual accounts on a staggered basis over 13 months from July 2000	CLOB shares released to owners for trading on KLSE over 9 months from January 2003
Fee charges to investors	1.5 percent transfer fee paid to Effective Capital based on 15 February 2000 closing price of repatriated shares	1 percent administrative fee to KLSE affiliate based on average closing prices of shares on last five trading days of October 2002.

CLOB = Central Limit Order Book
KLSE = Kuala Lumpur Stock Exchange

Source: Asian Wall Street Journal, 27 February 2000.

renewal of water contracts expiring in 2016, which Singapore tried to resolve with a loan offer that Kuala Lumpur turned down. Since the crisis, Malaysia has accused Singapore of seeking to discourage Malaysian cargo from going through Port Klang by offering rebates, and complained about differential treatment between East and West Malaysians with respect to Central Provident Fund contributions.[31] Even security issues—access to Malaysian airspace, including for search and rescue operations; military training and exercises; the Five Power Defence Arrangement (FPDA) exercises in 1998—were all affected by the crisis. Although these issues may subsequently be resolved, Malaysia's nationalist response to the crisis has weakened integration between the two countries and provided incentives for Singapore to reduce its dependence on Malaysia through whatever means possible.

Seeking Financial Support

The ability of Malaysia to sustain its capital controls without recourse to the IMF depended heavily on its capacity to tap other sources of funds; without these funds the current account adjustment would be that much larger. The government estimated that it needed to raise RM102 billion between 1999 and 2000 from domestic (RM81 billion) and foreign (RM21

31. The former were allowed to withdraw their Central Provident Fund savings when they left Singapore, whereas West Malaysians could not because they typically return regularly for employment.

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Table A2.6 External sources of funds, 1998-2000

Source	Funds (millions US dollars)
Funds approved or disbursed	
World Bank	700
Japan Export-Import Bank (JEXIM) IA	300
JEXIM II	700
Islamic Development Bank	25
Sumitomo-Nomura Bank, Japan	665
OECF Phase I	1,100
Consortium of foreign banks in Malaysia	1,300
Total	4,690
Funds being negotiated	
Islamic Development Bank	50
JEXIM IB	200
JEXIM III	500
Total	**750**

Note: As of April 1999.

Source: White Paper on Status of the Malaysian Economy, 6 April 1999, 53.

billion) sources. Domestically, Malaysia enjoys not only high savings rates, but high public sector savings as well. In addition to being able to issue bonds, the government is able to tap the EPF, Petronas, and public insurance funds to meet short-term financing needs.

On the foreign front, the government's initial strategy of tapping the international financial markets had to be aborted; a planned $2 billion bond issue in mid-1998 ran into trouble immediately in the face of ratings agencies' downgrades. The imposition of controls certainly did not help with the international financial markets, either. Following the controls, the country's stock market was removed from several regional indexes, and in February 1999 ratings agencies complained about political intervention in the country's financial regulation and the reduced independence of the central bank (*Straits Times* and *International Herald Tribune*, 24 February 1999).

The government's response was to court a variety of sources of nonconditional or less conditional funding, including the World Bank and a consortium of foreign banks operating in Malaysia. However, the centerpiece of Mahathir's financial diplomacy was Japan. Mahathir was swift to endorse Japan's proposal for an Asian Monetary Fund, and has supported—in deeds as well as words—Japan's skepticism with respect to the IMF's approach to the crisis. As shown in table A2.6, Japan became a major patron.

Malaysia was one of the first beneficiaries of the Miyazawa Initiative, which falls under Japan's Overseas Economic Cooperation Fund. Japan has also supported Malaysia in trade financing and guaranteeing sover-

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eign bonds raised through Japanese banking institutions. In sum, the crisis actually provided an opportunity for Mahathir to formulate a new Look East policy, reaffirming political as well as economic ties to Japan while eliminating the need to have recourse to the IMF. As the economy began to recover in 1999, it was able to once again tap international financial markets; ratings agencies upgraded the country, and the $2 billion bond issue aborted in July 1998 was successfully floated at the end of May 1999 (*Asian Wall Street Journal*, 27 May 1999; *Straits Times*, 28 May 1999).

Conclusions

Whatever gains the government received from short-term capital repatriation and the ability to stimulate the economy—and they are hard to judge—these effects were partly offset by the costs with respect to reputation, perceptions of the integrity of the policymaking process, and inflows of foreign direct investment. As will be argued in chapter 5, the controls were also part of an adjustment strategy that left close, discretionary relations between business and government in place.

These judgements do not speak to the wisdom of capital controls as a longer-run strategy to reduce vulnerability to short-term capital movements; however, they do suggest some complexities with respect to the timing of such policies. If modest prudential controls are maintained or imposed during periods of strong growth, they may moderate outflows during a crisis. However, if confidence falls sharply, investors might be willing to pay fairly stiff penalties to exit. During crises, the government is thus likely to have incentives to impose controls on outflows rather than inflows, which are more damaging to confidence; in short, incentives during crises may be perverse.

Finally, the crisis has a foreign policy dimension. As in the past, Prime Minister Mahathir has used foreign “threats"—particularly hedge funds—for domestic political purposes. As the case of the CLOB shows, the costs of the crisis are borne by foreigners, in this case CLOB shareholders and Singaporean investors. Moreover, the harsh way minority shareholders were treated in the CLOB episode does not speak well for Malaysia’s treatment of foreign investors, and the strategy could have broader implications for intra-ASEAN cooperation.

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