동남아시아연구 13권 1호(2003) : 383~400

Capital Flows, Political Cleavages and Economic Policy Choice: Malaysia during the Asian Economic Crisis*

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I. Introduction

The World Bank identified eight high-performing Asian model economies in the early 1990s. They were Japan, Taiwan, South Korea, Malaysia, Thailand, Singapore, Hong Kong, and Indonesia(World Bank 1993). Of these eight, only four were hit hardest by the recent Asian economic crisis. These four, South Korea, Indonesia, Thailand and Malaysia, have taken different trajectories of politico-economic development since the unprecedented magnitude of economic crisis undermined the previously highly-touted Asian model of economic development. South Korea has so far made the most strenuous and successful efforts to transform its old developmental state model into a neoliberal one. Indonesia has, in general, followed an IMF-mandated neoliberal policy line after defiant Suharto resigned suddenly, but without much success. The country also briefly experi-

* This article draws on a paper presented to a conference on "Asian Political Economy in an Age of Globalization," at Tuck School of Business, Dartmouth College on May 10-11, 2002. The author thanks, among other participants, John Gerring, Kellee Tsai, Dave Waldner, David Kang, Derek Hall, and Kathleen Collins for their helpful comments.

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mented with some elements of populism under the transitional Habibie government, but populism did not prevail in post-transitional politics. Thailand, which triggered the regional crisis, upheld neoliberalism until Chuan Leekpai's cabinet was replaced by a populist government in early 2001. In the face of the economic crisis, Malaysia rather opted to retain its own style of pre-crisis developmental state model as Anwar Ibrahim's homemade neoliberal experiment was faltering. Having these various post-crisis trajectories in mind, this study deals with one of the two notable unorthodox responses to the crisis: Malaysia's venture to retain its pre-crisis development model. It particularly explains Malaysia's unorthodox reaction with reference to its unique composition of foreign capital inflows and political cleavage structure prior to the onset of the crisis.

The existing literature on the Asian economic crisis, especially in development economics or international political economy, deals almost exclusively with its origins or post-crisis financial and corporate reform issues. Despite some difference in their analytical emphasis and practical implications, debates in the mainstream political economy of the Asian economic crisis have been limited to the neoliberal agenda, whose key words include, among others, transparency, accountability, anti-corruption, and banking or financial reform. As a result, there are few comparative studies in the Asian political economy literature that deal with alternative post-crisis development paths in the face of seemingly unchallengeable globalization pressures. Unorthodox policy choices such as Mahathir's anti-neoliberal policy and Thaksin Shinawatra's populism deserve more attention.[1]

1) The author deals with Thaksin's populism in another manuscript, Economic Crisis and the Rise of Populism in Thailand: In Comparative Perspective.

II. Malaysia's Post-crisis Economic Policy Choice

Of the four crisis-hit Asian model countries, Malaysia was the single outstanding country that did not resort to the International Monetary Fund (IMF) for financial support despite its worsening economic conditions. Not only didn't it go under the influence of the IMF, but it also succeeded in placing selective capital controls, defying powerful external pressures to leave its capital account open. Before moving to explore the issues of why Malaysia opted to stay out of the IMF influence and how it was able to, let me provide a brief summary of its post-crisis economic policies in this section.

In an attempt to forestall the economic crisis, Malaysia initially adopted an austerity economic package consisting of IMF-style policies. This homemade neoliberal policy package was coordinated by Deputy Prime Minister and Finance Minister Anwar Ibrahim. Included in the package were curbs on credit growth, increased interest rates, redefinition of non-performing loans (NPLs), and cuts in government expenditure.[2)] However, such policies that focused on domestic economic factors had little effect in controlling the currency crisis, as the regional crisis worsened.

In January 1998, Prime Minister Mahathir, who strongly suspected that the crisis was a collusion of rapacious international financiers, established a separate economic policy coordination body, the National Economic Action Committee (NEAC), whose executive director was Daim Zainuddin. Daim was Mahathir's trusted assistant, United Malay National Organization(UMNO) Treasurer and former finance minister. Later, he also entered the cabinet as Special Functions Minister, with very ambiguous duties. Along with the set-up of the NEAC,

2) For a summary of this policy package, see Samuel Bassey Okposin and Cheng Ming Yu (2000, appendix 8).

Daim's appointment was intended to check the influence of Finance Minister Anwar, who was until then Mahathir's heir apparent. Accordingly, the standard deflationary measures were diluted and then reversed, so that the policy focus shifted noticeably from austerity to boosting economic growth in mid-1998. In late August, the governor and deputy governor of the central bank resigned over economic policy disputes. Along with Finance Minister Anwar, both favored IMF-style policies, in particular, a tight monetary regime. This economic policy reversal culminated with the dramatic imposition of capital controls on September 1, which was a measure that the NEAC began to discuss as early as the preceding January.[3] Among other measures, the ringgit would be valueless outside of Malaysia effective October 1, 1998. Also, foreign portfolio investment could not be withdrawn from Malaysia for a year after coming in. On the next day, the exchange rate of the ringgit to the US dollar was fixed at 3.8.

Even though these capital controls might be a surprise given the current prevalence of neoliberalism, it is worth noting that Malaysia would take similar capital controls even before the recent economic crisis when its economy was under great distress. For instance, the country introduced temporary capital control measures in January 1994 to curb a surge of short-term capital flows as follows:

> [B]anks were subjected to a ceiling on their external liabilities not related to trade or investment; residents were barred from selling short-term monetary instruments to non-residents; banks had to deposit at no interest in

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3) However, The rule on one-year holding of portfolio capital was liberalized from February 15 this year [1999] to allow foreign investors to repatriate principal capital and profits, subject to a graduated levy depending upon when the funds were brought into Malaysia and the duration of the investment. Utusan Express, 1 September 1999.

the central bank monies in ringgit accounts owned by foreign banks; and banks were restricted in outright forward and swap transactions they could engage in with foreigners(Martin Khor 1998).

Also note that the 1998 capital controls were selective in the sense that they were not applied to inward foreign direct investment or long-term capital flows, and the country continued to promote FDI inflows. For instance, in mid-1998, the Ministry of International Trade and Industry announced temporary suspension of its policy on foreign corporate ownership limit for the manufacturing sector.

III. Economic Crisis and Policy Preference

Even though Malaysia's 1998 selective capital controls have drawn much international attention, the scope of related debates is quite limited, centering around its effectiveness and impacts on economic growth.[4] I have not seen any study that deals with the deeper origins of adopting such an apparently costly measure. To explain the unorthodox measure, one might point out the prime minister's personal business interests or corrupt ties with the business sector. Unlike Indonesia, pre-crisis Malaysia, however, remained relatively clean by the international standards(Stephan Haggard 2000:40-1). In my view, the selective capital controls were no other than a single policy tool to defend a bigger policy regime, the Malaysian style of development model. In order to better understand the Malaysian choice, we have to pay more attention to domestic political sources of resistance to globalization and different sources of economic development

4) For instance, Ethan Kaplan and Dani Rodrik(forthcoming).

finance.

Malaysia's peculiar ethnic political cleavage structure explains why the Malaysian government preferred to retain its old development model by not associating itself with the IMF. The Malaysian government was afraid that under an IMF stewardship, it would have to rearrange its national economic development priorities to the effect that it might forsake the New Economic Policy(NEP), which was introduced to address the roots of the country's worst ethnic conflicts in the late 1960s. In other words, under an ethnically blind IMF stewardship, it would be impossible for the state to sustain strong intervention in the economy in favor of a particular ethnic group. In particular, Prime Minister Mahathir perceived the crisis as a serious threat to his lifetime-long goal, i.e., raising up the economic status of Bumiputras. The following quote shows why he preferred to maintain what others call crony capitalism.

> Mahathir said that if the country is incapable of defending its independence, it will eventually have to bow to the pressures of foreign powers, especially, the IMF which was controlled by a superpower. If the country were to give in to the IMF, it will stop the social engineering process implemented by the government to bridge the gap among the races through the New Economic Policy and order that subsidy given to the people be terminated.[5]

IV. Relative Sovereign Policy Autonomy and Development Finance

The Malaysian government was able to carry out its economic policy prefer-

5) Utusan Express, 30 July 1999.

ence because of a favorable structural condition, its unique strategy for development financing. Like the other crisis-hit Asian model countries, Malaysia heavily financed its economic development with foreign capital, especially, foreign borrowings. Unlike the other countries, however, it aggressively promoted foreign direct investment (FDI). As a result, the share of FDI in net foreign capital inflows, which is a sum of net FDI, net flows on debt, and portfolio equity flows, was comparatively high in Malaysia prior to the onset of the crisis. Table 1 shows that Malaysia was the only country where FDI consistently accounted for more than 30 percent of total capital inflows from 1990 to 1997, despite some fluctuation over time.[6)]

Table 1. Shares of FDI in Net Capital Inflows in the Four Crisis-hit Asian Model Economies (percent)

Year	Korea	Malaysia	Thailand	Indonesia
1990	33.33	301.03	38.03	12.68
1992	8.58	68.12	33.81	15.83
1993	6.62	35.31	11.25	60.14
1994	2.56	55.09	12.09	19.44
1995	6.33	35.72	9.21	22.69
1996	5.91	32.10	21.95	28.62
1997	13.62	39.23	40.57	31.05

Sources: UNCTAD(2001) and World Bank(2000).

When we compare FDI and debt stocks, Malaysia's FDI stock before the crisis was smaller than its debt stock. Yet, the pre-crisis FDI stock accounted for 33 percent of the gross national product(GDP) in Malaysia, which was the greatest among the crisis-hit Asian model economies(Table 2). In terms of the ratio of inward FDI stock to debt stock, Malaysia also outperformed any other crisis Asian model economy. The country's FDI stock amounted to 84 percent of its

6) For earlier capital flows to East and Southeast Asia, see World Bank(1996).

debt stock in 1995. Even though Indonesia had the highest level of FDI stock before the crisis, its FDI stock accounted for only 41 percent of its yet bigger debt stock. By contrast, the contribution of FDI to South Korea's economic development before the crisis remained minimal. Thailand was located in between Indonesia and Korea. As a consequence of these characteristics of development finance, Malaysia became less exposed to volatile international capital flows.[7] This enabled the Malaysian government to dare to confront the IMF and other international financial institutions during the crisis, by porviding a greater extent of sovereign policy autonomy.

Table 2. Inward FDI and Foreign Debt Stocks in the Four Crisis-hit Asian Model Economies in 1995 (US $ billion; a percentage of GDP)

	FDI stock	debt stock	ratio of FDI to debt
Malaysia	28.7 (33 %)	34.3 (39 %)	.84
Indonesia	50.6 (25 %)	124.4(62 %)	.41
Thailand	17.5(10 %)	100.0(59 %)	.18
Korea	9.4(2%)	85.8(19%)	.11

Sources: UNCTAD(2001) and World Bank(2000).

V. Development Finance and Political Cleavages

How do we explain Malaysia's relatively heavy reliance on FDI for development financing? The literature on capital flows or FDI in particular pays little attention to the preference of host countries over the composition of capital inflows. Even when the existing studies deal with the domestic conditions of host countries that affect the composition of capital flows, they do so from the perspec-

7) FDI is more stable than other capital flows. World Bank(1999, 55).

tive of international capitalists or donor countries. They often address the question of how to manage the risk of nationalization or what policies are effective in hosting FDI. They do not explore underlying political conditions that drive host countries to adopt FDI-promotion policies.[8)]

This section does not provide a general theory of the preference of capital-importing countries over the composition of capital flows. Even though this issue would deserve a separate study, it is beyond the scope of this study. However, the case of Malaysia shows that, to explain why a country promotes FDI, we need to understand its political cleavage structure. In the case of Malaysia, this means that the Chinese-Malay division affected the Malaysian government's policymaking on development finance. By intervening actively in the economy, the Malaysian government has made vigorous efforts to restructure its severe economic inequality among the ethnic communities since the early 1970s. In 1971, when the New Economic Policy (NEP) was introduced, Malay or Bumiputra ownership of share capital in the corporate sector was 4.3 percent. The NEP aimed to increase this minuscule Bumiputra share of equity to 30 percent by 1990, while cutting down the foreign share from about 60 percent to 30 and targeting the non-Bumiputra share at 40 percent.[9)]

To achieve the goal of economic growth together with ownership restructuring, Malaysia introduced, among other measures, a relatively liberal approach to FDI.[10)] FDI, especially through foreign joint ventures with Malays, was believed

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8) UNCTAD(1999), John Williamson(2001), Monika Schnitzer(2002), Elizabeth Asiedu and Hadi Salehi Esfahani(2001), Robert E. Morgan and Constantine S. Katsikeas(1997), and Roger Svensson(1998). See also Peter Montiel and Carmen M. Reinhart(1999), William C. Gruben and Darryl Mcleod(1998), and World Bank(1996).

9) Dasar Ekonomi Baru(New Economic Policy), public document of the Prime Minister's Office of Malaysia at http://www.smpke.jpm.my.

10) For the details of investment policy, see Paul J. Davidson and Franca Ciambella(1997,

to check and balance the disproportional Chinese share of the economy, and, at the same time, transfer managerial technology to Malays. To contend with ethnic Chinese, Malays badly needed not just capital but also management skills in the early 1970s. Development financing exclusively through foreign loans would require a large pool of competent entrepreneurs that could manage their own businesses without managerial assistance, which the Malay community simply lacked.[11] Such a financing scheme would get ethnic Chinese more involved in economic development than a debt plus FDI financing scheme. Malays' active partnership with ethnic Chinese businessmen would not contribute to overcoming the existing economic imbalance between ethnic Chinese and Malays. In short, the Malaysian government was more liberal to FDI than other Asian model economies because politically dominant Malays did not have sufficient capital and managerial expertise but had yet to counterbalance the dominant ethnic Chinese economy.

The shortage of management expertise in the Malay community and the subsequent Malay dilemma were illustrated by the heavy industrialization drive during the 1980s. The Malaysian government initially resorted to heavy borrowings from abroad, especially Japan, for various projects under the Heavy Industries Corporation of Malaysia(HICOM). Since the Malaysian government did

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ch. 4). For case studies of FDI in Malaysia, see Rajah Rasiah(1995, chs. 2, 4 and 5), K.S. Jomo, Greg Felker and Rajah Rasiah, eds.(1999, chs. 11 and 12), J. Thomas Lindblad(1998, chs. 6 and 7).

11) Before the MCA, UMNO had attempted to go into business in 1946, merely months after its formation, by establishing companies involved in banking, transportation, and trading, purportedly to benefit the Malays. Because of the party's lack of business acumen and expertise, however, these ventures failed to develop. Edmund Terence Gomez and K. S. Jomo(1997, 45). Also see N. J. Funston(1980). The lack of Malay entrepreneurship is also proved by the fact that business licenses awarded to Malays were often subleased or sold to foreigners and Chinese.

not want to get ethnic Chinese involved in the program, it collaborated with foreign, mainly Japanese, companies. Later when most of the public enterprises under the HICOM turned out to be unsuccessful due partly to incompetent and insufficient Malay managerial skills, the government had to allow non-Bumiputra and foreign managers to run most of the foreign-debt funded projects(Gomez and Jomo 1997:78).

Malaysia's industrialization drives were characterized by Malay concern about the economic dominance of ethnic Chinese. This concern went back even to the early import substitution industrialization(ISI) period before the initiation of the NEP.[12] The ISI tended to favor foreign capital because of Malay concern that ethnic Chinese would be otherwise the primary beneficiaries of ISI(Gomez and Jomo 1997:76). After the economic policy shifted away from the ISI in the early 1970s, the Malaysian government relied more on foreign capital to promote economic development, especially since it was wary that growth would otherwise probably contribute more to the accumulation of wealth by ethnic Chinese(Gomez and Jomo 1997; Alasdair Bowie 1991).

Interestingly enough, ethnic Chinese business groups reacted to the Malay-dominant government's discrimination in a way to reinforce the already heavy reliance on foreign capital, particularly, foreign direct investment.

> Chinese business leaders appear to have decided that networking with other Chinese businesses and with the socioeconomic and political institutions of the community has little to offer them in terms of either financing, social status or political influence. Rather, leading Chinese business groups appear to have chosen a two-prolonged strategy: working

12) For an extensive discussion of the Malaysian ISI and export-oriented industrialization strategies from the 1950s to 1990s, see Rokiah Alavi(1996, ch. 2).

closely with Bumiputra political patrons to achieve business success in Malaysia, while at the same time building relations with non-Malaysian-preferably other so-called 'overseas Chinese'-capital that can serve as a potential source of wealth should conditions in Malaysia deteriorate(Gomez and Jomo 1997:48).[13)]

The ethnic cleavage structure, in which the ethnic Chinese and Malay business communities have keen interest in checking and balancing each other, has driven both communities to favor foreign direct investment as opposed to foreign loans.

VI. Summary and Prospects

Unlike other crisis-hit Asian model economies, economic development in Malaysia was heavily financed not only by foreign loans but also by foreign direct investment. The comparatively heavy reliance of Malaysia on FDI contributed to reducing its external vulnerability to volatile short-term capital flows and enabled it to maintain a relatively great extent of autonomy in national economic policy-making during the 1997 regional currency crisis.

The great contribution of foreign direct investment to development financing in Malaysia was due largely to its unique ethnic cleavage structure. Given the politically salient ethnic division, it was not an attractive option for the Malay-dominant Malaysian government to finance economic development exclusively through domestic savings or borrowing from abroad while blocking

13)Also see Heng Pek Koon(1992).

FDI. Heavy reliance on domestic (mostly, Chinese) savings, even if accompanied by ethnic Chinese-Malay partnership, was not expected to contribute to overcoming the ethnic economic imbalance; it was rather likely to solidify the economic dominance of the ethnic Chinese business sector. Another alternative of relying primarily on foreign loans while minimizing FDI as in South Korea was not feasible either, because the Malay community did not have a sufficient pool of competent entrepreneurs. Consequently, the best possible finance scheme for economic development in Malaysia was joint ventures with foreign capital supplemented by borrowing from abroad. This was indeed the development scheme the Malaysian government promoted prior to the onset of the crisis.

However, a great risk in Malaysia's liberal approach to FDI is that it might simply increase foreign ownership of the economy without helping Malays to expand their economic control. During economic recessions, the Malaysian government often relaxed the NEP ownership and other requirements; for instance, foreign investors were once allowed to own 100 percent of their projects without exporting 80 percent of products(Gomez and Jomo 1997:79).[14] As noted above, during the recent economic crisis too, the government suspended strict ownership requirements for all investment applications received during the period from July 31 1998 to December 31 2000 as well as for all pending applications, while imposing the dramatic controls on short-term capital flows. This exemption was so comprehensive that it applied to all new manufacturing, diversification, and expansion projects except some restricted sectors such as paper packaging and printing. The policy later extended to December 31 2003.[15] As a consequence of

14)To help revive the economy, a more liberal Investments Promotion Act was enacted in 1986.

15) For the details, see the investors' guide at the official site of Malaysian Industrial Development Authority, http://www.mida.gov.my.

this liberal policy, wholly foreign-owned investments began to pick up in 1998, and they had almost surpassed the volume of jointly owned projects by the end of 1999(Table 3). By contrast, wholly Malaysian-owned investment projects during the same period plummeted and did not recover to the pre-crisis level. Even though it is still early to conclude whether the new investment policy has been effective in bringing FDI back, the proportion of full foreign ownership in new investment projects has apparently increased since the policy went effective, while that of joint ownership has steadily decreased.

Table 3. Approved Manufacturing Projects by Ownership in Malaysia, 1995-1999 (RM million; percent)

Year	1995	1996	1997	1998	1999
Foreign ownership	6,400 (31)	12,956 (38)	4,226 (16)	7,411 (28)	7,824 (46)
Joint ownership	8,600 (41)	15,122 (44)	17,476 (68)	13,233 (50)	7,835 (46)
Malaysian ownership	5,869 (28)	6,180 (18)	4,119 (16)	5,762 (22)	1,185 (7)
Total(100%)	20,869	34,258	25,821	26,406	16,899

*The table includes equity and loans, and the percentage is in parentheses.
Source: IMF(2000).

A newly mounting challenge to the Malaysian government is that the traditional Chinese-Malay ethnic division, which provided the cornerstone of the Malaysian style of developmental state model, is no longer as solid as before the crisis. Even though the crisis did not demolish the rigid ethnic cleavage, the Malaysian political cleavage structure is not as monolithic as before. While the country was weathering the economic crisis, alternative political cleavages that gained momentum after the crisis came to crosscut the previously dominant ascriptive cleavage.[16] Along with the ever-increasing foreign share in the national economy, the more complex political cleavage structure will make it increasingly

16) For further systematic discussion of post-crisis changes in Malaysia'political cleavage structure, see Jungug Choi(2003).

difficult for the Malaysian government to keep the developmental state model unmodified.

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Abstract

Capital Flows, Political Cleavages and Economic Policy Choice:
Malaysia during the Asian Economic Crisis

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Of the four formerly high-performing Asian economies that were hit hardest by the unprecedented magnitude of economic crisis in the late 1990s, namely, Thailand, Malaysia, Indonesia and South Korea, Malaysia alone opted to retain a pre-crisis development model while defying neoliberal reforms. This study deals with crucial structural conditions that favored Malaysias unorthodox policy choice during the crisis. It holds, specifically, that the comparatively heavy reliance of Malaysia on foreign direct investment (FDI) in pre-crisis development financing enabled the country to maintain a relatively great extent of sovereign policy autonomy in adverse international circumstances, by reducing external vulnerability to volatile short-term capital flows. This study continues to assert that the great contribution of FDI to development financing, in turn, was due largely to Malaysias unique ethnic cleavage structure. This implies that political cleavages ultimately determine economic policy choice.

Key words: economic policy, political cleavages, capital flows, Asian economic crisis, Malaysia